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The Secretariat
Gas Industry Company Limited
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SUBMISSION ON GIC LEVY PROPOSAL

Introduction

1. Vector welcomes the opportunity to make a submission on the GIC's proposed design of the levy to recover the costs of its activities. More generally, Vector very much looks forward to working with GIC with a view to successful implementation of the regulatory regime for the gas industry.

2. The GIC is tasked with recommending regulations and rules for the industry, including a levy on industry participants to recover its estimated costs. The levy, on the recommendation of the Minister of Energy, may be made into regulation by Order in Council. The GIC is currently consulting industry participants on the amount and allocation of its cost recovery levy through the GIC Levy Proposal Discussion paper, which sets out the proposed amount of the levy and the structure of its allocation, before making its recommendation to the Minister.

Summary of Vector's view

3. Overall, Vector supports the GIC's proposed levy. In particular, Vector agrees that there is no strong reason as to why pipeline companies should pay a levy contribution, as such parties – while interested parties – are not the direct beneficiaries of the GIC's work at present. To the extent they are in future, the levy could change, or

a direct fee be imposed. Furthermore, as evidenced by the Commerce Commission's treatment (under the regulatory regime for electricity lines businesses) of the Electricity Commission's levy – a direct pass through to retailers/consumers – there is no point in levying intermediate parties (pipeline operators) if the cost is simply passed on.

4. That said, as this is the first piece of analytical work released by the GIC, Vector is keen to ensure that decisions are based on robust analysis. While Vector considers the GIC's draft decision would be unlikely to change with further analysis, we nonetheless consider that further work could have been undertaken to support the GIC's position (and should be undertaken to bolster the final position). Furthermore, the GIC needs to be mindful that, given the levy is given effect to by regulations, it will invariably be subject to the same standard of assessment as accorded to Government-imposed levies, such as that for the Electricity Commission. As the GIC's paper points to (but not exhaustively), there are established 'tests' for levies to satisfy. In some cases, Vector is concerned that the GIC may be exposed to potential challenges on the current levy if further work is not undertaken. We have endeavoured to point the GIC to these potential areas of weakness in our submission.

5. Vector's support for the proposal is, therefore, pragmatic and our comments on analytical rigor should be seen in a broader context of the GIC's work generally. Vector also notes that the gas industry, in order to maintain a "slim" regulatory structure and achieve outcomes in a timely fashion, needs to accept that a level of pragmatism, and not paralysis by analysis, will be necessary on some issues. This is not to say robust analysis is not important; rather, Vector generally supports the GIC taking a 'horses for courses' approach to issues. In the case of the levy, the key requirement, in Vector's view, is that the levy recovers the necessary funding as cost-effectively and simply as possible. Within this context, any further time on this administrative issue is better spent tackling the issues of substance on the GIC's to-do list, subject to the GIC doing sufficient additional work to cover off the risk of challenge to its final decision.

General comments on the proposal

6. In general, Vector agrees with the GIC's proposal, noting that it correctly references the Treasury Guidelines¹ that require levies to reflect the benefits flowing from the activities and the causers of the costs. However, Vector considers the analysis undertaken to date would be strengthened by some or all of the following:

- the GIC providing the draft strategic plan and budget, which would assist in clarifying the intended costs and outputs to measure the levy proposal against;
- referencing other important factors to the GIC's consideration, specifically (discussed below):

¹ Treasury Guidelines for Setting Charges in the Public Sector, December 2002

- some specific parts of the Treasury Guidelines, for example, section 6 that requires charging practices be underpinned by planned services and outputs matched to beneficiaries and cost causers;
- Audit Office Guidelines;²
- principles applied by the Regulation Review Committee;³
- international precedent; and
- a comparison of charging practices under previous industry arrangements, for example, through the Gas House.

7. If these issues have been considered by the GIC, they should be published to allow industry participants to review the levy proposal in a more informed way. Where they have not been considered, they should ideally be supported by further work to the extent the GIC, on a preliminary assessment, considers they would materially affect the current proposal. From Vector's knowledge of these issues (discussed below), we doubt they would fundamentally change the current proposal; nonetheless, the GIC should satisfy itself that this is so.

8. More generally, and building in the GIC's draft proposal, it is important for all entities in the industry to know that the costs, and any additional costs, will be allocated according to a set of known principles, because this levy regulation will set the precedent for future levy setting. As such, the final levy position should include all relevant rationale (albeit, as Vector has noted above, in a pragmatic way if the issues considered do not appear material to the outcome).

Suggestions to further improve the analysis

Provide the draft strategic plan and budget

9. The Act does not require the GIC to consult on its strategic plan and budget, which are still being finalised prior to being presented to the Minister of Energy for approval in late April. However, as part of good regulatory practice, the GIC should consider whether it wants to proactively (and voluntarily) subject its thinking to industry appraisal. Arguably, there is a strong case for levy payers to clearly understand what they are being asked to pay for. While such scrutiny is not a feature of the Commerce Commission regime, the Electricity Commission is now required to consult on its budget. Such scrutiny is also becoming more common overseas, for example, Ofgem now consults as part of development of its Corporate Strategy and Plan. The GIC should undertake such consultation routinely.

² Audit Office publication, Guidelines on Costing and Charging Public Sector Goods and Services, May 1989

³ Including in accordance with Standing Orders, specifically 382

10. Furthermore, in not providing the aforementioned information as part of the levy proposal, the GIC may be leaving itself open to claims that it has not met appropriate standards or correctly considered the levy in line with the Gas Act, Treasury Guidelines, Audit Office Guidelines and Regulations Review Committee principles. Lack of detailed information on costing and outputs has caused problems with the electricity industry levy regulations. Where possible, this should be avoided by the GIC.

11. The fact that the strategic plan and budget are still in draft as the levy proposal is not fatal to the process, since the plan and budget could still be provided with provisions in the levy regulations to allow further review if the final strategic plan and budget differ materially from the drafts.

Further reference to The Treasury Guidelines

12. Section 6 of The Treasury Guidelines states:

“The integrity of charging practices is underpinned by the robustness of cost recognition and allocation methodologies. If the costs of producing the good or service are unknown or misrepresented, it is almost impossible to set charges appropriately. The onus is on the provider to demonstrate (perhaps through external verification) that the method it has selected is as accurate as practicable and is based on a realistic assessment of cost-inducing factors.”

13. The levy proposal does not contain detailed information on the costs of producing the service, and hence raises the possibility of a complaint. Since the onus is on the provider to demonstrate the methodology is accurate and based on a realistic assessment of cost-inducing factors, the information should ideally be contained in the levy proposal. This would allow industry participants to accurately review the position.

Reference to Audit Office Guidelines

14. There is no reference to the Audit Office Guidelines in the proposal. This is of concern because, in a co-regulatory environment, the industry body approved under legislation still needs to show compliance with these guidelines in order to satisfy Government objectives and the principles applied by the Regulations Review Committee.

15. The failure to reference the Audit Office Guidelines presents similar problems to The Treasury Guidelines, in so much as costs and outputs have not been detailed in the proposal.

16. For instance, section 4.4 of the Audit Office Guidelines states that:

“A separate charge must be calculated for each output produced by an organisation. If the costs of a service are recovered directly from consumers, the outputs should be identified at a low level. That is, complex outputs should be divided into more specific component outputs and separate charges should be made for each component ... It is particularly relevant when one of the components is a service of which the public sector agency is a monopoly supplier.”

17. Also, section 2.5 of the Audit Office Guidelines states that:

“Indirect costs should be allocated to outputs based on the extent to which the indirect cost contributes to, or was caused by, the output.”

And

“Where a beneficial or causal relationship is not readily identifiable ... the costs should be allocated systematically among the outputs.”

18. Without the details of the costs and outputs of the GIC, it is not possible to accurately determine compliance with these and other parts of the Audit Guidelines. This should ideally be addressed by the GIC in its finalised position.

Reference to principles applying to Regulations Review

19. By not referring to the principles relating to regulations review as followed by the Regulations Review Committee, or showing the details of costs and outputs, the GIC risks the levy proposal falling foul of these principles. This may risk the regulations being not accepted by the Minister (who will invariably be keen to ensure all necessary conditions are satisfied) or, if passed, risk the Regulations Review Committee, whether asked or off its own volition, reviewing the outcome.

20. Particular concerns that need to be justified are that the levy allocations have been made to ensure that as a charge for services, they are:

- Not in excess of the costs of that service in order to avoid being classified as an unauthorised tax in contravention of section 22(a) of the Constitution Act 1986, and hence are not declared ultra vires and invalid;⁴ and
- Not a cross-subsidy or over-recovery.

Unauthorised tax

21. If the levy is intended to recover costs, there should be evidence of a discernible relationship between the amount of the levy and the service received by the person paying the levy. The Regulations Review Committee has previously endorsed the High Court of Australia’s view that:⁵

“If the person required to pay the exaction is given no choice about whether or not he [sic] acquires the services and the amount of the exaction has no discernible relationship with the value of what is acquired, the circumstances may be such that the exaction is, to the extent that it exceeds the value, properly to be seen as a tax.”

⁴ See the introduction and section 5 of the Treasury Guidelines

⁵ *Air Caledonie International and others v Commonwealth of Australia*: Quoted in ‘Activities of the Regulations Review Committee during 2001: Report of the Regulations Review Committee’, page 9.

Cross-subsidy

22. Cross-subsidies are generally seen to conflict with general fee-setting principles, so the proposal needs to provide evidence that none have resulted in setting the levy. The Regulations Review Committee has previously pointed out:

“Any cross-subsidisation in the provision of particular services should be authorised by primary legislation [which is not the case here] and be transparent: cross-subsidisation that is not transparent may be inequitable and unfair.”⁶

“Cross-subsidisation and over-recovery of costs are repugnant to the general fee-setting principles”⁷

Consider international precedent

23. In developing the co-regulatory model, the industry has drawn on the experience with similar arrangement governing the New South Wales Gas Market Company (GMCo). There is no reference in the levy proposal to comparisons between the GIC approach and GMCo’s approach (recognising, of course, that its services relate to the retail market only), or approaches taken by other Australian market operators.

24. For GMCo, fees are set by members, namely the market participants and then effectively approved by the NSW government under the Deed between GMCo and the NSW Government, with ACCC oversight in terms of competition law.

25. Our brief review suggests that no Australian gas market operator charges on a volume (per GJ) basis.⁸ Instead, all apply multi-part cost recovery regimes with an emphasis on per customer charges. To bolster its analysis, we suggest the GIC cover off why its recommended approach differs from its counterparts in Australia. To assist the GIC, a brief description of the cost recovery regimes adopted in Australian gas markets is attached to this submission.

Compare to previous charges

26. The levy proposal does not set out any comparison between the GIC proposed levy and any charges under previous industry arrangements such as through the Gas House. The Treasury Guidelines state (emphasis added):

“Clearly, all costs need to be recovered somehow: whether from users or others who benefit from the service; or from those whose actions give rise to it; or from the taxpayer. The Guidance can be used to identify a preferred user charge option that can ***then be compared with the existing charging arrangements*** or tax-funded alternatives.”

⁶ Interim Report of the Regulations Review Committee on Complaints relating to the Births, Deaths, and Marriages Registration (fees) Amendment Regulations 2001, and Investigation into identity services fees regulations, p 3.

⁷ Activities of the Regulations Review Committee during 2001, page 12.

⁸ Source: conversation Simon Orme with GMCo CEO, Patricia Mackenzie, 13 April 2005.

27. It may be the case that previous industry arrangements are so different to the GIC, or outdated, that such analysis is futile. Nonetheless, the issue should be considered and covered off by the GIC in finalising its proposal (even if only to note that this aspect of the guidelines has been considered).

Closing comment

28. If you would like further assistance or wish to discuss this submission, please contact Peter Alsop, Vector's Regulatory Manager, in the first instance (021 370 869). Again, Vector very much looks forward to working with the GIC.

Kind regards

A handwritten signature in black ink, appearing to read 'Mackenzie', written in a cursive style.

Simon Mackenzie

Group General Manager Networks

Attachment: Examples of cost recovery regimes in Australia

Gas Market Company (GMCo) - www.gasmarketco.com.au

GMCo's cost recovery arrangements have evolved into a three-part regime as follows:

- 10% of the total budget is payable equally by all GMCo participants, including both retailers and networks. This is known as the standing charge and corresponds broadly with the overhead cost of operating GMCo. The standing charge was originally 40% of the GMCo budget but has been reduced as costs have been decreased and also as establishment costs (including the cost of the IT infrastructure operated by LOGICA) have rolled off;
- Up to 45% of the total budget is recovered on the basis of customer related activity by retailers, namely consumer switching and creation of new delivery point identifiers (i.e. new customer connections); and
- The balance (up to 45%) is allocated on a market share basis as calculated in sales volumes for each retailer as a portion of total market volumes.

GMCo explicitly adopted a contracting-out organisational model, with administration, and market services purchased from other parties on a contestable basis. One implication is a high level of transparency regarding the size of the different components of GMCo's budget. A further principle was that charges should at least in part reflect the allocation of decision rights under the constitution.

Retail Energy Market company (REMCO) - <http://remco.net.au/>

REMCo is closely related to GMCo and operates in WA and SA. REMCo's shareholding and corporate model is very similar to GMCo and discussions are underway regarding a possible merger. REMCo also has a three-part cost recovery structure, although it differs from the GMCo model in important respects, such as:

- Joining fee. This is set low so as not to create a barrier to entry for new participants. This is equal for all participants (including networks).
- An annual fee. This is also levied equally across all members, including networks.
- A market share based charge. This is the largest portion of cost recovery and is levied only on retailers. It is based on customer numbers, not volume of gas sold.

VENCORP - www.vencorp.com.au

VENCOP operates as a Victorian Government owned entity and therefore operates under a different framework relative to GMCo and REMCo. Its fees are submitted to, and approved by, the ACCC.

VENCORP's fee structure is relatively complex,⁹ as it also provides transmission and balancing services (i.e. market operation services), including metering services as well as system security services. Accordingly, networks are liable for a significant portion of VENCORP's cost recovery.

Retailers face a three-part charging structure consisting of:

- An initial market registration fee (joining fee) at a rate set under ACCC approval.
- A monthly service fee per participant.
- A monthly FRC fee which is based on a cost per customer (NB, not on a volume basis).

Comment on Australian systems relative to proposed GIC system

The proposed GIC levy contrasts with the systems adopted in Australia. The Australian versions consist of multi-part charging systems and emphasize customer related activity. None of the Australian systems listed above have adopted a cost recovery system based around sales volumes. This reflects the fact that retail market costs are typically customer driven, not volume driven.

⁹ See http://www.vencorp.com.au/docs/About_VENCorp/FRC%20Cost%20Recovery.pdf for more details.