Submission to Gas Industry Company on Levy Discussion Paper

From

Contact Energy

17 March 2006

Contact Energy welcomes the opportunity to provide a submission on the Gas Industry Company's Levy Consultation. We now have a year of experience with the current levy structure, and Contact believes that this is an appropriate time to re-examine the way the levy is structured and calculated to ensure that it is as equitable and as practical as possible.

In our experience, there have been ***three significant detriments to the current structure of the retail levy:***

1. **Complexity of Retail Levy Calculation**. It is our understanding that the current structure, a combination fixed and variable levy, was intended to be a compromise solution. In reality, it has delivered a complex and cumbersome charging mechanism, at the expense of a simple and practical option. The fact that different retailers have chosen to bill the levy to their customers differently, as highlighted in the discussion document, is an indication that the current levy structure is not necessarily straightforward to implement in existing retailer databases.

   Contact submits that the hybrid structure of the retail levy has enhanced neither the equity nor the practicality of its application, and we believe that the structure should be changed to a simple, fixed, per-ICP levy as proposed below.

2. **Time Lag between Levy Calculation and Payment.** This issue was raised several times in the discussion document, and Contact agrees that it is a significant concern. At the moment, the amount of levy payable for both the retail and the wholesale portions is based on historical data and does not adequately reflect the movement between Retailers in customer numbers and consumption levels due to customer switching. That is, the amount of the retail and wholesale levy is determined by past consumption, but retailers have only present customers and their consumption levels from which to recover the levy.

   In Contact's experience, this situation has, at times, resulted in a mismatch between past and current consumption levels and customer numbers. The situation is particularly aggravated by the long lag time in the calculation of the retail levy: by the time the retail levy is first payable, in July, the information on which it is based is already nine months old; by the end of the fiscal year, it is 17 months out of date. This is true of both the fixed and variable components of the retail levy. The situation is similar with the wholesale levy, for which there is a four- to six-month lag. In this case, retail companies are in the position of needing to recover winter levy amounts with summer bills.

   Contact submits that both of the retail and wholesale levy calculations impose significant volume risk on retailers, and we propose that more recent data be used, as outlined below.

3. **Threshold between Retail and Wholesale**. Contact agrees that the existing levy structures and 10TJ threshold have created a situation that could be perceived as unfair, as suggested by the consultation document. We also consider that the steep change in the amount of levy payable by a consumer of slightly less than 10 TJ as compared to a consumer of slightly more than 10 TJ is likely to create distortions in consumption decisions.

   Contact considers that the best way to address this issue is not through more complexity, as would be the case with the suggested "no step" function, but rather by changing the retail levy to a fixed, per-ICP amount.

As a result of our experience with the levy and our concerns that have arisen through the course of the year, Contact proposes ***two main changes to the levy structure and calculation:***

1. **Use of Previous Month Data**. As Contact highlighted above, we have significant concerns about the mismatch between the historical data used to calculate the levies and the consumption levels and customer numbers on which retailers can recover the levies. In a situation where customer levels have declined since the levy calculation, the retailer is left with a levy obligation that cannot be completely recovered from its present customers. In the case where consumption and/or customer numbers have increased, the retailer will over-recover the levy, at the expense of the Retailer who has lost customers and associated load.

   Contact considers that a better basis on which to calculate the levy is to use the previous month's data, as suggested in the consultation paper. We propose that the Gas Industry Company use the previous month's allocation quantities and ICP numbers as at month end as the basis for the GIC levy invoices. This method would be similar to the way that the Electricity Commission levy is calculated.

   For a source of data, Contact suggests that the Gas Industry Company use the GJ allocation quantities produced by the downstream allocation agent, Tom Tetenburg, and NGC Reconciliation. These figures are available within a few days of month's end. Although they are subject to further revisions, our analysis suggests that any anomalies in the data are generally self-correcting in the following month. For ICP numbers, Contact suggests that the Gas Industry Company could get month-end numbers from distributors (or, in time, the central registry). Contact would be happy to discuss these suggestions in further detail with the Gas Industry Company if that would be helpful.

   Using current data to calculate the retail and wholesale levies will eliminate the time lag between the calculation of the levy and its imposition on consumers. Contact considers that this will make the levy structure more equitable, as it will provide a better match between gas consumers and consumption levels and the amount of levy paid.

   Contact acknowledges that such a calculation framework would involve greater uncertainty for the Gas Industry Company in terms of the amount and timing of its levy receipts. We consider that this volatility could be managed through rolling any over- or under-recovery of the levy into the following year's levy calculation. In addition, the suggestion for the Gas Industry Company to build up a level of operating reserves as a cushion against levy volatility should be considered further.

2. **Fixed Retail Levy**. The consultation paper discusses in some detail the equity arguments for and against a fixed versus a variable retail levy. It concludes that "there is no clear cut case" for either option, and thus "more emphasis should be given to adopting the most administratively simple (lowest transaction cost) solution."[1] Contact agrees that a simple approach would be best, although we are surprised that the paper does not then consider what we believe to be the simplest solution and the best framework for a retail levy.

   A fixed retail levy has a number of advantages, some of which we outlined when we supported this option during the last levy consultation:

[1] Gas Industry Company, Levy Discussion Paper, February 2006, p. 15.

a. Less volatile and easier to project The discussion document highlights concerns that retailers and consumers have expressed regarding year on year volatility. Basing the retail levy on the volume of gas consumed exposes the levy to year-on-year fluctuations in gas consumption, and thus, potentially, to swings in the variable levy rate. The number of ICPs, on the other hand, is a much more stable and predictable number. Basing the levy on the number of ICPs would tend to dampen potential year-on-year rate shocks. In addition, if the Gas Industry Company moved to using month-end data to calculate monthly invoices, the receipts from a fixed retail levy would be easier to project than a variable levy, thus mitigating some of the uncertainty involved with the switch to monthly data.

b. More equitable Contact continues to believe that a fixed retail levy is the more equitable option, as retail customers benefit equally from switching, allocation, and reconciliation processes. It may be true, as the discussion paper suggests, that more efficient mechanisms will lead to a more competitive market and thus to lower prices. However, Contact considers this to be a second order effect at most. An increase in competition (and thus a decrease in price) would surely be caused by a number of factors, one of which might be the Gas Industry Company arrangements. So while we agree that the arguments can be made either way, we believe that there are stronger reasons to believe that a fixed levy is the more equitable option.

c. Easier to implement. From a retailer's perspective, a fixed levy is much easier to implement that one that includes both fixed and variable components.

d. No threshold issue. An additional benefit of the entirely fixed retail levy is that it would virtually eliminate the 10 TJ threshold issue. By our calculations, a fixed retail levy would be $6.56 per ICP (based on $1.575m retail allocation and 240,000 ICPs). Contact considers that this amount is not material enough to give rise to the fairness and distortion issues that are present under the current levy structure.

Other Comments

Budget Projections

Contact Energy is disappointed at the amount of information given in the consultation paper regarding the budget projections. Ultimately, it is gas consumers who pay the levy, and thus we feel that gas consumers should be entitled to have a say in the Gas Industry Company's budget. As retailers, we have a responsibility to manage costs and to be able to justify our tariffs to our consumers. Just as we endeavour to provide good customer value through managing our retail and gas costs, we consider we should have the opportunity to make sure that the Gas Industry Company levy is providing good value.

We acknowledge that the Gas Industry Company does not have the same obligations in this regard as the Electricity Commission. However, the Gas Act does stipulate that, in order for a levy recommendation to be accepted, the Gas Industry Company must have "consulted with industry participants on the levy rate or amount."[2] From our perspective, an integral component of the levy amount is the Gas Industry

[2] Gas Act 1992, section 43ZZD, clause 2(b)

Company budget. Contact therefore requests that more detailed budget information be included in any levy consultation in the future.

In particular, we would appreciate more detailed cost breakdown of the major budget items listed in the consultation document. For example, the workload described for the Distribution Contracts workstream seems similar to that of the Open Access Review: publish an issues paper, consult, develop proposals, and report to the Minister. Yet the budget projection for Distribution Contracts is $71K, whereas for the Open Access Review it is $575K. Without more detailed information, it is unclear why a budget eight times larger is justified for one workstream over another.

Other information that Contact would like to see in future consultations is a comparison of budgeted costs with the previous year's budgeted and actual costs. In this way, stakeholders can see trends over time in various expenditure classes.

Timing of Levy Changes

The Gas Industry Company indicated in its workshop presentation that it aims to publish new levy regulations by early June. Contact is concerned that this timetable does not allow adequate time for retailers to process the change before the new rate goes into effect. Changing the levy rate involves several steps for retailers, including programming the change into the customer database, preparing communications to customers, and giving customers 30 days' notice of the rate change. Under the Gas Industry Company's current schedule, it would not be possible for retailers to begin charging the new levy rate as of 1 July, although retailers themselves would be charged this new amount. This does not seem to be a practical or equitable outcome. Contact strongly suggests that retailers be given a minimum of 2 months' notice before any levy change takes effect.

Treatment of Over- and Under-Recovery

This issue is not included in the consultation paper, but the topic arose in the levy discussion workshop. Contact Energy is strongly of the view that any over- or under-recovery of the levy by the Gas Industry Company should be rolled into the following year's levy amount.

The reason for this is that retailers have no mechanism by which they can credit any levy refund back to consumers. The exercise would entail calculating each customer's consumption over the year to determine what proportion of the refund he or she was entitled to, which would be a complicated operation in a large customer database. Further complications would arise in the cases where consumers had switched away from Contact during the year, or who had moved house, for example.

Even harder to manage would be a lump-sum debit at year's end. It is difficult to imagine how retailers could recover such an amount. It is our belief that presenting customers with a retrospective bill for a gas levy under-recovery would not be received well.

Thus, it is for the sake of simplicity and practicality that Contact believes that any over- or under-recovery of the levy should simply be rolled into the Gas Industry Company's levy calculation for the following year. We note that the Gas Act specifically allows for this treatment in the calculation of levy amounts.

Answers to Specific Questions:

1. ***The appropriateness of the levy setting principles set out in Section 5;***

Contact believes that the listed principles are appropriate, although we note that the list is quite long, and there is no indication of the relative importance of any of the principles. Must a levy satisfy all criteria equally? Or are some principles more important than others?

2. ***Any other matter which should be considered in recommending appropriate levies;***

Contact has no further suggestions.

3. ***Whether your organisation would support a move from the current annual levy determination, to a two year levy determination period as discussed in Section 6.1;***

Contact considers that this suggestion has merit and is worth considering further. We reserve our final position on the matter until we see the details of how the two-year process would be managed. In particular, we would need some assurance about how budgets were constructed and what would happen in the case of unforeseen costs.

4. ***The conclusions in relation to the retail levy fixed/variable split as set out in Section 6.2;***

As we discussed above, while we can see the arguments on both sides of the fixed versus variable retail levy question, we believe that there is a stronger argument for a fixed retail levy.

5. ***Any thoughts on how the structure of the retail levy might be improved, given the benefit of experience since its implementation;***

Contact submits that the current hybrid retail levy structure is overly complex and that this complexity provides no benefits over a simpler levy structure. We strongly suggest that the retail levy be changed to a fixed, per-ICP levy.

6. ***The theoretical suitability of the suggested "no-step" retail levy function discussed in Section 6.3;***
7. ***The practicality of introducing a "no-step" retail levy function;***
8. ***The time required for retailers to provide a distribution of end user consumption information for the previous gas year to the Gas Industry Co if a "no-step" retail levy function were to be introduced;***
9. ***Any other alternatives which may be more appropriate than the "no-step" function suggested in Section 6.3;***

Contact strongly believes that the best way to fix a problem with a complex levy structure is not to overlay more complexity. We believe that the simple, practical, equitable solution is to change the retail levy to a fixed charge. We consider that this move will provide a number of benefits, as outlined above. Among these benefits is the fact that the 10 TJ threshold issue would virtually be eliminated.

10. Whether basing the levy on historic GJ and ICP data, as discussed in Section 6.4, is a significant issue;

11. Whether you would support a move to using more recent reference quantities;

12. Any other ways you would support to address the timing issue;

As discussed above, Contact considers this to be a very significant issue. We support the suggestion to move to monthly allocation and ICP data.

13. Which, of Section 8 Options 1, 2, 3 or 4 you prefer;

14. Why you prefer that Option;

As explained above, Contact supports a fixed retail levy and a variable wholesale levy.

Our second preference would be Option 1, where the retail levy remains unchanged and the wholesale levy amount is adjusted upward.

15. Whether there are any other options that you think the Gas Industry Co should be considering.

No further comment.