Statement of Levy Principles

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GAS INDUSTRY COMPANY LIMITED

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About Gas Industry Co.

Gas Industry Co was formed to be the co-regulator under the Gas Act.

As such, its role is to:

- recommend arrangements, including rules and regulations where appropriate, which improve:
  - the operation of gas markets;
  - access to infrastructure; and
  - consumer outcomes;
- administer, oversee compliance with, and review such arrangements; and
- report regularly to the Minister of Energy and Resources on the performance and present state of the New Zealand gas industry, and the achievement of Government's policy objectives for the gas sector.

1 Introduction

Gas Industry Co was established in 2004 to perform the role of the 'industry body' as set out in Part 4A of the Gas Act 1992 (Act). In performing its statutory role, the Company has developed a Corporate Strategy goal to *optimise the contribution of gas to New Zealand* and its purpose is to *provide leadership for the Gas Industry and the New Zealand Gas Story*. The following strategic objectives form the Corporate Strategy:

- Promote efficient, competitive, and confident gas markets.
- Facilitate efficient use of, and timely investment in, infrastructure.
- Deliver effectively on Gas Industry Co's accountabilities as the industry body
- Build and communicate the New Zealand Gas Story (includes review of industry performance)

In consultation with the industry, Gas Industry Co develops an annual Statement of Intent[1], which includes an annual work programme, an indication of further activity in following years, and associated levy funding requirements.

Along with governance objectives set out in the Act, Gas Industry Co must have regard to the objectives and outcomes in the April 2008 Government Policy Statement on Gas Governance (GPS).

Each financial year, the Company must consult with stakeholders on the costs for the work programme described in the Statement of Intent, which are funded through a levy and fees imposed on the industry. Submissions from stakeholders are sought on this Statement of Proposal.

Although submissions and our responses are published each year, we thought it would help stakeholders to understand the process of future levy consultations if our approach to setting the levy was set out in one place.

The purpose of the Statement of Levy Principles is to describe the legislative authority, levy principles and levy structure Gas Industry Co uses when developing its levy recommendation for funding each year, under the levy provisions of the Gas Act 1992 (the "Act").

[1] The Statement of Intent was formerly called the 'strategic plan'. An amendment to the Gas Act in December 2012 changed the title of this document but not its content, which covers Gas Industry Co's proposed scope of operations.

2 Funding

2.1 Sources

The Company has two statutory sources of funding from which it can meet the costs of undertaking its role as industry body under the Act. It also receives some funding directly from its shareholders[2].

Table 1: Funding sources for Gas Industry Co

	Funding Source	Authority
1	A levy of gas industry participants	s43ZZB – s43ZZE Gas Act 1992
2	Market fees imposed pursuant to various rules and regulations made under the Act	s43S Gas Act 1992
3	Shareholder fee	Gas Industry Co Ltd Constitution, clause 28

Gas Industry Co's primary source of funding is the levy of gas industry participants.

However, a portion of the Company's funding also comes from market fees, which are fees authorised by specific rules or regulations made under Part 4A of the Act.

In addition, the Company collects annual shareholder fees of $5,000 per shareholder[3]. These funds are set aside as a reserve against future contingencies.

2.2 Authority

Levy

The Act enables the Governor-General, acting on a recommendation from the Minister, to make general regulations under ss43ZZB-ZZE for a levy on industry participants. The Minister's recommendation is, in turn, based on a recommendation from Gas Industry Co following consultation with the industry.

[2] The Company obtained loan funding directly from shareholders in its establishment year; this money was paid back over the next two years from levy funding.
[3] The shareholder fee is set annually by the Board. For much of the Company's history, the fee was set at $10,000. In December 2012, the fee was reduced to $5,000 as the retained earnings (equity) reserve into which these fees were paid was approaching a level deemed sufficient to meet contingent events.

The basis for the amount of the levy in any given financial year is the estimated costs of Gas Industry Co exercising its functions as the industry body in that year. The amount of levy funding required in a given year fluctuated early in the Company's history as workstreams were established, but in recent years the costs of operation have flattened and even decreased.

Generally, the Company requires approximately $6 million per annum for all activities; around $4 million is raised through the levy, and the remainder is provided by market fees (see below).

Costs that may be met from the levy have been defined in section 43ZZC of the Act and are reproduced in Table 2.

Table 2: Industry body costs that may be met from the levy

	Section 43ZZC Gas Act 1992
(a)	The costs of making recommendations concerning any gas governance regulations and rules under Part 4A.
(b)	The costs of administering, monitoring compliance with, investigating, enforcing, and applying penalties or other remedies for contraventions of, gas governance regulations and rules, to the extent that the industry body is required to do so by those regulations or rules or requested to do so by any government policy statement applicable to the gas industry or the Minister.
(c)	The costs of establishing, operating, and facilitating the operation of markets for industry participants (including by contracting with other parties, entering into a joint venture or contractual arrangement, or other means).
(d)	The costs of establishing or implementing one or more complaints resolution systems.
(e)	The costs of providing advice to the Minister on matters concerning the gas industry.
(f)	The costs of governance of the industry body.
(g)	The costs of collecting the levy.
(h)	The costs of the industry body of carrying out any other functions or duties, or exercising any powers, under Part 4A.

Market Fees

2.3 Other rules and guidelines

Within the context of deriving an annual levy, various external agencies have also provided guidance from time to time on aspects which may impact on the levy setting process. These agencies include Parliament, the New Zealand Treasury, the Office of the Auditor-General, and the Ministry of Economic Development.

Table 3: External agencies with an interest in levy setting

Agency	Guidelines
Parliament	Under Standing Order 382, the Regulations Review committee considers regulations against a set of criteria in order to ascertain if they ought to be drawn to the special attention of the House.
Treasury	Guidelines promote equity, efficiency and cost minimisation by helping to identify the relevant economic considerations, and sets out a framework for evaluating charging options.
Auditor-General	Guidelines encourage the efficient allocation of resources and minimising the cost of supply and transactions, and dealing equitably with those who benefit from the output and/or those whose actions give rise to it. They also promote stakeholder consultation and participation in the charge review process wherever possible.
MED	In its consultation paper *Consultation Regarding Levy of Industry Participants under Section 172ZC of the Electricity Amendment Act 2001* the Ministry of Economic Development has set out the principles it believes are appropriate to an overall levy structure.

Source: FY2008 Levy Consultation Paper

3 Levy principles

Section 43ZZD(2) requires the Minister to accept a levy recommendation as long as certain conditions are met. In order to objectively assess whether the requirements of s43ZZD have been met, Gas Industry Co has reviewed the guidelines of the above-mentioned agencies and adopted a set of principles and developed a methodology for determining its levy proposal. The Company considers that adherence to these principles and methodology will enable it to provide an assurance to the Minister that the requirements under s43ZZD have been met, lessening the chance of a levy recommendation being delayed or rejected.

Although MED's principles were originally applied in the context of the electricity market, they can be considered to apply generally to the setting of levies. Therefore, Gas Industry Co has drawn heavily from those principles and adapted them for its own use. The revised principles are outlined in the table below. Gas Industry Co considers that these principles capture the essential elements of Standing Order 382, Treasury and Audit Office Guidelines, as well as the MED's principles in respect of the setting of levies.:

Table 4: Gas Industry Co Levy Principles

#	Levy Principle	Description
1	Economic efficiency	The levy structure should promote efficient market behaviour (or at least not detract from it significantly).
2	Beneficiary/causer pays	The costs of regulation development and implementation should be allocated in a way that reflects the cause of regulation (causer pays) and/or the incidence of the benefits from regulation.
3	Rationality	Where levies are to recover costs that are allocated to participant classes, there should be a relatively strong logical nexus between the participants on whom a levy is imposed and the costs being recovered through that levy.
4	Simplicity	• The levy structure should not create undue transaction costs for the organisation which implements and administers it, nor for the participants who must pay it. • The levy structure should only consist of as many individual levies as are necessary to recover the costs in an efficient manner, taking account of all the other principles applying. • The levy structures should be transparent to industry participants.
5	Equity	• Users in similar situations should pay similar amounts. • Competitive neutrality should be preserved, so that within a class of participants the allocation of costs should not competitively advantage one participant over another.

#	Levy Principle	Description
6	Revenue sufficiency	• The levies, together with other sources of revenue such as penalty payments, need to be sufficient to recover the costs borne by the organisation collecting the levy. • Levy setting must nevertheless be in accordance with section 43ZZC(3) of the Act, which says that the levy may be adjusted in any year to take account of under-recoveries and over-recoveries in previous years.

Source: FY2008 Levy Consultation Paper

4 Levy structure

4.1 Wholesale & Retail levy

The levy structure has always been developed as two components. A retail component, based on the number of ICPs in the system, paid by retailers; and a wholesale component based on energy quantities of gas, paid by industry participants who purchase gas directly from gas producers.

The reason for the split into the two components is to ensure that the costs of gas governance fall on the industry participants who derive benefit from the new arrangements. The wholesale levy funds activity for designing 'wholesale' arrangements, such as balancing and interconnection. The retail levy funds activity in developing and operating 'retail' market mechanisms, such as switching and downstream reconciliation.

The table below details the structure and levels of the levies that have been set since 2005.

Table 5: Historical Levy

Financial Year	Structure and level of levy	Levy ($000)			Total Expenditure ($000)
		Retail	Wholesale	Total	
2005	No levy	$0	$0	$0	$1,206
2006	Wholesale levy of 1.50 c/GJ Retail levy of 6c/GJ plus $4.00/year per active ICP	$1,772	$2,176	$3,948	$3,500
2007	Wholesale levy of 1.78 c/GJ Retail levy of $6.30 per active ICP	$1,570	$2,634	$4,204	$3,635
2008	Wholesale levy of 1.93c/GJ Retail levy of $8.18 per active ICP	$2,071	$3,107	$5,178	$4,559
2009	Wholesale levy of 1.79c/GJ Retail levy of $7.42 per active ICP	$1,911	$2,649	$4,560	$5,723
2010	Wholesale gas levy of 1.67c/GJ Retail levy of $6.40 per	$1,600	$2,422	$4,022	$7,491

Financial Year	Structure and level of levy	Levy ($000)			Total Expenditure ($000)
		Retail	Wholesale	Total	
	active ICP				
2011	Wholesale gas levy of 1.84c/GJ Retail levy of $6.40 per active ICP	$1,632	$2,666	$4,299	$7,029
2012	Wholesale gas levy of 1.66c/GJ Retail levy of $5.76 per active ICP	$1,468	$2,494	$3,962	$6,090
2013	Wholesale gas levy of 1.79c/GJ Retail levy of $6.23 per active ICP	$1,608	$2,691	$4,300	$6,357
2014	Wholesale gas levy of 1.63c/GJ Retail levy of $5.90 per active ICP	$1,534	$2,600	$4,133	$6,141

As part of each of the past the levy setting processes, Gas Industry Co has undertaken a review of the levy structure and assessed it against the principles described above. The outcome of that review has invariably found that, although there may be some usefulness in moving to a more complex levy structure that includes a third component for transmission/distribution (see comment below), the arguments for simplicity and stability strongly favour retention of the existing structure, that is, separate per ICP retail and per GJ wholesale levies. Industry has been asked to comment on the validity of the structure in each levy round and, to date, the current structure is generally accepted by the industry. This structure is now considered settled.

4.2 Cost allocation methodology

The levy is structured so that particular levy components fund relevant parts of the Gas Industry Co work programme. The work programme is divided into two aggregated blocks of work corresponding to each of the retail and wholesale levies. For these purposes:

- work on those parts of the gas supply chain upstream of distribution comprise the wholesale gas aggregated block of work; and
- work on consumer issues, retail markets, and distribution comprise the retail gas aggregated block of work.

Costs need to be allocated to these work streams to enable the level of levy to be calculated. Costs that are directly related to a work stream are allocated to that work stream. This includes costs for staff contributing directly to either the wholesale gas or retail gas work streams.

This leaves the issue of dealing with unallocated costs. Unallocated costs broadly comprise the overhead of Gas Industry Co, being governance, CEO, administrative support services, and office infrastructure. Work that is broadly related to gas governance, rather than to one of the two aggregated work streams, is also classified as unallocated.

Initially, unallocated costs were apportioned to wholesale and retail on a 50:50 basis. This was simple and tended to even out the overall distribution of costs, which in turn dampened differential movement between the levels of the two components of the levy. However, this approach attracted some criticism from levy payers who desired a less arbitrary allocation method.

Consequently, Gas Industry Co now apportions its unallocated costs on the basis of the total direct costs of each work stream. This approach is used as it is simple to apply and it better represents unallocated costs that are unrelated to staff salaries, such as Board costs and work on general aspects of gas governance. It also better reflects the dominance of consultant costs in the non-salary component of direct costs, which have historically been incurred as a substitute for sufficient permanent staff.

4.3 Industry advances reserve

The annual levy is designed to recover the costs of Gas Industry Co in undertaking its planned activities in the relevant financial year. However, due to the high level of uncertainty associated with making cost predictions over an extended timeframe, Section 43ZZC of the Act allows for the annual levy to deduct past over-recoveries or add past under-recoveries, where necessary.

The question of how this should be implemented was raised in the FY2007 levy consultation document. After receiving submissions on this document, Gas Industry Co considered it was appropriate for the Company to carry forward any over- or under-recovery into the following year's levy calculation. This approach was formalised in our reporting structure in FY2008, as part of the Company's implementation of New Zealand International Financial Reporting Standards, when the Board agreed to the creation of a separate reserve account, the 'Industry Advances Reserve'.

The purpose of the account is to identify clearly what portion of the Company's surplus was attributable to levy over- or under- recoveries. Gas Industry Co applies the balance of the Industry Advances Reserve, as reported in the Annual Report, to the subsequent levy-setting process. For example, an over-recovery in FY2008 was confirmed in the Annual Report by September 2009 and the adjustment included in the levy-setting process for FY2010. This was the earliest possible date that any over- or under-recovery could have been applied.

Under this policy, the amount of each proposed levy will always be consistent with the over-or under-recovery position reported in the Industry Advances Reserve, so that if the Company has a surplus, the levy would be set to reduce it, and vice versa.

4.4 Market fees

Market fees are fees which are specifically provided for within the respective gas governance rules and regulations made under the powers conferred under Part 4A of the Act. These rules and regulations (including any fee recovery provisions) are separately consulted on with the industry at the time the rules or regulations are being prepared.

Estimated market fees are required to be published in advance on the Gas Industry Co website. In order to ensure absolute transparency about the total costs of industry regulation, Gas Industry Co has also chosen to disclose anticipated market fees in its annual levy consultation document. However, this disclosure has created some confusion amongst levy payers as the market fees themselves are not re-consulted on each year.

Questions have been raised as to the legislative authority, appropriateness and level of scrutiny of market fees. The statutory support for market fees is in 43S(1)(a) of the Act, which allows gas governance rules and regulations to provide for the funding by industry participants of persons appointed to undertake specific roles under those rules and regulations. In addition, this provision is consistent with the beneficiary/causer pays levy principle (see above). The Board has decided it is appropriate for market fees to cover external consultants and service providers required by approved gas governance arrangements.

It should be noted that the vast majority of market fees are used to meet the costs of service providers under the various rules and regulations. Gas Industry Co, as a matter of policy, involves industry representations in the specification, tendering, and selection of service providers. Thus the associated costs are subject to a high level of industry scrutiny.