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The 2005/06 GIC Levy: Recommendation to the Minister of Energy

10 May 2005

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1 Proposal

The Gas Act 1992 (the Act) enables the industry body for the gas industry, namely the Gas Industry Company (GIC), to recommend to the Minister of Energy that levy regulations be made requiring industry participants[1] to pay a levy to the industry body (s43ZZB). The levy is to recover the estimated costs of the GIC exercising its functions as the industry body (s43ZZC). This paper presents recommendations on the level, design and implementation of the levy for the financial year ending 30 June 2006.

The GIC's key recommendations to the Minister of Energy are:

- that a wholesale levy of 1.5c/GJ be paid on all gas purchased from producers (or from the Crown in the case of Maui gas) by the buyers of that gas. It is recommended that the levy be calculated quarterly and paid monthly, based on a pro-rating of the party's total gas purchases in the quarter before the last completed quarter (for example, the three monthly payments in July, August and September 2005 will be based on gas sales in the quarter to 31 March 2005); and
- that a retail levy of 6c/GJ plus $4/ICP be paid by all gas retailers in respect of sales to, and numbers of, small consumers consuming less than 10 TJ pa (based on sales volumes in the last gas year to 30 September 2004 and small customer (ICP) numbers as at 30 September 2004, and paid in 12 equal monthly instalments); and
- that the first payment of the levies be made on 20 July 2005.

The amounts per household and per small business are not large. If the levies were all passed on, this proposal would cost the average gas-using household $5.88 pa plus GST (in the context of about $800 pa spent on gas) and the average 1,000 GJ pa small business $79 pa (in the context of gas costs of about $10,000 pa). A major gas user, consuming say, 6 PJ pa at a cost of around $50m pa, would pay a levy of $90,000 pa.

2 Background

Recent amendments to the Gas Act 1992 provide for the co-regulation of the gas industry by the Government and an industry body. The GIC has been established by the gas industry to fulfill the role of the industry body as set out in the Gas Act. The GIC was approved as the industry body by Order in Council on 22 December 2004.

The GIC is responsible for proposing arrangements (which may include rules and regulations) in a range of areas relating to the gas industry (including wholesale markets and processing, transmission and distribution networks and retail and consumer protection). Where appropriate, the GIC may ultimately be involved in the implementation of market arrangements and in the surveillance and enforcement of market rules. In carrying out its responsibilities, the GIC will promote least-cost industry based solutions.

[1] In legislation, "industry participants" includes retailers, distributors, producers, pipeline or meter owners, wholesalers and major upstream buyers.

3 Overview of paper

This paper is structured as follows:

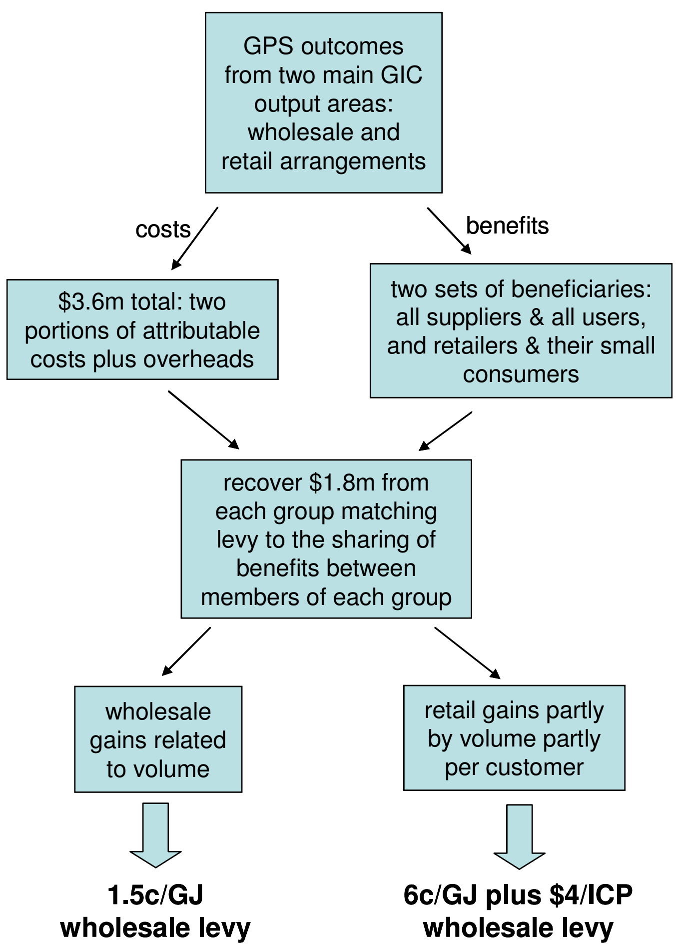
- Section 4 describes how the GIC's Strategic Plan provides for the required outcomes to be achieved through outputs in two key areas, namely wholesale and retail arrangements (which may include rules and regulations).

  The GIC's expected cost structure is explained in parallel with an identification of the main beneficiaries of each work area. It is submitted that the wholesale activities will benefit all parties in the sector and that the retail activities will primarily benefit retailers to small users and the small users themselves.

  Following Government cost recovery principles, the GIC recommends that half of GIC costs are recovered from each group. Section 4 also discusses the incidence of benefits upstream and downstream, and the GIC's analysis of whom to levy.

- Section 5 develops levies for each area tailored to the likely sharing of benefits amongst group members and presents the actual recommended levies. Figure 1, summarises the levy recommendations.

Figure 1:



- In section 6, the results of two rounds of industry consultation are presented. The key issues raised in submissions are discussed together with the GIC's reasons for adopting or rejecting the suggestions received. Further details of those consulted and their submissions are given in Appendix C.
- Section 7 presents the GIC's recommendations as to the implementation details for the levies, points of collection, timeframes etc.
- Section 8 assesses the GIC recommendations against other principles in the Treasury guidelines for levies and section 9 offers some concluding comments.

The five appendices provide additional information as follows:

- Appendix A outlines the theory behind how cost changes at one level in a value chain (cost reductions or imposed levies) can affect prices throughout the chain.
- Appendix B presents the results of the GIC's consideration of other retail levy options.
- Appendix C summarises the submissions made on the GIC's levy consultation papers.
- Appendix D is an outline Regulatory Impact Statement (RIS).
- Appendix E is a Business Compliance Cost Statement

4 Outcomes and costs

This section outlines the costs that will be incurred by the GIC in achieving the outcomes described in the draft GIC Strategic Plan and allocates the costs between the main beneficiaries of the two key work areas. The draft Strategic Plan was submitted to the Minister on 2 May 2005, in accordance with s43ZT of the Act.

4.1 Cost structure

4.1.1 Background

The GIC's assessment is that the outputs fall into two main areas – developing "wholesale" arrangements (such as balancing inflows and offtakes on a common transmission system) and improving "retail" mechanisms (such as customer switching protocols and consumer protection arrangements).[2]

The GIC will incur costs in carrying out these activities. As shown in the GIC's budget in the draft Strategic Plan, the GIC estimates that it will need to recover $3.6 million in the 2005/06 June year. This figure includes a partial recovery of the costs incurred since the GIC was approved as the industry body. These costs have been funded in the interim by the GIC's shareholders through loans to the Company. The GIC will seek to repay these loans from levy payments over two years.

The $3.6m includes many components that are common to the two major work areas. Where there are common costs, the usual way of attributing costs to a specific work

[2] The term "wholesale" is used is this paper to capture all gas supplied for electricity generation, petrochemicals, major industry and reticulated sales, with "retail" referring to gas supplied to other users (namely, small consumers).

area is to ask what costs would be **avoided** if that area of work were abandoned. At this stage, while the costs of the GIC (and in particular its Board, CEO, secretariat and technical advice) are not completely clear, it is not possible to identify specific avoidable costs for the retail- and wholesale-related activities. The GIC's best estimate of the amounts that would fall away if either area were dropped is that they are expected to be approximately equal.[3]

The two blocks of attributable costs do not represent the total GIC budget. There are overheads that would only be avoided if both activities were discontinued and the GIC wound up.

The draft Strategic Plan budget shows the following:

Personnel costs	$0.8 million
Board costs	$0.3 million
Other operating costs	$0.3 million
External advisers	$0.6 million
Working groups	$1.0 million
Partial recovery of expenses since 22 December 2004	$0.6 million
TOTAL	**$3.6 million**

At this stage, it appears that the attributable costs associated with the two work areas will each be about a third of total GIC costs ($1.2m each) and the overheads the remaining third ($1.2m).

4.1.2 Scale of costs

Before discussing who the costs could be recovered from, and in what way, it is helpful to note that the costs are not large in the context of the industry or the gas costs for each party being levied. As a result, the GIC is confident that any sensible levy structure will not distort market behaviour.

There are approximately 235,000 gas customers. Therefore, the $3.6m can be thought of, at one extreme, as approximately $14 pa per customer, or, spread over the total expected gas use of 120 PJ pa in 2005/06, as 3 c/GJ.

The $14 amount can be compared with the annual expenditure on gas of around $800 for an average gas-using household,[4] $10,000 for a typical small business,[5] and $400,000 million for Contact.[6] The 3c/GJ indicator is clearly negligible compared to even the lowest major industrial gas prices around $6-8/GJ.

As another point of comparison, the Electricity Commission levy now raises around $50m (ignoring the purchase of reserve energy) from a sector with a turnover of about $5 billion so its levy adds about 1%. Gas sector turnover is estimated to be of the order of $1 billion. Hence, GIC costs of $3.0m for the 2005/06 June year are around 0.3%.

[3] The work involved in managing the two retail working parties has been provisionally estimated as similar to that in the wholesale area. Even though there are two retail working groups planned, finding a model contract is not expected to be difficult and the wholesale area has potential for expansion into open access considerations and the outage contingency planning.

[4] The average household consumes about 25 GJ pa on a tariff of around $20/GJ plus 90c/day.

[5] The average small commercial or industrial user consumes about 1 TJ pa on a tariff of about $10/GJ.

[6] Valuing Contact's 50 PJ pa of gas for generation or on-sale at, say, $8/GJ.

4.1.3 Cost disciplines

The GIC is confident that there are strong disciplines in place to prevent unnecessary expansion of the costs of co-regulatory arrangements. The Company is committed to industry based solutions to the requirements of the GPS, achieved at least cost to the industry and consumers. Costs will be in the form of working party inputs and/or GIC supervision, the latter recovered through the levy. The company accounts will be open to industry shareholders and finally, the strategic plan (including its budget) and the levy have to be reviewed each year.

4.2 Cost recovery

4.2.1 Background

As noted at the outset, the Act provides for the GIC to recover its costs through levies on industry participants. Because the levy is to be imposed by regulations, the GIC is aware that its design must accord with Treasury and Audit Office guidelines for setting such charges,[7] and the principles applied by the Regulation Review Committee.

A central feature of all these guidelines is the “beneficiary pays” principle. In the GIC setting, this means that different parties in the gas sector should – as far as is feasible – contribute to GIC costs broadly in proportion to the benefits they receive from the GIC’s activities.

4.2.2 The Beneficiaries of GIC interventions

The GIC has identified two primary groups of beneficiaries, as illustrated by Figure 2:

- all suppliers and all users, as beneficiaries of the wholesale interventions, and the subset of
- retailers and their small users, as beneficiaries of the retail interventions.

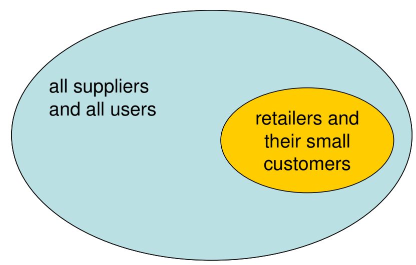


Figure 2

Wholesale arrangements and/or regulations

Better mechanisms for wholesale trading on an open access transmission system should lower costs for upstream industry participants (producers, wholesalers and retailers) and competitive pressures should in turn ensure that a significant proportion of these cost savings are passed through to all end users.

Retail arrangements and/or regulations

The GIC’s retail activities will, in the 2005/06 year, focus on a benchmark model contract for small users and on mechanisms to simplify the process for a small user of switching retailers. These interventions will thus primarily benefit retailers and their smaller users. These small users (more than 200,000 of them) typically consume less than 10 TJ pa and are supplied via distribution networks on retail tariffs.[8]

[7] Treasury, 2002 “Guidelines for setting charges in the public sector” and
Audit Office, 1989 “Guidelines on Costing and Charging Public Sector Goods and Services”

[8] 10 TJ pa is a common industry, Gas Act and Commerce Commission benchmark for the boundary between small “mass market” consumers and larger users.

4.2.3 Cost recovery without cross subsidy

The cost structure outlined in section 4.1.1 identified attributable costs for the wholesale and retail activities as $1.2m each and an overhead of $1.2m. To avoid a cross subsidy, the two broad groups of beneficiaries must share the overhead cost in some way, ie each must pay for the attributable costs of the activities they benefit from and something towards the common costs.

The Treasury guidelines suggest that the two groups should share the overheads in a way that reflects the relative benefits expected from the two areas of GIC activity. This is an uncertain process as numbers and volumes are strongly skewed; about 85% of customers consume only 12% of total gas.

In the absence of any clear guide as to the likely scale of user benefits, the GIC has attributed half the overheads and hence half of total GIC costs to each area. Thus the retail and wholesale levies have been designed so that each recovers $1.8m for the 2005/06 year, as illustrated by Figure 3.

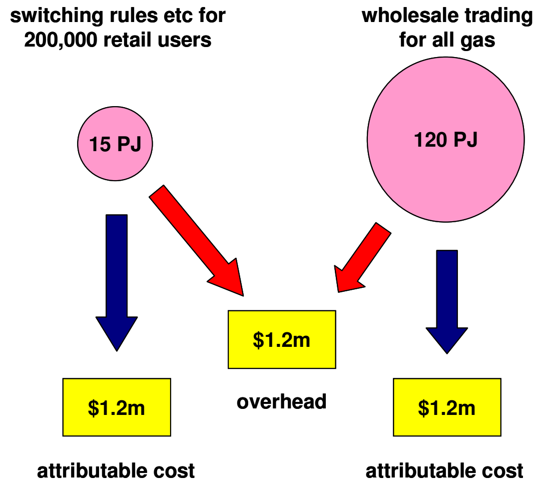


Figure 3

4.2.4 Vertical incidence

The justification for gas regulation is that it is expected to reduce costs and prices. As described, the GIC is seeking to achieve industry commitment to, or arrangements for, coordination mechanisms that will lower wholesaling and retailing costs. The general expectation is that competition will ensure that most of these gains are passed on to consumers but the precise effect on profits and prices will depend on competition and is, in any event, outside GIC and government control. This “incidence” issue – who ultimately benefits and who ultimately pays – is relevant to both benefits and the levy. It is discussed throughout this paper and discussed further in Appendix A.

The important consideration here is that wherever a cost is lowered, the benefits are likely to diffuse both upstream and downstream. In other than perfectly competitive markets, reduced wholesaling costs will increase what producers can earn, and the margins that wholesalers and retailers can retain – as well as lowering final prices. Where gas prices are currently determined by fixed contracts, benefits may not be shared so freely upstream and downstream.

4.2.5 Club goods

The benefits for both suppliers and users are “club goods”; the benefits are largely confined to the sector, even though there will be some spill over into the costs of other goods and services.[9] Where GIC initiatives will benefit all sector participants – even if they did not contribute to GIC costs – a compulsory levy can help ensure the correct

[9] Whether or not there is a case for a wider funding base, the amendments to the Gas Act have determined that the GIC will be funded from a levy on industry participants.

level of GIC activity.[10] This is consistent with the provision in the Act that the GIC be levy funded.

4.2.6 Networks

The GIC also considered whether network owners should be considered beneficiaries of the GIC's activities, but the extent of the benefit derived by networks from the planned regulatory activity is not obvious. Even if all the GIC costs were associated with open access, this appears mainly to benefit users of the network, not the network owners themselves. Nevertheless, networks could be seen as giving rise to the need for some of the GIC's costs. Improved gas competition may also improve network utilisation. However, if the network is regulated, this benefit is likely to be passed on to retailers. If the network is not regulated, then earnings might be currently capped by bypass pipeline costs which might also decline somewhat with improved wholesale and retail competition, so again the benefit would be passed on.[11]

The consequence of identifying networks as beneficiaries of the GIC's activities or as the origin of some of the GIC's costs would be to recover some costs through a levy on networks. However, the same analysis as is outlined above for the benefits applies to the levy; it would very likely be passed on to retailers and consumers.

4.2.7 Wholesale coverage

The GIC recommends that the levies should cover all competing gas supplies. The open access systems for Maui and NGC transmission pipelines will handle gas with the dominant New Zealand specification, but any non-specification gas delivered on independent pipelines will still compete in the same wholesale fuel market.[12] The extension to gas from new discoveries can be assessed as and when it happens. The GIC considers it unlikely that the prospect of a GIC levy will have any material impact on such projects.

4.2.8 The 10 TJ boundary

The discussion above identifies the beneficiaries of the GIC's retail activities as those retailing to small users and the users themselves. The recommended boundary is at 10 TJ pa. Retailers have pointed out a potential for awkwardness arising from the difference between a 9.99 TJ customer for whom they will be levied say, $600, and a 10.1 TJ user for whom they will pay no retail levy.

However, the GIC sees no reason for retailers to pass on the levy to final users with the same abrupt cut-off. With there being little likelihood that the levy for 2006/07 will reflect the same allocation of costs or the same pattern of imputed benefits, and with the 2005/06 retail levy recommended in this paper being based on a past gas year, the levy obligations will be effectively fixed costs to retailers with no obvious economic drivers for pass through.

[10] This assumes of course that the GIC only proposes interventions for which benefits exceed costs.

[11] In the electricity sector, the Electricity Commission levies networks but has a much more direct role in regulating their activities than is envisaged for the GIC. If necessary, the economic regulation of networks (price and quality) will be primarily a Commerce Commission responsibility.

[12] e.g. Waihapa to TCC and New Plymouth; Kapuni to Fonterra in Taranaki.

Next year, there may be better data available enabling a finer graduation of levies across user consumption classes and thus no perverse effects from customers moving across the 10 TJ boundary between now and then.

The GIC has also considered the possibility of raising or abandoning the 10 TJ "small user" boundary on advice that some larger users will still benefit from the GIC organisation of registry and switching working groups. Despite the measure of arbitrariness in the cut-off, the GIC has concluded that **some** boundary is necessary and that the 10 TJ level is practicable and recognises that users above his cut-off generally have individually negotiated gas sales contracts and will be less dependent on good switching mechanisms in achieving good terms and conditions of supply; they have more countervailing power than small users buying on a tariff. The GIC discussed the possibility of confining the retail levy to distribution networks but this was seen as unworkable as some major users are supplied off distribution networks while some are connected directly to the transmission grid.

4.2.9 Summary

The GIC recommends that the separate levies for 2005/06 be developed to recover costs in the two primary areas of anticipated GIC activity, namely the development of wholesale arrangements and/or regulations and retail arrangements and/or regulations. On the basis of the level of precision achievable in the first GIC budget, the GIC recommends that the wholesale and retail levies each be set to cover the incremental costs of the associated activities and to contribute half each to the GIC overheads. In other words, the wholesale and retail levies should each recover $1.8m in the 2005/06 year.

5 Cost allocation amongst group members

Section 4 outlined the GIC recommendations as to the high level allocation of costs between the beneficiaries of wholesale and retail interventions, namely half each of the budget total of $3.6m. This section recommends an approach to tailoring the actual levies to the horizontal incidence of the benefits in the two areas, ie an approach to making the levies reflect how the benefits gained by each group are likely to be shared between the members of that group.

5.1 Fixed costs

The focus is on benefits because, in both the wholesale and retail portions, the allocated cost is largely fixed. For example, the $1.8m of GIC **costs** attributed to retail activities is not directly related to either the GJ consumed by small consumers or the number of small users supplied by individual retailers.[13] Similarly, the $1.8m of GIC **costs** attributed to wholesale activities will not vary with GJ conveyed or consumed.

The relevant consideration, consistent with Treasury guidelines, is how the benefits of the GIC's wholesale and retail work streams will be shared amongst the participants in each group.

[13] Even the industry costs associated with registries, information exchange protocols etc are unrelated to customer numbers or GJ consumption levels. These systems all display substantial economies of scale. A computer based registry can record 200 or 200,000 customers.

5.2 Wholesale

As discussed earlier, improved wholesale trading will lower costs for upstream industry participants and competitive pressures should ensure that a significant proportion of these cost savings are passed through to end users. The benefit pass-through is most likely to be in the form of a reduction in wholesale prices. Because the wholesale price is a component of final contract prices and retail tariffs, all gas users will benefit in proportion to their consumption of gas.

This implies using a cents/GJ levy so that the contribution to GIC costs is also in proportion to volume sold or used.[14]

Given that the wholesale levy needs to recover $1.8m, and based on the GIC's estimate that total gas use in the 2005/06 year will be 120 PJ, the GIC recommends a wholesale levy of 1.5c/GJ. Details of the recommended implementation are set out in Section 7.

5.3 Retail

Improved retail switching and reconciliation mechanisms should lower retailer costs and enable more effective competition. Intensified competition may benefit users through unit price or monthly charge reductions or through improvements in service.

- If stronger competition lowers the retailer's variable costs or applies pressure to the variable margin and thus lowers the $/GJ **price** of gas, then the benefit to users clearly depends on volume and a cents/GJ levy is indicated.
- However, it is also possible that better retail switching processes etc will lower retailers' costs per customer and so lead to a drop in fixed charges. They may also improve service quality. In these cases, a $/ICP levy would be more appropriate.

If the benefits gained by individual customers are partly fixed and partly variable, an equitable levy structure could comprise a range of cents/GJ levies with lower rates for larger users, or a range of $/ICP levies with higher rates for larger users.

Because the GIC does not have adequate market data at present to match the $1.8m revenue requirement with such sets of different levy rates for users with different consumption levels, the practical way of allowing for fixed and variable benefits is to apply a fixed and a variable levy, raising half the required amount from each component.

The GIC therefore recommends for 2005/06:

- a 6c/GJ levy, and
- a $4/ICP levy

to be collected from retailers in relation to their GJ sales to, and numbers of, small customers. Details of the recommended implementation are set out in Section 7.

[14] The GIC has considered other bases for collecting the levy upstream such as wholesaler gas entitlements, turnover and profit, but these are difficult to observe objectively, and not as simply associated with benefits.

These amounts are based on the GIC's estimate that there are 220,000 small users consuming less that 10 TJ pa, accounting for 15 PJ of gas use overall.

The advantages and disadvantages of some of the different retail levy structures considered are outlined in Appendix C.

5.4 Comparators

Volume and customer bases are both common in levies set by regulatory agencies although per GJ components are less common where the focus is on retail mechanisms. For example:

- The New Zealand Electricity Commission recovers most of its wholesale related costs though c/kWh levies but does use a $/ICP levy for all "Part E" processes related to the customer registry and switching. The detailed rationale was not explained in the discussion papers leading up to the setting of the Electricity Commission levies but seemed to rely on the proposition that the relevant Commission costs depended more on customer numbers than volumes. The GIC's analysis has focused more on benefits since the GIC's supervisory role in improving retail switching mechanisms is more of a fixed cost (as discussed above).
- In New Zealand, gas retailers presently pay a cents/GJ fee to the "allocation agent" that operates under the gas Reconciliation Code.
- The gas related costs of the government Energy Safety Service are recovered through a 2c/GJ levy.

The closest parallels to the GIC's retail functions may be the Australian companies serviced by M-co, the Gas Market Company in NSW and the Retail Energy Market Company operating in WA and SA.

Like the GIC, both charge an annual fee to shareholders or participants but recover most of their costs through levies. The Gas Market Company recovers 45% of its budget through levies on customer related **activity**, ie on customer switching or new connections.[15] The remaining major portion is recovered on a per customer basis. The Retail Energy Market Company recovers most of its costs from a per customer levy.

Vencorp is a levy funded Victorian government owned entity with major operational, planning and development roles for both gas and electricity. It operates the Victorian gas transmission network and manages the state's wholesale gas market. Vencorp charges a per customer levy to gas retailers for its "Full Retail Contestability" services.

The examples described show that different jurisdictions have come up with different approaches but the GIC has not found compelling arguments for a sole reliance on ICP levies. The GIC has considered the arguments for and against different mixes of GJ and ICP levies and has concluded that the two part solution recommended in this paper better reflects the beneficiary pays principle than either a full cents/GJ or $/ICP options. Please refer to Appendix B for a discussion on the retail tariff variations.

[15] This is analogous to the Energy Consumer Complaints Commission fees based on the numbers of complaints.

6 Consultation

In the course of preparing this paper, a broad range of industry stakeholders were consulted and their views solicited. A first Discussion paper on the levy was circulated on 24 March with a request for comments by 15 April. The paper explained the GIC's cost allocation process and proposed a 1.5c/GJ wholesale levy and a 12c/GJ retail levy.

To respond to the issues raised in submissions and to provide more detail on implementation of the proposed levies, a follow up consultation document was circulated on 22 April with a request for responses by 3 May. The follow up paper described the GIC's use of the beneficiary pays principle to the retail levy and proposed the levy structure that is now recommended in this paper, a 1.5c/GJ wholesale levy and a 6c/GJ plus $4/ICP retail levy.

Appendix D gives a list of those consulted, a summary of the main issues raised in the first round and a synopsis of each submission, together with a GIC response.[16]

The key messages arising from this consultation are as follows:

- Gas users are not confident that a pass through of the benefits of GIC activities is likely but nevertheless expect a full pass through of the levy.
  - Large users in very competitive markets don't welcome the added cost, but at the levy scale recommended, do not claim any threat to viability.
  - Small user representatives were less worried about the dollar amounts in the combined levy – however it is structured – but also objected to a full pass through on the basis of the view that upstream parties will retain a good measure of the benefit.
  - The GIC has sought to explain that the flow though of both the benefits and levies depends on competitive pressures which are difficult to predict and, in any event, outside GIC control.
- Suppliers view the gas industry as intensely competitive and expect benefits to be fully passed through. As a consequence, they want a levy structure that facilitates pass through and an implementation plan for the levy that will allow them time to adjust tariffs.

  The GIC has concluded that if it had been the intention of the legislation that the levy is fully passed on to consumers, then a direct levying of consumers would have been provided for. The GIC considers that some of the benefits of cost reductions will be retained by upstream parties so it would be inappropriate to design the levy to minimise upstream incidence.
- A number of submissions sought detail of the GIC budget as a basis for a better understanding of the levy. Some additional information was provided in the follow up consultation paper with an explanation (like that earlier in this paper) that costs can only be approximately attributed to work areas at this stage. In subsequent years, the GIC intends to provide greater detail on its budgets and cost structures, with a strong desire for transparency. Due to the establishment stage of the GIC, greater clarity on the budget was not considered beneficial.

[16] This analysis of the first round submissions was included in the follow up consultation paper.

- First round submissions argued for the inclusion of a cents/GJ component in the retail levy and this has been included in the GIC recommendations above.
- Finally, a few submissions recommended using the 2006/07 year levy to redress any significant mismatches between forecast and actual GIC activities, costs and likely benefit patterns in 2005/06. The GIC will consider this suggestion further later in the year.

7 Implementation

The GIC convened an *ad hoc* working group to confirm the details of how different levy options could be implemented. The working group comprised the Reconciliation Code allocation agent, billing and reconciliation specialists from Contact, Vector, NGC and Genesis, and the GIC's legal and policy advisors. Based on this advice, the GIC recommends the following specification of how the levies should be implemented for 2005/06.

7.1 The 2005/06 wholesale levy

The working group's view was that there may from time to time be uncertainty as to the ownership of gas at grid offtake points and that it would be easier to define the obligation to pay the wholesale levy with reference to a sale of gas further upstream. Contact made a submission to the same effect.

The GIC therefore recommends that the 2005/06 wholesale levy of 1.5c/GJ be paid by gas buyers at the first point of sale from the gas producer. This may be a reseller buying from a producer (and on-selling to retailers) or a retailer buying from a producer directly (and on-selling to end users) or a major user buying from a producer.[17] In the case of Maui, the first point of sale of gas is from the Maui partners to the Crown, so the GIC proposes that for Maui gas, the 2005/06 wholesale levy will be paid by the purchaser from the Crown. Here the buyers will include Methanex, Contact and NGC.

The working group advised that accurate information about gas sales is not available on a monthly basis. So as to deal with settled quantities, the working group further recommended that the 2005/06 wholesale levy obligation be calculated on the basis of the total gas sales made in the quarter before the last completed quarter, and be paid in three equal monthly instalments (eg the three payments in the quarter to 30 September would be based on gas sales in the quarter to 31 March). The GIC recommends this approach.

The GIC further recommends that regulations provide for the first payments of the wholesale levy to be made by 20 July 2005. The regulations should allow for a 10% penalty for late payment.

The GIC further recommends that the levy regulations allow GIC to access quarterly sales figures from producers (or in the case of Maui gas, from the Crown) for the purposes of levy verification.

[17] Direct wholesale buyers are "industry participants" and so can be levied under the Act.

7.2 The 2005/06 retail levy

The cents/GJ component

The working group advised that accurate information about retail sales is available only at the end of a gas year (to 30 September 2004) and not during the course of the gas year. The GIC therefore recommends that the retail levy be calculated on the basis of this historic information.

The GIC recommends that the 6 c/GJ component of the retail levy to be paid by gas retailers for the 2005/06 year be based on the gas volumes supplied during the last completed gas year ending 30 September 2004. These volumes are now settled and the GIC recommends that gas retailers be required to pay (in 12 equal monthly instalments commencing 20 July 2005) in respect of their sales of gas during the year to 30 September 2004 to consumers who used less than 10 TJ in that year.[18]

The GIC also recommends that the levy regulations allow the GIC to access retailers' sales figures in relation to the year to 30 September 2004 for users above 10 TJ pa, as well as below 10 TJ pa, and to reconcile the totals with the allocation agent that operates under the gas Reconciliation Code.

The ICP component

The GIC recommends that the $4/ICP component of the retail levy to be paid by gas retailers for the 2005/06 levy be based on the small user (less than 10 TJ pa) ICP numbers associated with each retailer as at the end of the last gas year (ie as at 30 September 2004). This approach is expected to minimise transactions costs (since the numbers are settled and known by third parties) and minimise compliance costs (since no new business systems are required to establish the levy obligation).[19] It is recommended that regulations require payment to be made in 12 equal monthly instalments with first payment by 20 July 2005. The regulations should also allow for a 10% penalty for late payment.

NGC Transmission and the local distribution networks have a record of customer numbers at this time that can be used for verification. The GIC recommends that the levy regulations allow GIC to access this snapshot customer number information from NGC Transmission and distribution networks for the purposes of levy verification.

8 Levy design principles

For completeness, this section reviews the GIC recommendations against other elements in the Treasury and Audit Office guidelines for public sector charges that have not been specifically mentioned in the analysis so far.

Devolution of the regulatory role

Where a government agency is proposing a new levy, control agencies look for evidence that all alternatives to government provision of the service have been

[18] The simplifying approach of making one calculation of the annual obligation was recommended by the Federation of Family Budgeting Services.

[19] The payment of the levy will require some additional setup in retailers' banking arrangements (although providing for the instalments should be trivial) and if retailers choose to pass the levy on, there will be some setup costs in establishing a line item on customer bills.

explored. The GIC is an instance of where that process has been fully completed. The Minister of Energy recommended the GIC be appointed as the industry body under the recent amendments to the Gas Act, with the result that the regulatory function is “outsourced” as much as possible.

Contestability and pressure on costs

The regulatory function is still contestable. If the GIC ceases to meet government expectations in the key areas of the GPS on Gas Governance, the government can turn the functions over to a modified Energy Commission.

The pressure on costs is partly secured by maximum reliance on industry working groups as the “engine rooms” of the GIC’s development of arrangements or recommendations for regulations. The participation of the industry personnel with the expertise necessary to contribute effectively to the working groups has a high opportunity cost to the companies involved. The other sources of pressure on GIC costs will be industry shareholders, industry directors and the annual review of the Strategic Plan and levy required in the Act.

Under and over recovery of costs

If GIC costs are lower than expected in 2005/06, then the cash advances from shareholders can be repaid more quickly. If future when there are no such debts, lower than expected costs will lead to a cash surplus. The GIC intends to use memorandum accounts to carry any such surpluses forward, reducing the levy at the time of the next review.

As mentioned above, the GIC will give further consideration to a year to year “wash-up”. If the pattern of GIC costs is radically different from that underpinning the levy in a particular year, the subsequent levy could be structured to “repay” an overcharged area at the expense of an undercharged area.

The GIC will also give further consideration to the possibility of intra-year levy reviews. If the GIC undertook an expanded role (not signalled in an annual strategic plan), then it may be necessary to modify the levy within a year not just on June anniversaries. In the near term, there will be some buffer available for moderate additional costs above forecast by adjusting the repayment rate of the shareholder advances.

9 Conclusions

The GIC recommends to the Minister of Energy that

- a wholesale levy of 1.5c/GJ be paid on all gas purchased from producers (or from the Crown in the case of Maui gas), by the buyers of that gas. It is recommended that the levy be paid monthly, based on a pro-rating of the party’s total gas purchases in the quarter before the last completed quarter (for example, the three monthly payments in July, August and September 2005 will be based on gas sales in the quarter to 31 March 2005); and,
- a retail levy of 6c/GJ plus $4/ICP be paid by all gas retailers in respect of sales to, and numbers of, small consumers consuming less than 10 TJ pa (based on sales volumes in the last gas year to 30 September 2004 and small customer (ICP) numbers as at 30 September 2004); and that
- the first payment of the levies be made on 20 July 2005.

The wholesale levy is modest compared to a current representative wholesale gas value of around $8/GJ.

The dollar amounts per household and per small business will also not be not large; if the levies were all passed on, the recommended levy would cost the average gas-using household $5.50 pa (in the context of about $800 pa spent on gas) and the average 1 TJ pa small business $79 pa (in the context of gas costs of about $10,000 pa).

The GIC trusts that these recommendations are clear. A *pro forma* Regulatory Impact Statement is included as Appendix D and Appendix E is a BCCS. If there is any further background or explanation that the GIC can provide to assist officials in responding to this paper, please advise

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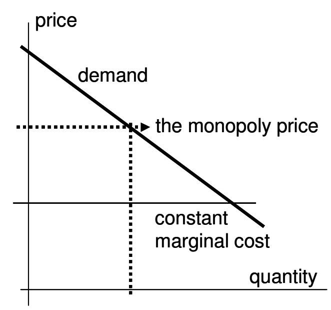
Appendix A: Incidence – who really benefits and who really pays

The GIC will be developing coordination mechanisms to improve market access and reduce costs for all industry participants. In perfectly competitive conditions, all the benefits would pass through to consumers. In less than perfectly competitive markets, part of the benefit of reductions in costs will be captured by the suppliers themselves.

The simplest illustration of this idea is the change in the price charged by a monopolist when its marginal costs are reduced. With linear costs and demands, the monopoly price is half way between the marginal cost and the price that reduces demand to zero. If the marginal cost is reduced by a regulatory intervention, the monopolist's profit maximising price will drop by half as much. Consumers will benefit but the supplier will make an equal amount of additional profit. The same sharing arises in a Cournot market with more players.



Thus, as a general principle, it seems safe to assume that some of the benefits of GIC activities will be captured by producers and supplers.

A similar sharing will happen with the levy (even though the levy is expected to be much smaller than the gains from the GIC interventions). Where the levy increases a marginal cost, the competitive market price in an oligopoly setting is unlikely to increase by as much. Consumers will pay more but suppliers will sacrifice some profit. Suppliers may intend to pass on the levy fully but will find, in a not fully competitive setting, that it is more profitable not to. The levy may be notionally passed on but subsequent market adjustments will effectively share the burden.

These effects are debatable as is the degree of competitiveness of the gas market. But the principle remains that both benefits and levies are likely to be shared between upstream parties and consumers to some degree. If the benefits are shared, then it seems appropriate that the levy is shared also, even though the degree of sharing may differ on the cost and benefit sides. The GIC concludes that the framework accords with the beneficiary pays principle.

Appendix B: Retail tariff variations

The GIC examined a number of different options for the retail levy. As explained in the main body of this paper, the GIC's view is that the costs of its supervision of working parties on retail matters are essentially fixed costs, largely unrelated to GJs or ICPs. The more relevant consideration is the pattern of benefits derived by small users.

On the assumption that all levies are passed through to consumers, the choice of the retail levy structure affects the distribution of total contributions to GIC costs amongst households and other small users in the mass market below the 10 TJ pa threshold. Major users (paying just the wholesale levy) are unaffected. The following table shows the shares.

shares of total GIC costs			
three retail levy options	**households**	**small industrial & commercial users**	**major users incl. generators**
12c/GJ	26%	30%	44%
$8/ICP	45%	11%	44%
6c/GJ + $4/ICP	36%	20%	44%

Another way of comparing the retail levy options as they affect small users, is to calculate the levies' average cents/GJ contribution to total wholesale and retail costs. The average household uses 25 GJ pa and the average small industrial and commercial consumers uses about 1 TJ pa, ie 1,000 GJ pa.

average contributions			
three retail levy options	**households**	**small industrial & commercial users**	**major users incl. generators**
12c/GJ	13.5c/GJ	13.5c/GJ	1.5c/GJ
$8/ICP	33.5c/GJ	2.3c/GJ	1.5c/GJ
6c/GJ + $4/ICP	23.5c/GJ	7.9c/GJ	1.5c/GJ

The GIC regarded the single part $8/ICP option as loading a disproportionate share (45%) of the total GIC costs onto households that use about 6% of total gas. It also appeared to overstate the amounts of benefit that will accrue to household users relative to small industrial and commercial users. The 12c/GJ option appeared to pass too much of the retail costs to the relatively small number of industrial and commercial users below 10 TJ pa. The GIC viewed the combination of a 6c/GJ levy and a $4/ICP charge as better reflecting the benefits gained by the two groups.

Appendix C: Summary of submissions

The two consultation papers were sent to the following

Stephen Barrett	Chief Executive	Contact Energy Ltd
Murray Jackson	Chief Executive	Genesis Power Ltd
Ron Rosenberg	Chief Executive Officer	Multigas (NZ) Ltd
Stephen Parker	National Manager	Gas Association of NZ
Trevor Goodwin	Chief Executive	Wanganui Gas Ltd
Richard Tweedie	Chief Executive Officer	Todd Energy
Peter Reidy	Chief Executive	Nova Gas Ltd
Doug Heffernan	Chief Executive	Mighty River Power
Harvey Weake	Chief Executive	Methanex New Zealand Ltd
Michael Butler	Energy Manager	Fonterra Co-operative Group
Bruce Chapman	Government Relations	Carter Holt Harvey
Graeme Everett	Energy Manager	Norske Skog Tasman
Dick Whitelaw	Energy Coordination Manager	NZ Steel Ltd
Fred Staples	GM Pulp Division	Pan Pac Forest Products Ltd
Ralph Matthes	Executive Director	MEUG
Tom Tetenburg	Allocation Agent	Tetenburg & Associates
Mark Franklin	Chief Executive Officer	Vector Ltd
Steven Boulton	Chief Executive	Powerco Ltd
Peter Whitehouse	Adviser Environment & Technology	Business NZ
Bryan Crawford	Chief Executive	Natural Gas Corporation
Wilhelm Alheit	Logistics Manager	ACI Glass Packaging NZ
Dave Bennett	Chief Executive	Austral Pacific Energy Ltd
Len Houwers	General Manager	Ballance Agri-Nutrients (Kapuni)
Kevin Johnson	Executive Director	Bridge Petroleum Ltd
Tai Ruwhiu	General Manager	Greymouth Petroleum
Ray Garbutt	Engineering Manager	Heinz Wattie's Ltd
Thomas Zengerly	General Manager	The New Zealand Refining Co Ltd
Gordon Ward	General Manager	NZOG Services Ltd
Steve Hounsell	Managing Director	OMV New Zealand
Paul Zealand	Chairman	Shell NZ Ltd
Don Morgan	Chief Executive	Swift Energy NZ Ltd
Clyde Bennett	NZ Asset Manager	Tap Oil Ltd
Kerry Starling	Manager Procurement	Tenon Ltd
Lianne Meiklejohn	Group Supply Manager	Fletcher Building Limited
Ewen Gardiner	General Manager	Tatua Co-op Dairy Co Ltd
John Rampton	Chief Analyst, Gas & Oil Resources	Ministry of Economic Development
Dr Mike Patrick	Executive Officer	PEPANZ
Dennis McGowan	General Manager	Westech Energy
Ajit Bansal	General Manager	Shell (Petroleum Mining)
Liz MacPherson	General Manager	Ministry of Consumer Affairs
David Russell	Chief Executive	Consumers Institute
Graham Stairmand	President	Grey Power
Eileen Imlach	Consumer Affairs Commentator	NZ Council of Women
Raewyn Nielsen	Executive Officer, New Zealand Federation of Family Budgeting Services	
Louise May	Social Policy Mgr, New Zealand Association of Citizens Advice Bureaux	
Bernie Harris	Sec'y, Federation of Wellington Progressive and Ratepayers Associations	

The first Levy Discussion paper was circulated on 24 March with a request for responses by 15 April. The submissions relating to that first paper are summarised below and a list provided of the main points in the individual submissions together with a GIC commentary.

In light of the first round of submissions, the GIC decided to circulate a follow up consultation paper to respond to the issues raised, to advise of modifications to the levy proposals, and to provide additional detail on the implementation of the proposed levies.

The following table attempts to bring together succinctly how many respondents expressed similar views. The subsequent landscape tables outline each submitter's key points together with a GIC commentary.

Summary

Recommendation	Vector	NGC	Mighty River	Contact	Genesis	Wanganui	Ballance	MEUG	Residential
wanted to see budget	✓		✓				✓	✓	
want cost disciplines		✓	✓				✓		
ensure levy pass through		✓	✓	*					
prevent levy pass through							✓		✓
use ICP levies for retail		✓		✓		✓		✓	
get info powers for levy		✓		✓					
tax fund some activities			✓						
Repay levies if costs vary					✓				
more application points								✓	
GIC sunset clause							✓		

* Contact not persuaded that inability to pass on the levy is a problem

Key:

- **wanted to see budget** – levy proposal should have been complemented by budget to explain the origin of the cost estimate and justify initial allocations
- **want cost disciplines** – GIC planning should show controls on bureaucratic cost growth, especially when the levy is reviewed
- **ensure levy pass through** – delay levy onset until tariffs can be increased and ensure that pass through from point of collection is not prevented by contracts

- **prevent levy pass through** – industry participants will get most of the benefit of GIC activities and should carry costs by not passing on the levy
- **use ICP levies for retail** – recover part or all of costs attributed to retail from a single $/ICP levy or a set of such levies graded by consumption level
- **get information powers for levy** – levy regulations should provide for GIC to get necessary information from allocation agent and networks
- **tax fund some GIC activities** – some powers like regulation enforcement should be funded from general taxation
- **repay levies if costs vary** – adjust future levies to wash up any major variations in GIC spending from initial allocations
- **more application points** – consider more combinations of wholesale levy application points amongst wholesale buyers and sellers
- **GIC sunset clause** – set an expiry date by which key measures must be in place and thereafter seek a fresh mandate from industry

Main points of submissions

Vector	
The proposal to government should be supported by thorough analysis in the terms defined by Treasury and Audit Office Guidelines and the Regulation Review Committee's principles. Vector probably would have preferred to see such analysis in the discussion paper.	Intended to be covered in this paper.
Include the strategic plan and budget in the consultation. Without this, the process may not comply with 43ZZC (or 43ZZD) of the Act. The key is relating costs to outputs.	Response in follow up consultation and in this paper.
Wanted statement of approach to cost allocation, ie the initial 50/50. The Audit Office Guidelines also require a clear identification of outputs and an allocation of costs to these.	Response in follow up consultation and in this paper, to the level of precision possible.
Warns that the Regulation Review Committee could expect to see a clear relationship between the levy and the service being received by the person paying it.	This is potentially problematic but unavoidable. The GIC clearly believes that the benefits flowing to consumers from its work will far outweigh the costs of the company, and for that matter, the costs that will be carried by the industry in working with GIC. But the levy will arguably not be physically paid by the primary beneficiary of the GIC "service"; it will be collected from a retailer or wholesaler.
Verify that there are no cross subsidies	Discussed in follow up consultation and in this paper
Compare GIC levy recommendations with those of similar bodies overseas and with earlier NZ gas sector levies.	Discussed in this paper.

NGC	
Endorses Vector view about need for rigour in levy justification.	
The point of collection should be chosen to ensure that payer is **not** prevented from passing the levy downstream.	It is hard to find a collection point where we could be sure of this outcome without gaining access to all sales contracts; such blockages are potentially unfair to some sellers but amounts are modest.
Prefers a set of $/ICP levies graded by consumption levels to cover both wholesale and retail – so long as it doesn't delay implementation	To set the right $ levels, a substantial data gathering exercise would be required to identify customer numbers in different consumption classes from all retailers and networks. This may be feasible at the next levy review. A simple two-part approach is dealt with in this paper.
Wanted to see GIC budget to understand basis for the levy.	Response in follow up consultation and in this paper.
Wants future GIC costs to be reported and matched to activities.	The GIC Board and government will determine an appropriate monitoring and reporting regime.
Approves of GIC acquiring information gathering powers in the regulations for the purposes of the levy.	The allocation agent and the networks hold retailer information on condition that it is kept confidential; GIC needs the regulations to provide powers to access this information (while still maintaining confidentiality).
Some costs should be allocated to other areas like open access, the complaints scheme and the National Gas Outage Contingency Plan	Most of the costs attributable to work streams will be carried by the firms providing participants for the working groups. As other work areas open up in future years, GIC will need to determine whether the pattern of likely **benefits** has changed
Genesis	
Annual review should allow for future levies to recover contributions if it is found that GIC activities and costs vary substantially from initial allocations.	Agreed. For example, the second year wholesale levy may be 1c/GJ but could be reduced further if wholesale activity in first year had been much less that expected and retail much more, with the offsetting amount added to the second year retail levy to "wash up" the imbalance.

Mighty River Power	
GIC should seek government funding for some activities like rule compliance monitoring and enforcement. Refers to Scott paper on Electricity Commission roles.	Dr Scott's paper recommends a separation of activities between those properly undertaken by an industry body and those the proper domain of government. This is a decision for Government not GIC.
GIC should give close attention to cost control especially at the times the levy is reviewed.	Agreed.
The imposition of the levy should be delayed to allow retail tariffs to be increased at the same time.	With the legislation requiring that only industry participants are levied, it is hard justify designing the levy and planning its implementation so that there is **no** industry participant contribution.
Contact	
Agree with wholesale levy structure but suggest collection at first point of sale after production.	Discussed in follow up consultation and in this paper.
Retail levy should be a single universal $8/ICP since all customers will benefit equally from GIC activities.	Discussed in follow up consultation and in this paper.
Drop the 10 TJ pa boundary for the retail levy.	Discussed in follow up consultation and in this paper.
Any inability to pass on the levy (because of particular sales contracts) is not an issue.	Most gas sales contracts have a standard provision that any government imposed levies or taxes will be passed on but there are apparently exceptions.
GIC should get necessary customer numbers etc from NGC and the allocation agent.	Discussed in this paper.
Wanganui Gas	
Favours $/ICP approach for retail levy.	Discussed in follow up consultation and in this paper
Levies will make gas less competitive.	The levies are very small relative to prevailing tariffs.
Retailers will incur additional administrative costs in collecting and paying the levy	Agreed. GIC has sought to minimise retail compliance costs by relying on existing data for the GJ and ICP numbers.

Ballance	
7 PJ pa user resents the $105,000 impost; unconvinced about consumer benefit from GIC activities; favours a levy mechanism that ensures that the industry participants carry a fair share of the burden	The only way to minimise pass through is for major gas sector businesses to agree on (possibly different) fixed contributions for the first year. Such an agreement has not been forthcoming. Regulations could specify some fixed proportional pass through in existing fixed price contracts but this would be unfair relative to contracts that allow complete pass through.
MEUG	
Wanted to see GIC budget (including company advances and the interest provisions for repayment) to understand basis for the levy.	Discussed in follow up consultation and in this paper.
GIC should determine offsetting reductions in vote: Energy and consequent reductions in gas Energy Resources Levy and the MED safety service Gas Levy.	The Energy Resources Levy is a royalty and not a cost recovery mechanism. The Gas Levy funds the government's energy safety service as it relates to gas and there is, as yet, no direct link to GIC activities.
Want more clarity about which pipelines are included in the wholesale levy and rules for new pipelines.	Hopefully the Discussion Paper makes clear the intention that regulations will apply the wholesale levy to all gas supplies to all users.
GIC retail costs should be recovered using a $/ICP levy.	Discussed in follow up consultation and in this paper.
Residential consumer groups (summary)	
Commentators speaking for residential users were not overly concerned by any of the possible cents/GJ or $/ICP levy amounts *per se* but were not convinced about the consumer benefits from GIC activities; they favour a levy mechanism that ensures that the industry participants carry a fair share of the burden.	See comment on Ballance submission above
One submission was that the retail activity costs were out of proportion to the benefit consumers might get.	This can be redressed in the second year levy.

Appendix D: Regulatory impact statement

D.1 Statement of the nature and magnitude of the problem and need for Government action

Section 43ZZB of the Gas Act 1992 authorises the industry body (GIC) to recommend regulations that will require industry participants to pay a levy to the industry body.

D.2 Statement of the policy objectives(s)

The levy is to be used to meet costs as specified under section 43ZZC of the Gas Act 1992. The levy is to comply with the conditions set out in section 43ZZD of the Gas Act 1992.

D.3 Statement of feasible options (regulatory and/or non-regulatory) that may constitute viable means for achieving the desired objective(s)

The status quo is not an option as there currently is no levy.

The preferred option is the levy recommended in this paper.

D.4 Statement of the net benefit of the proposal, including the total regulatory costs (administrative, compliance and economic costs) and benefits (including non-quantifiable benefits) of the proposal

The accompanying draft GIC strategic plan contains budgets outlining the total costs that are to be recovered through the levy.

The GIC assumes that the amendments to the Gas Act presuppose that benefits to the gas sector will outweigh the costs of the industry body appointed to achieve the objectives of the GPS on Gas Governance.

D.5 Statement of consultation undertaken

Industry stakeholders including officials have been consulted. See Section 6.

D.6 Business compliance cost statement

see following page

Appendix E: BCCS

Sources of compliance costs The only compliance issues raised in consultation were; the initial calculation of levy obligations, adjustments to retail billing systems where levies are passed on, setting up systems to pay GIC, and handling additional complaints and inquiries to retailers.

Parties likely to be affected

Retailers: Contact, Genesis, Wanganui Gas, Auckland Gas, Mercury Energy (Mighty River), Nova Gas, the e-gas, e-gas 2000, Direct Energy. The smallest retailers are $13m turnover businesses,[20] with possibly $1.3m in margin.

Buyers at first point of sale include Contact, Genesis, NGC, Multigas, Nova and Fonterra, the smallest spending about $50m pa on gas.

Estimated compliance costs The first three compliance costs above are one-off costs for the year in the case of retail, with quarterly adjustments to the payments in the wholesale case. The total time input is estimated to be around five hours. At an incremental staff cost of around $120/hr, the cost could be of the order of $600 for each retailer and wholesale buyer. One retailer expects an upswing for a month or two in customer inquiries and complaints when the levy is imposed. This could add a personnel cost or degrade the existing inquiries service for all callers. One extra person diverted to complaints for a month might cost $3,000. The subtotal might then be $3,600 per retailer, small relative to their businesses. Total maybe $36,000 across ten retailers, plus $5,000 across the major buyers. The overall total could be around $41,000, small in the context of the $3.6m being raised.

Long term implications The most likely levy changes in future years will be alterations to the **levels** of the different components of the original levy (as work areas and expected benefit distributions change), rather than the adoption of new bases. As a result, compliance costs should be substantially lower in future years.

Level of confidence in compliance cost estimates

The above estimates may be conservative (in the sense of overstating potential compliance costs). Consumer representatives in the consultations did not regard the dollar amounts of the levy as material.

The key compliance cost issues raised in consultation only those listed.

Overlapping compliance requirements The 2c/GJ gas levy for the Energy Safety Service is charged on retailers' sales volumes. The GIC has not attempted to harmonise the data requirements because the data capture costs are so small.

[20] Selling around 0.5 PJ pa to 10,000 small users at $20/GJ plus 90c/day/customer

Steps taken to minimise compliance costs The gas volume and ICP values on which the retail levy is based have been linked to the last complete gas year for which volumes and customer numbers are now settled. This will minimise uncertainty in estimating levy obligations. Similarly, the wholesale levy is based on reconciled volumes two quarters earlier to minimise administrative costs.