Application of gas governance arrangements to private networks: analysis of submissions

Date issued: September 2009

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.

Authorship

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1 Introduction

1.1 Background

As the approved industry body under Part 4A of the Gas Act 1992 (Gas Act), Gas Industry Company Limited (Gas Industry Co) is responsible for working with both the Government and gas industry participants to develop outcomes that meet the policy objectives as stated in the Government's April 2008 Policy Statement on Gas Governance (GPS). To date, Gas Industry Co has made recommendations for, and the Minister of Energy has approved, two sets of rules that particularly relate to the downstream gas market:

- Gas (Switching Arrangements) Rules 2008 (Switching Rules)
- Gas (Downstream Reconciliation) Rules 2008 (Reconciliation Rules)

Both of these sets of rules contain provisions for granting exemptions from rule compliance in certain situations. The Switching Rules provide for transitional exemptions, which are specifically transitional in nature, while the Reconciliation Rules provide for general exemptions that may remain in force on a longer term basis. Both types of exemptions, and the processes and policies by which applications for them are administered by Gas Industry Co, are outlined in the Information Paper 'Dealing with Exemptions under the Downstream Reconciliation and Switching Rules,' dated March 2009 and available on Gas Industry Co's website.[1]

The applicability of the Switching Rules and the Reconciliation Rules to all industry participants, as well as the applicability of the policy framework of the gas industry more generally, has been questioned by some in the industry. In particular, Nova Gas has questioned whether the regulatory provisions that apply to 'gas distributors' under the Gas Act (and its associated regulations and rules) should apply to bypass network operators.

In response to this debate, Gas Industry Co commissioned a report by Dr Geoff Bertram of the Victoria University of Wellington (Bertram report). The Bertram report examines whether there are systematic differences between different types of networks; and, if so, if these differences are sufficient to justify different applications of the gas governance arrangements in general. The report also considers whether these differences are relevant to the consideration of exemption applications for the Switching Rules and Reconciliation Rules. The Bertram report was released for industry consultation in March 2009.

[1] http://www.gasindustry.co.nz/sites/default/files/u21/Inform_paper_on_exemptions_148798.3.pdf

1.2 Bertram report conclusions

The Bertram report begins with the principle that any regulatory regime should be as simple, transparent, and uniform as possible. It notes that exemptions for particular categories of industry participants may create incentives for rent-seeking or gaming behaviour, to the detriment of the efficient functioning of the market as a whole. Any exemption application should therefore be scrutinised not just in terms of the benefits it would potentially provide to the applicant, but also for the consequent effects it would have on other industry participants and on market operation.

The Bertram report distinguishes between six different types of possible gas distribution systems, not all of which are present in New Zealand. The two main types that are addressed in the report are open access networks and private bypass networks, in which the owner of the pipeline owns all the gas transported in it and resells the gas to different end-users.

The Bertram report notes that bypass networks typically raise the level of competitive market discipline embodied in prices and other conditions available to retail customers within the bypass zone. Because the survival of bypass operators often depends on their price competitiveness, such networks generally do not need to be regulated with respect to the level and structure of their retail tariffs. However, the Bertram report also finds that the fact that a private bypass network is bringing competitive pressure to bear in a restricted market segment should convey no presumption of a right to be exempted from regulations or rules directed to wider purposes at the level of the gas market as a whole.

In terms of other types of regulation, the Bertram report identifies that the clearest *a priori* case for exemption of a private bypass network relates to reconciliation, because the operational need for independent reconciliation of gas quantities does not exist with a network used by only one gas retailer. However, and as noted below, the report was equivocal on this point because of a number of other factors. The report indicates that such exemptions should be subject to the following provisos:

- that there are no external effects on the ability of other industry participants to carry out allocation and reconciliation processes efficiently and fairly; and
- that there are no other grounds for making private bypass networks subject to the reconciliation rules.

The Bertram report also finds several regulatory areas where, for reasons of consumer protection and the efficient operation of the wider gas market, private bypass networks should not be exempt from requirements. These areas include:

- Retail regulations, which may include standard terms and conditions for retail supply contracts, provisions regarding low-income customers, and contract terms regarding customers' ability to switch retail suppliers;
- Distribution-level regulations that facilitate customer switching between distribution networks;

- Information disclosure regulations, which enable the central registry to compile accurate industry-wide statistics and to monitor the efficient operation of the gas supply chain;
- Switching protocols, including the maintenance and availability of detailed customer meter records; and
- Rules related to the calculation and disclosure of unaccounted-for gas (UFG).

1.3 Submissions received

A workshop on the Bertram report was held on 31 March 2009. Submissions on the Bertram report closed on 17 April 2009. Eight submissions were received from:

- Contact Energy Limited (Contact)
- Energy Direct NZ Limited (Energy Direct)
- Genesis Power Limited (Genesis)
- Mighty River Power Limited (Mighty River)
- Nova Gas Limited (Nova)[2]
- Powerco Limited (Powerco)
- Vector Limited (Vector)

Gas Industry Co thanks those who were involved in preparing submissions. The full text of all submissions are available on the Gas Industry Co website at www.gasindustry.co.nz.

1.4 Structure of this paper

Chapter 2 of this document provides a summary of the submissions received in response to the Bertram report. Chapter 3 analyses the three broad issues discussed in the paper. Each section briefly reviews the conclusions of the Bertram report, summarises the main points and common themes from the submissions, and then provides Gas Industry Co's response. Chapter 3 is organised around the following questions:

- Under the Gas Act, are private bypass networks subject to gas governance arrangements?
- Do the differences between private bypass networks and open-access networks in general justify differential treatment in the gas governance arrangements?
- How should bypass networks be treated with respect to existing rules and regulations?

[2] Nova provided two submissions: a report from LECG and a submission of its own.

2 Overview of submissions

2.1 Contact

Contact submits that all customers are entitled to the same benefits and protections provided by gas governance arrangements, irrespective of the type of distribution network to which they are connected. In particular:

- all networks should be subject to regulations aimed at consumer protection;
- there is no justification for exempting bypass networks from the Switching Rules; and
- UFG should be disclosed on bypass networks, as such disclosure would:
  - provide a useful benchmark;
  - help to identify misallocated ICPs and anomalies in physical connection; and
  - help to identify gas gate metering errors.

In terms of the Reconciliation Rules, Contact acknowledges that as bypass networks are not open access, and there is no requirement for allocation of gas gate quantities and UFG to multiple retailers, the reconciliation rules should have limited or no application with respect to bypass network owners.

2.2 Energy Direct

Energy Direct submits that bypass networks should not be exempt from the Switching Rules or the Gas (Information Disclosure) Regulations 1997 (Information Disclosure Regulations). Exemptions from the Reconciliation Rules could be granted subject to conditions. The reasons for these positions are summarised below.

Switching Rules

Bypass networks should not be exempt because:

- the Gas Registry should be a complete database of all gas connections, which will ensure that full information is available in the event of a gas emergency or safety issue; and
- bypass networks should be required to comply with the Switching Rules when customers switch between bypass and open access networks.

Information Disclosure Regulations

Bypass networks should not be exempt because:

- these regulations are intended to provide customers with full information that they can use to negotiate with network service providers; and

- there is no reason bypass networks should be exempt.

Reconciliation Rules

Exemptions for bypass networks may be granted, as all consumption at the gas gate would be allocated to the bypass network owner. Such exemptions should be subject to the conditions that the bypass network retailer:

- is required to supply historic consumption information if the supply switches to another gas network and/or retailer; and

- agrees not to trade on the local open access network for individual supplies also connected to the bypass network.

2.3 Genesis

Genesis makes three points in its submission:

- duplication of gas distribution networks is highly unlikely to be efficient or desirable;

- all market participants benefit from market arrangements and should bear their share of market costs; and

- exemption of bypass networks from gas governance regulations should require a high standard of justification on a net public benefit basis.

2.4 Mighty River

Mighty River submits that the Bertram report is fundamentally sound and well thought through. In its view, regulation should focus on addressing market failures: controlling the market power of natural monopoly businesses and removing barriers to competition in competitive and potentially competitive parts of the market.

In terms of the gas market, Mighty River submits that where a bypass network operator exists, the ensuing duopoly does not necessarily mean that there are no network issues around access, pricing, and service quality that need addressing. Duopoly situations need to be evaluated on a case-by-case basis.

In the specific case of Nova, Mighty River notes that although the Commerce Commission did not place Nova under price control, there can still be concerns about the level of competition and whether regulation is needed to promote competition. Mighty River also submits that the population and maintenance of the Gas Registry under the Switching Rules should apply to all gas end-users, including those on the Nova networks.

2.5 Nova

Nova has provided its own submission as well as a report it commissioned from Kieran Murray of LECG. Nova's submission is summarised below, and the conclusions of the LECG paper are summarised in the following section.

Nova raises a number of concerns with the Bertram report. In particular, it considers that the Bertram report:

- proposes that the Commerce Commission was wrong in its assessment that Nova faces workable competition in bypass network areas;
- attempts to apply the essential services doctrine improperly;
- places the onus on Nova to prove that the costs of regulation outweigh the benefits;
- raises concerns about how a bypass network operator could engage in strategic behaviour based on incorrect assumptions;
- regards some potential gas industry developments as negative, even though consumers are likely to benefit;
- has the potential outcome of protecting gas distributors from competition; and
- misinterprets the provisions of the Gas Act in terms of the treatment of private networks.

LECG paper

LECG addresses a number of themes in its paper:

- Nova is not a 'gas distributor' under the Gas Act;
- bypass markets are workably competitive;
- bypass pipelines do not fulfil the criteria of 'essential facilities' and accordingly do not warrant access regulation;
- the costs of regulating open access networks should not fall on unregulated bypass networks;
- regulatory intervention can only be justified on the basis that benefits exceed the costs; and
- minimum conditions of imposing regulation are that regulation would address a clearly identified problem of some consequence and that it presents the best solution for resolving that problem.

2.6 Powerco

Powerco submits that it agrees with the conclusion of the Bertram report that there is no general principle justifying the exemption of private networks from gas industry rules and regulations. Such networks are a key part of a functioning gas market and must be included in market regulation to ensure fairness for end consumers and efficiency of the overall gas system.

Powerco explains that it considers Nova to be a gas distributor within the sense defined by the Gas Act, as it operates a large network with a substantial number of ICPs and by virtue of the Gas Operator (Nova Gas Limited) Order 1998, as the Gas Act stipulates that such a declaration may be made if it is necessary to enable the subject of the order to 'start or carry on a business as a gas distributor.'[3]

In terms of market regulation, Powerco notes that there are two broad reasons for regulating: as a response to market power (the absence of workable competition) and to facilitate the market. Depending on the rationale for the regulation, the case for exemption of private networks from regulation is likely to differ, and assessment should be carried out on a case-by-case basis. The Information Disclosure Regulations are an example of regulation in response to market power, and where workable competition exists, an exemption is appropriate. Powerco notes in this context that there is no principled reason why open access pipelines in bypass areas remain subject to the Information Disclosure Regulations.

In Powerco's view, the focus of the gas regulatory environment has shifted from market power concerns to market facilitation issues. In this context, the fact that a private network is bringing competitive pressure to bear on a small proportion of the market is not relevant in considering exempting a participant from regulations directed at wider purposes than addressing market power. All customers are entitled to the same benefits and protections provided by the gas governance arrangements. In particular, there should be no exemptions from regulations specifying standard terms and conditions for retail supply contracts, nor from regulations regarding reconciliation, switching, and the provision of end user information.

2.7 Vector

Vector submits that the gas governance regime should ensure that:

- industry arrangements support and do not impede competition between pipelines and/or between gas retailers;
- all consumers that stand to benefit from industry arrangements are covered by gas governance arrangements; and
- accurate and transparent information for all participants of the gas industry is readily available.

In terms of existing gas governance arrangements, Vector submits that Nova should be subject to the Information Disclosure Regulations, the Reconciliation Rules, and the Switching Rules.

[3] Gas Act 1992, section 5(1).

Vector agrees with the Bertram report that there is justification for exempting new entrants from open access requirements in the short term, but that the case for long-term exemptions is weak. The maturation of the Nova networks implies that they should now be subject to gas governance regulations.

3 Review of questions raised in Bertram report

3.1 Are private bypass networks subject to gas governance arrangements?

What the Bertram report says

The Bertram report distinguishes between two principal types of distribution networks:

- open-access networks, which provide the services of gas transportation and related services to upstream and downstream clients on a non-discriminatory basis; and
- private networks, which do not provide third party access and which transport the network owner's own gas either for the owner's own use or for sale to different clients.

The Bertram report further differentiates private networks based on the type and number of end-use consumers of the network and on the market context in which the network operates.

Powerco is an example of an open-access network; Vector and Wanganui Gas operate hybrid open networks: they are open access but also transport the owner's own gas. Nova is characterised as a private network in limited bypass (duopoly) markets.

No distinction between private networks and others appears in the Gas Act, nor in the April 2008 Government Policy Statement on gas industry governance. The regulatory provisions in the Reconciliation Rules and the Switching Rules apply to all industry participants, including those that are private networks.

What the submissions say

Nova submits that the Bertram report has erred in concluding that the legislative framework treats open access and private networks as the same thing. In Nova's view, it does not provide distribution services under the Gas Act, as Nova does not provide that service to other parties and only transmits its own gas on its pipeline. Nova makes a distinction between 'gas distributor,' which it does not consider itself to be, and 'pipeline owner,' which captures all gas pipelines and applies in circumstances where the Gas Act is intended to apply across the board.

Powerco is the other submitter to address this issue directly. Powerco submits that it considers Nova to be a gas distributor within the sense defined by the Gas Act, as it operates a large network with a substantial number of ICPs. This situation, Powerco notes, is very different from a situation where a single feed enters a building complex and the end users are supplied from one ICP. This latter case is not a private network but small scale outlet pipe work owned by the customers and located downstream of the metering system.

Powerco submits that Nova can also be classified as a gas distributor by virtue of the Gas Operator (Nova Gas Limited) Order 1998, as the Gas Act stipulates that such a declaration may be made if it is necessary to enable the subject of the order to 'start or carry on a business as a gas distributor.'[4]

Gas Industry Co comment

Gas Industry Co is firmly of the view that Nova is a gas distributor under the Gas Act and is therefore subject to the same gas governance arrangements as any other gas distributor. The Gas Act defines a gas distributor as 'any person who supplies line function services to any other person or persons.'[5] Nova's argument is that, by transporting its own gas through its pipelines, it is not providing line function services to other persons and therefore cannot fall under the Gas Act's definition of gas distributor. Gas Industry Co does not agree with Nova's view.

Gas Industry Co considers Nova provides line function services to the consumers connected to its bypass networks (that is, it maintains and operates its bypass pipelines for the conveyance of gas to those consumers). The phrase 'any person or persons' in the definition is not limited to other retailers or third parties transporting gas on its network. Nova's networks exist to transport gas to its end-use customers, and consumers on Nova's bypass network could not be supplied with gas if line function services were not supplied to them.

A consumer receives the benefit of line function services in one of two ways: either the retailer makes arrangements with the relevant distributor, or the consumer contracts directly with the distributor to provide those services. This is consistent with the approach taken to the provision of electricity line function services under the Electricity Act 1992. Gas Industry Co understands that Nova has previously entered into gas supply agreements with commercial customers that explicitly differentiate between terms and prices for the supply of energy and the supply of distribution services.

The scheme of the Gas Act also supports this view. The Gas Act (and regulations such as the Gas Regulations 1993) contains a number of provisions applicable to gas distribution systems, including design, construction, installation, and operation. There is nothing in the Act which indicates that the application of these provisions should be predicated on the commercial access arrangements of those systems. Further, if Nova's interpretation is adopted, it raises questions about the applicability of those safety and operational provisions to its bypass networks.

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[4] Gas Act 1992, section 5(1). 'Person' is defined broadly in the Interpretation Act 1999 to include a corporation sole, a body corporate, and an unincorporated body.
[5] Gas Act 1992, section 2(1).

The requirement for gas distributors to be authorised to operate is also required by the Gas Act[6]. The designation of 'gas operator' confers, among other things, the power to construct and maintain gas fittings on roadways and level crossings. For new entrants, the Minister may declare a person to be a gas operator 'if the Minister is satisfied that a declaration is necessary to enable the person to start or carry on a business as a **gas distributor**.'[7] As Powerco notes in its submission, Nova has been declared a gas operator under this provision by the Gas Operator (Nova Gas Limited) Order 1998.

Finally, even by Nova's own interpretation of the term 'gas distributor,' there have been indications that more than one retailer may be operating at some of Nova's bypass gas gates. At the Hastings, Flatbush, and Tawa B bypass gas gates, reconciliation data has been previously provided to the allocation agent for both Nova and Auckland Gas Company. Gas Industry Co notes that Auckland Gas Company is a separate legal entity from Nova, in which case Nova would be supplying line function services to another retailer. This situation would unequivocally fall under the definition of gas distributor in the Gas Act.

3.2 Do the differences between private bypass networks and open-access networks in general justify differential treatment in the gas governance arrangements?

What the Bertram report says

Applicability of regulatory arrangements to bypass networks and regulatory costs

In evaluating the regulatory implications of different types of distribution networks, the Bertram report notes that it is useful to take the standpoint of the consumer, who is the final acquirer of gas and whose interests ought ultimately to be served by any regulatory regime, along with any wider interests of society. The evaluation should then assess the extent the consumer is empowered to choose freely among alternative sources of supply and to secure the best possible value for money. The less power a consumer has in specifying the terms of its gas supply, the stronger the case there is for regulation.

The Bertram report notes that regulatory requirements for private merchant pipelines may differ in some respects from those for open-access systems, due to the absence of within-system requirements to maintain competitive neutrality, balancing and reconciliation arrangements across multiple gas owners. However, there are many regulatory functions that will apply uniformly across both categories of network. The Bertram report finds that there is no general principle justifying exemption of private pipelines per se from rules and regulations made for the gas industry as a whole. The question of whether exemption from regulation ought to be

[6] Historically, the term 'gas distributor' has been used to describe a pipeline owner that supplies transportation services to itself. This usage was evident in the Gas Act 1982 (now repealed), where 'gas distributor' was used to signify the gas companies who both transported gas on their networks and supplied gas to end-use customers. Each of these gas distributors was required under the previous Gas Act to hold a franchise that specifically authorised the gas distributor to supply gas in its particular area of operation.
[7] Gas Act 1992, section 5(1) (emphasis added).

allowed requires consideration of the circumstances of each case and of the purposes being pursued by the regulator.

The Bertram report canvasses some situations in which Nova has been exempted from regulatory requirements. In particular, it notes that the Ministry of Economic Development has not required Nova to comply with the Information Disclosure Regulations. Similarly, Nova is not subject to regulatory control under the Commerce Act 1986, as the Commerce Commission in its Gas Control Inquiry found Nova to face workable or effective competition. However, the Bertram report does not consider that these exemptions provide a sound general basis for regulatory exemptions in principle. In terms of the costs of regulation, the Bertram report suggests that there is an argument that, as both networks in a duopoly situation are jointly accountable for the provision of open access transportation services, they should both contribute towards meeting the common costs arising from open access.

Long term regulation of bypass networks

The Bertram report also surveys a number of policy considerations that suggest in the long term, the interests of gas users and economic efficiency may best be served by requiring bypass operators to become open access. By this logic, a regulator aiming to maximise competitive pressures in the market would allow a new-entrant bypass owner some period of undisturbed operation as a private network, with exemption from regulatory obligations, in order to recoup its fixed costs of entry. Thereafter, the new entrant would be obliged to offer open access, and both it and the original network would be jointly accountable for the provision of open access transportation services.

What the submissions say

Applicability of regulatory arrangements to bypass networks

Nova's is the only submission that disagrees strongly with the discussion paper on this issue. The LECG paper, which Nova submitted, contends that the Bertram report invites Gas Industry Co to set aside the conclusions of the Commerce Commission and to adopt a view that competition is limited in bypass network markets. It states that the Bertram report provides no evidence to support this view and provides no basis for refuting the Commerce Commission's findings. It therefore concludes that there is workable competition in gas bypass markets and accordingly that Nova should be exempt from open access regulation.

The LECG paper takes issue with the regulatory principles discussed in the Bertram report. It contends that the regulatory issues identified in the report have not been established to exist in practice or to be of sufficient magnitude that they warrant regulation. Further, if it does turn out that these issues need to be addressed, Gas Industry Co would then need to evaluate the range of possible options available for resolving the issues. If regulation is seen as the best option, it needs to be shown that the benefits of that regulation would exceed its costs. The LECG paper states that this process should also be followed in considering an exemption application.

The remaining submissions largely agree with the conclusions of the Bertram report that there are a number of reasons for regulating, and the case for exemption needs to be considered on a case-by-case basis. Contact's submission frames the issue in terms of consumer protection and contends that all customers should benefit from these protections, regardless of the type of network that supplies their gas. Mighty River couches the issue in terms of market failure: regulation should curb the power of monopoly businesses and remove barriers to competition in competitive and potentially competitive parts of the market. Powerco states that there are two broad reasons for regulating: as a response to market power and to facilitate the market. Vector echoes the consumer protection and market facilitation reasons outlined above and further states that regulation should ensure that accurate and transparent information on the gas industry is available for all participants. Genesis notes that the exemption of bypass networks from gas governance regulations should require a high standard of justification on a net public benefit basis.

Regulatory costs

Four submissions address the subject of the cost of regulating. Nova rejects the suggestion that bypass networks should be subject to a levy matching that on the open-access network. It states that the purpose of competition policy is to protect competition, not to protect firms exposed to competition.

Genesis states that all market participants benefit from market arrangements and therefore, by default, should bear their share of market costs. Powerco similarly states that, in a duopoly market, both suppliers are accountable for open access services, and consequently both should contribute to meeting the common costs arising from open access. Vector frames the issue in terms of competition effects and states that the present arrangements provide an unfair competitive advantage to Nova as Nova does not have to share in the costs of open access but receives the information advantages derived from open access arrangements.

Long term regulation of bypass networks

In terms of application of the essential service doctrine, Nova and Vector are the two submitters to address this issue. Nova submits (in the LECG paper) that the doctrine has not been applied in New Zealand, but if it were, it would not apply to bypass markets, as a close substitute exists and the pipeline is duplicable. The LECG report finds that instead of creating a case for increased regulation, the essential services doctrine provides a rationale for removing access regulation. In contrast, Vector largely agrees with the conclusions of the Bertram report that the long run responsibility for open access should fall where it can be most efficiently performed and therefore a long run exemption for bypass networks from open access and related obligations is not justified. However, Vector considers that efficient outcomes can be achieved in the New Zealand gas market without requiring open access on all Nova pipelines at this stage.

Gas Industry Co comment

Applicability of regulatory arrangements to bypass networks

Gas Industry Co considers that the conclusions of the Commerce Commission (Commission) in the *Gas Control Inquiry: Final Report* (Gas Control Inquiry) are a useful starting point in considering regulation for the gas industry, but ultimately the application of the Gas Control Inquiry is limited by the context in which it was developed.

The Gas Control Inquiry focused extensively on the prices that gas consumers were being charged for pipeline services, and, to a lesser extent, the quality of those services. The concern at the time was that pipeline companies were potentially earning excess returns and operating inefficiently. The Commission's assessment of competition in the relevant markets was accordingly made in the context of potential monopoly abuse of market power and associated price and quality concerns.

In the case of Nova, the Commission wrote:

> Compared to the incumbent network operator, Nova Gas has a network which is very much smaller, it does not have an unbundled distribution charge, it does not make its network available to other retailers, and its principal activity is gas retailing. The Commission recognises that Nova Gas has a reputation as being a maverick in the market. These factors significantly reduce the potential for coordinated behaviour and for oligopolistic outcomes.[8]

The Commission's focus on the potential of 'coordinated behaviour' and for 'oligopolistic outcomes' illustrate the nature of its competition concerns. The Commission considered the structure of the bypass market and the evidence of competitive behaviour in that market, and it concluded that the level of competition was strong and that therefore the conditions for imposing price control on Nova were not satisfied under the Commerce Act 1986.

Gas Industry Co does not consider that a finding by the Commission that Nova should not be placed under price control necessarily means that Nova should be exempt from all regulatory obligations. As a number of submissions have pointed out, industry regulation can also aim to achieve a variety of objectives, including consumer protection and facilitation of the market. Indeed, consumer protection and market facilitation are important objectives of Gas Industry Co under the Government Policy Statement on Gas Governance (GPS).

The Government's objective for the entire gas industry is:

> To ensure that gas is delivered to existing and new customers in a safe, efficient, fair, reliable and environmentally sustainable manner.[9]

Among the specific outcomes expected in the GPS are effective and efficient customer switching arrangements; and accurate, efficient, and timely arrangement for the allocation and reconciliation of downstream gas quantities. In other words, Gas Industry Co's mandate is not specifically related to monopoly price concerns; such concerns fall under the purview of the

[8] Commerce Commission, Gas Control Inquiry: Final Report, Public Version, 29 November 2004, para 18.21.
[9] Hon David Parker, Government Policy Statement on Gas Governance, April 2008, para 9.

Commerce Commission. Gas Industry Co's focus is on the wider functioning and coordinating of the market as a whole.

It is important to note that the GPS does not distinguish between bypass and open access networks in its expectations; the implication is that the arrangements should apply to the industry as a whole. In this context, the conclusions of the Gas Control Inquiry do not seem relevant to the application of regulatory arrangements aimed at market facilitation and consumer protection.

Gas Industry Co recognises that there will be times when exemptions from industry rules and regulations are desirable, and there are provisions in place for considering exemption applications on a case-by-case basis. However, after considering the conclusions of the Bertram report and the submissions of industry participants, Gas Industry Co does not consider the fact that an industry participant is a bypass network is itself sufficient reason to support a regulatory exemption. Gas Industry Co will continue to assess each exemption application individually, based on its own merits.

Consideration of costs and benefits

The Gas Act sets out the process by which Gas Industry Co must develop recommendations for gas governance rules and regulations. Among other things, Gas Industry Co must identify all reasonably practicable options for achieving the regulatory objective and assess the costs, benefits, and likely efficacy of each option. If regulation is selected as the preferred option, then Gas Industry Co must publicly consult on the matter before any recommendation is made to the Minister.

This process of assessing options and evaluating costs and benefits is conducted on an industry-wide basis. The available options are identified out of all the options that could practicably be adopted by the industry as a whole, and costs and benefits are evaluated in terms of the effect on the industry as a whole. Once a set of rules or regulations is implemented, it applies to the entire industry.

The LECG paper seems to imply that a cost-benefit analysis should be conducted in respect of each exemption application, but such an implication overlooks the fact that the relevant set of rules or regulations have already been scrutinised in relation to their costs and benefits to the industry as a whole. The Minister's acceptance of the recommendation is an acknowledgement that the benefits of the proposal, which may include hard-to-quantify social benefits, outweigh its costs.

Once rules or regulations are implemented, it is important that Gas Industry Co apply them as intended. Rules and regulations are made by the Minster and the Governor-General respectively and, therefore, exemptions should only be granted in limited circumstances and in accordance with the requirements of the relevant rules or regulations. Gas Industry Co will continue with its practice of publicly consulting on exemption applications and evaluating the merits of each application with respect to established regulatory criteria.

Regulatory costs

The issue of fairness is often cited in conjunction with considerations of the imposition of regulatory costs. Nova contends that it would not be fair to impose the costs of regulation on an unregulated firm; Genesis, Powerco, and Vector state that all market participants benefit from open access arrangements and should fairly share in the costs.

Gas Industry Co considers that separating the issue of costs from specific regulation is to cloud the relevant issues. As outlined above, the consideration of costs is an integral part of the process of developing governance arrangements in the first place. The likely costs and net benefits are scrutinised in the process of developing policy proposals and are specifically included in any recommendation to the Minister. Once a set of rules or regulations has been implemented, unless there is express provision to the contrary, there is a presumption that it applies equally to all industry participants. Any exemption from bearing the costs of the rules or regulations would only come with an explicit exemption from the rules or regulations themselves, in accordance with regulatory exemption criteria and established procedures.

Nova's concern is therefore unfounded: the issue of costs is not about unregulated firms subsidising the cost of regulation, but rather all regulated firms bearing those costs.

3.3 How should bypass networks be treated with respect to existing rules and regulations?

What the Bertram report says

Reconciliation Rules

The Bertram report begins by establishing the reasons why reconciliation and allocation are important in an open-access system with multiple retailers: an independent means of keeping track of injections and off-takes of gas can lead to a fair and reasonable allocation across retailers of the cost of gas lost from the system. The report notes that this need is not relevant to a network used by only a sole gas retailer. The report then canvasses a number of potential circumstances in which there could be spill-over effects across networks and concludes that, in such a situation, a uniform set of allocation and reconciliation arrangements should apply across the entire distribution sector, both open-access and private.

Rules relating to the calculation and disclosure of UFG, however, can have important efficiency and customer protection roles apart from any need for reconciliation. An exemption from reporting UFG should in general not be available for merchant pipelines, notwithstanding the absence of multiple system owners.

Switching Rules

The Bertram report notes that the Switching Rules are intended to enable customers to choose between competing retailers, without qualification about the extent of competition in the relevant market. It also outlines several potential operational issues if bypass networks are exempted from the Switching Rules.

Gas (Information Disclosure) Regulations 1997

The Bertram report notes that the aim of the Gas (Information Disclosure) Regulations 1997 (Information Disclosure Regulations) is to secure non-discriminatory access terms and conditions for third parties on open-access pipelines. Nova was originally exempt from these regulations for its landfill systems, and the Ministry of Economic Development in 1999 consulted on a proposed amendment that would extend the exemption to Nova's bypass system, although this amendment has never been implemented. However, Gas Industry Co understands that the Ministry has to date not taken any enforcement action to require Nova to comply with these regulations.

The report states that the aims of information disclosure have widened since the Ministry's consultation in 1999 and now include considerations such as industry-wide safety, reliability, efficiency, fairness, environmental sustainability, performance monitoring, and correct signalling of costs. Under these widened objectives, the report states, Nova should be required to comply with the Information Disclosure Regulations.

What the submissions say

Reconciliation Rules

Contact: Reconciliation Rules should have limited application to bypass network owners. However, disclosure of UFG for bypass networks would benefit the market, as the information would provide a useful operational benchmark, help identify physical misconnection and misallocation of ICPs, and help identify gas gate metering errors.

Energy Direct: Bypass networks may be granted exemptions, as long as the bypass network retailer:

- is required to supply historical consumption information if the customer switches to another gas network or retailer;
- agrees not to trade on the local open access network.

Vector: Nova should be required to comply with these rules. Reconciliation arrangements can help to track UFG and to allocate it to its causer.

Switching Rules

Contact: There is not a significant compliance burden or detriment to the effective functioning of the gas market that would justify bypass network owners being granted privileged status with respect to registry participation and associated transparency of information.

Energy Direct: It is inappropriate to exempt bypass networks. The Gas Registry is intended to be the database of record of all gas connections; bypass network connections should be treated in the same way as connection on other networks. A complete Gas Registry will ensure full information is available in the event of a gas emergency or safety issue. Bypass networks should also be required to comply with the Switching Rules when customers switch between bypass and open access networks.

Mighty River: Population and maintenance of the Gas Registry should apply to all gas end users, including those on the Nova networks.

Powerco: All industry participants, including Nova, should be included in the Gas Registry. Exemption of private bypass pipelines from the Gas Registry would be anti-competitive and against the interests of end-users.

Vector: Nova should be required to comply with these rules. If Nova is exempt, then it has the ability to trawl the registry in search of new customers, while other participants are unable to view information on Nova's customers. This confers an unfair advantage to Nova. Compliance with the rules will also facilitate the effective implementation of switching arrangements.

Gas (Information Disclosure) Regulations 1997

Energy Direct: Bypass networks should be subject to the regulations. The Information Disclosure Regulations are intended to provide customers with full information to negotiate with network service providers, and there is no reason why bypass networks should be exempt.

Mighty River: Nova's operation as both a closed network and a closed retail operation gives rise to regulatory constraints. Mighty River is concerned by Nova's failure to comply with the Information Disclosure Regulations.

Powerco: In bypass markets where workable competition exists, an exemption from information disclosure regulations is appropriate. Powerco is concerned about the lack of principled consistency in the application of the regulations; in particular, there is no principled reason why Powerco should remain subject to the regulations in areas where Nova's bypass networks exist. However, Powerco agrees that the focus of gas regulation has shifted away from issues of access to pipelines to issues such as reconciliation, UFG, and the ability of customers to switch suppliers.

Vector: Nova should be required to comply with the Information Disclosure Regulations. Vector agrees that the grounds originally identified for Nova's exemption are no longer sufficient in the current industry environment.

Gas Industry Co comment

Gas Industry Co does not have responsibility for administering the Information Disclosure Regulations, but industry comment on the topic has been included in this paper for the sake of completeness.

In terms of the Reconciliation Rules and the Switching Rules, both sets of rules contain specific provisions for the granting of exemptions, and Gas Industry Co has established procedures for processing and considering applications for exemptions. Any exemptions granted can only be made on the basis of the provisions and criteria contained in those rules. A description of the process and criteria can be found in the Information Paper *Dealing with Exemptions under the Downstream Reconciliation and Switching Rules*, dated March 2009 and available on Gas Industry Co's website.[10] It is Gas Industry Co's intention to continue to evaluate exemption applications in accordance with the procedures described in that document and the criteria specified in the relevant sets of gas governance rules.

[10] The website address is http://www.gasindustry.co.nz/sites/default/files/u21/Inform_paper_on_exemptions_148798.3.pdf