

NOVA GAS LTD

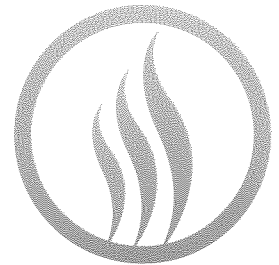
The Todd Building

95 Customhouse Quay

P O Box 10 141, Wellington

Phone 64 4 472 6263

Fax 64 4 472 6264



22 May 2006

Gas Industry Company Limited  
PO Box 10 646  
**WELLINGTON**

Attention: Gael Webster

Dear Gael

### **Compliance and Enforcement Arrangements in the New Zealand Gas Industry**

Nova Gas has reviewed the consultation paper regarding the proposed compliance and enforcement regime for rules and regulations implemented by the Minister of Energy on advice from the Gas Industry Company (GIC).

#### **Application of the Compliance Regime**

Nova Gas believes that the most important issue with regards to involvement by the GIC in compliance and enforcement is the question of which components of the industry are expected to be the subject of regulation.

Nova Gas expects that there are a number of potential scenarios ranging from a comprehensive set of rules and regulations governing every aspect of the industry to a restricted set of regulations governing only certain aspects of the industry where a clear and demonstrable need for regulations has been established. The electricity industry is an example of comprehensive regulation (arguably of competitive market processes that did not require regulation) and at the other end of the scale the Gas Industry is an example of an environment governed for the most part by contract law.

The objectives of the GIC regarding the development of rules and regulations is contained in the Government Policy Statement:

*"The Government expects the industry body to develop and submit to the Minister of Energy for approval proposed arrangements, **including regulations***

*and rules where appropriate, providing for effective industry arrangements in the following areas:"*

*Wholesale Markets and Processing.....*

*Transmission and Distribution Networks.....*

*Retail and Consumer Arrangements.....*

Nova believes that the GIC should be facilitating development of contractual or voluntary industry arrangements before regulations are considered.

Regulation should only be applied where competition is absent and/or where competitive market failure has occurred. Typically, regulation is required where a dominant party controls infrastructure. In such situations, to ensure that all participants have equal access to infrastructure at a reasonable price (ie. no monopoly rent), regulation is required. This is even more important where the owner of the asset is able to use control of this infrastructure to control competition in other related markets. In the gas industry the owner of such infrastructure is thus able to control its competitors in the competitive gas energy market.

There are several examples of regulation in recent times including the separation of lines and retail/generation activity of network companies in 1999 and more recently the decision of the Government to regulate the unbundling of the Telecom NZ Ltd phone network. Regulation was adopted to prevent the anti-competitive behaviour of the owners who were also active in the downstream retail markets.

### **Regulation of switching and registry processes**

Nova Gas is concerned that the paper appears to assume that regulations are required in relation to customer switching arrangements, even though it has not been shown that competitive market failure has occurred. We understand that there has been a working group established by the GIC considering improvements to existing arrangements including the investment in a central registry system. Nova Gas has participated in the consultation process that resulted and believes that the objectives of the improvements proposed have been based on achieving improved operational efficiency and lower switching costs for the industry. Compliance and enforcement has not been raised as a high priority issue if at all in any of the consultation documents and it would appear premature for the GIC to be advocating regulation at this time.

Regulating the switching and registry arrangements we believe will lead to a sub optimal outcome for industry due to the increased overheads associated with monitoring, reporting and investigation of potential technical rule breaches. It is clear to us that this has happened in the electricity industry as a result of regulation with significant resources being applied by industry participants and the Electricity Commission to the

process of reviewing breaches of rules that have no impact on consumers, service providers or market outcomes.

Nova believes that contractual arrangements are appropriate for switching and registry processes on the basis that there is already a degree of oversight from the Commerce Commission protecting consumers from anti competitive behaviour of retailers.

As we have seen in the electricity industry, we believe that rules regulations will lead to higher compliance costs being imposed on the industry that will result in higher gas prices to consumers.

Additionally, the industry will also suffer from a loss of efficiency from regulation.

- Productive efficiency will reduce due to higher compliance costs.
- Dynamic efficiency will also reduce as more effort and cost is required to change regulations than voluntary or contractual arrangements.

### **Nova's Preferred Form of Industry Arrangements**

Nova Gas prefers industry arrangements to be in the form of common industry codes that are governed by change processes prescribed within the code. We would prefer the GIC to play a facilitation role in the governance processes of these codes to ensure that arrangements continue to develop in a timely manner and that they are not captured by particular special interest groups within the industry.

Compliance with the industry arrangements contained within the industry codes of practice can be referred to in standard industry contracts such as transmission and distribution services arrangements. So long as the codes of practice are comprehensive in their application, then compliance and enforcement issues can be dealt with appropriately through the justice system. It is inefficient to set up additional duplicate compliance processes when there is an alternative process available that is more efficient.

The GIC should be able to offer participants the carrot of a low cost governance structure for the industry and retain the regulatory stick if arrangements that do develop fail to deliver pro competitive outcomes.

### **Form of Rules under Regulation**

While it may be expedient to simply adopt existing contractual arrangements as the basis for regulations, the natural differences between contractual and regulatory arrangements and their enforcement means that regulations should be drafted in a different way than what may be the case under existing contractual arrangements.

Current contractual arrangements and codes of practices are highly prescriptive. This is possible due to the natural trade-offs that parties seeking enforcement of the contractual terms make. If a breach of a provision is minor and technical with no market impact, then parties will rationally choose not to seek compliance through the courts due to the cost/benefit trade-off. Codes of practice in particular could include prescriptive detail that aids efficiency on the basis that if a technical rule breach occurs but it does not actually injure or disadvantage other parties then this is corrected without activating an expensive, time consuming and bureaucratic process prescribed by regulation. The same rules in a regulatory context such as that proposed create significant legal risk, cost and inefficiency regardless of the impact on others.

If competitive market failure has occurred (and hence that regulations are in fact more efficient), resulting in regulation being introduced then the regulatory process (which will inevitably be expensive, time consuming and bureaucratic) should only be activated when the action of a participant has disadvantage another. The focus of regulations should be on actions of participants that disadvantage others. It may be that a two tier system of rules that parties must comply with and guidelines that promote efficiency are developed to reduce the impact of compliance requirements that results from a regulatory environment.

Experiences of participants in the electricity industry highlight the additional costs of compliance imposed when prescriptive rules taken from a previous contractual arrangement are used as a basis for regulations.

## **Summary**

Nova Gas believes that the most cost effective approach to achieving the objectives of the Government Policy Statement will be to facilitate improvement of existing contractual industry arrangements and the development of new contractual arrangements where required.

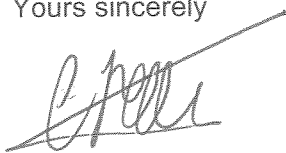
Industry working groups established and facilitated by the GIC are making progress in several areas where there are clearly commercial incentives for improvements.

We also note that the drafting of regulations needs to bear in mind the compliance regime and the simple adoption of prescriptive rules from a contractual arrangement is not desirable given the different obligations for compliance. The effects in the electricity industry of using rules taken from a contractual framework as a basis for regulations has lead to unnecessary compliance costs and inefficient outcomes.

It is Nova's view that regulation of aspects of industry arrangements should be seen as a last resort only to be exercised where it has been shown that competitive market failure has occurred and should the industry fail to develop appropriate pro competitive arrangements.

We look forward to working with the GIC to meet those objectives in a cooperative and non-regulatory manner.

Yours sincerely

A handwritten signature in black ink, appearing to read 'C. Teichert', with a long horizontal stroke extending to the right.

Charles Teichert

**Downstream Trading Manager**