GAS INDUSTRY COMPANY LIMITED
P.O. Box 10-646, Wellington, New Zealand
Telephone: +64 4 472 8194, Facsimile: +64 4 472 8195
www.gasindustry.co.nz, email: info@gasindustry.co.nz

GIC Levy Proposal

Discussion paper

24 March 2005

Table of Contents

1.	Summary	1
2.	The scale of the proposed levies	4
3.	Proposed allocation of costs	5
4.	Proposed coverage	6
5.	Relating costs to activities	6
6.	Proposed levy bases and collection points	7
7.	Indicative levies	8
8.	Revenue variability	10
9.	Consultation	10

1. Summary

The Gas Industry Company role

Recent amendments to the Gas Act 1992 provide for the co-regulation of the gas industry by the Government and an industry body. The Gas Industry Company Limited (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 (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 aim to promote least-cost industry based solutions.

Benefits and costs

The GIC's activities are intended to benefit industry participants and consumers by contributing to the achievement of the Government's overall policy objective and its specific policy outcomes with respect to the gas industry.

The GIC will incur costs in carrying out these activities. The GIC's strategic plan and budget are still being finalised prior to being presented to the Minister of Energy for approval in late April 2005. The initial estimate, however, is that the GIC 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 have these loans repaid by levy payments over a two year period.

The GIC's costs in subsequent years will depend on activities undertaken in those years and, as the levy must be set annually, may result in corresponding changes to the levy regulations from time to time.

Cost recovery through levies

The Gas Act provides for the GIC to recover the costs of exercising the functions under the Gas Act through levies on industry participants.[1] This discussion paper seeks the comments of interested parties on the best way to structure such a levy. Following this consultation, the levy – both the structure and the amount to be raised – will require the approval of the Minister of Energy, and the making of levy regulations. The GIC will present its proposal to the Minister in late April 2005 after taking into account comments on the proposals in this Paper.

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

Treasury guidelines for such levies require that they reflect the benefits flowing from the regulatory activities and the causers of the costs.[2] Hence, in designing a levy structure, the GIC needs to balance the practical need for simplicity and ease of implementation with ensuring an appropriate allocation of costs to industry participants that are themselves, or that are supplying, the beneficiaries of the GIC's activities, or that are giving rise to the costs.

Passing on of levies

The GIC will be developing coordination mechanisms to improve market access and lower costs for industry participants. Lower costs and more open competition should lower prices and/or improve the quality of supply, so end users are likely to have the most to gain from enhancements to the operation of gas markets.

Similarly, the economic effect of the levies is likely to be shared upstream and downstream. The levies on industry participants will become part of their overall costs and will be passed on to consumers to a greater or lesser degree. The GIC is not able to influence if, to what extent, or how levies are passed on.

Distinguishing the GIC's wholesale and retail-related activities

The GIC's assessment is that its costs will arise from two main areas – developing "wholesale" arrangements (such as balancing inflows and offtakes on a common transmission system) and developing "retail" mechanisms (such as customer switching protocols and consumer protection arrangements).[3]

- Wholesale arrangements will benefit all gas users and their suppliers, broadly in proportion to the volumes they use.
- Retail mechanisms and consumer protection will benefit smaller users, those using less than 10 TJ pa.[4]

The initial GIC budget indicates that its costs will be split approximately 50/50 between wholesale- and retail-related activities. Therefore, the GIC proposes to raise $1.8m from a "wholesale" levy and $1.8m from a "retail" levy. Some upstream market participants are also retailers and would be exposed to both levies.

---

[2] Treasury, 2002 "Guidelines for Setting Charges in the Public Sector"

[3] 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 others (namely, small consumers).

[4] 10 TJ pa is a common industry and Commerce Commission benchmark for the boundary between small "mass market" consumers and larger users who are more likely to have individualized gas sales contracts. A 10 TJ pa consumer might be spending $100,000 pa on gas at a commercial tariff of $10/GJ.

Proposed wholesale levy

The GIC proposes that the wholesale levy should be set in proportion to gas sales. In order to raise $1.8m, the GIC estimates the wholesale levy would need to be set at 1.5c/GJ on all gas sold.[5] The GIC anticipates that this will raise approximately:

- 13% of the $1.8m from retailers serving small users (households and small industrial & commercial users); and
- 87% from sales to major users (including generators and co-generators).

Proposed retail levy

The GIC has considered a number of options for the retail levy. The GIC considers the levy should recover the second $1.8m from retailers supplying small users. Consumption rates vary widely, from around 25 GJ pa in households to about 1000 GJ pa in the average small industrial and commercial enterprise.

Because many of the costs of retail mechanisms arise in handling the numerous smaller customers, it could be argued that a fair retail levy would probably set different c/GJ or $ per customer rates for users in different consumption bands and levy retailers according to their customer distributions in these bands. Retailers with customer bases weighted towards the smallest users would pay relatively more.

However, in the absence of centrally collected data on such classifications, the GIC proposes to adopt a simple approach for this first year levy. It is estimated that small users (below 10 TJ pa) account for about 15 PJ of gas use. This indicates that a retailer levy of 12c/GJ on sales to such customers would be needed to generate the $1.8m required to be levied.

Proposed collection

The GIC proposes that the wholesale levy is paid by those owning gas delivered to all transmission line offtake points. This is intended to cover all supplies to electricity generators, petrochemical plants, other major users and retailers.

The GIC proposes that the retail levy would be paid by all those selling gas to small users, on the basis of the volume of such sales.

The wholesale and retail levies would be calculated monthly in relation to the gas delivered to transmission lines offtake points, or sold to small users, as the case may be, that month. Payment would be required by or on the 20th of the following month.

The GIC proposes that the first monthly payment of the wholesale levy and the retail levy accrue on 30 June 2005 with payment required by or on 20 July 2005.

[5] Total gas use is estimated to be currently around 120 PJ pa with about 15 PJ pa consumed by small users.

Estimated impact of proposed levies

From the limited public information that is currently available on wholesale and retail market shares, the GIC estimates that the total of the proposed wholesale and retail levies would be collected from industry participants in the following proportions:[6]

Contact	Genesis	NGC	Swift	Todd	Others[7]
35%	27%	11%	4%	4%	19%

The levy must be set annually and may be adjusted as the activities of the GIC evolve.

The GIC invites comment on the proposed levy structure and rate. Specific questions on which comment is sought are set out in the body of this discussion paper.

2. The scale of the proposed levies

To assess whether the proposed wholesale and retail levies are likely to have significant commercial impacts, possible levy rates can be compared with existing tariffs and with expenditure on gas. If all of the GIC's budgeted costs of $3.6m were recovered from a cents/GJ levy, the indicative rate would be 3c/GJ. This is small compared to domestic tariffs of more than $20/GJ and major user prices of around $8/GJ. Similarly, if all of the GIC's costs were recovered from per customer charges, the annual rate would be of the order of $15 per customer.[8] Again, this is small compared with the average annual expenditures on gas of $500 per household and $10,000 per small industrial and commercial user.[9]

The GIC considers that neither per GJ nor per customer fees will materially distort consumers' decisions as to participation in the market or volume of use.[10]

[6] The Todd and Swift figures refer to their direct wholesale sales via their own pipelines, not any retail interests.

[7] including Wanganui Gas, Auckland Gas, Mercury Energy, Nova Gas, e-gas, e-gas2000, Multigas, Direct Energy

[8] $3.6m recovered from sales to 235,000 customers

[9] As another point of comparison, the electricity levy now raises more than $100m from a sector with a turnover of about $5 billion so that levy adds about 2%. Gas sector turnover is of the order of $1 billion so the GIC's costs of $3.6m are less than 0.4%.

[10] 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.

3. Proposed allocation of costs

Since the GIC levy will be imposed by regulation, its design must accord with 2002 Treasury "Guidelines for Setting Charges in the Public Sector". The Guidelines have two central features:

- "beneficiaries" should pay; and
- those who impose costs should pay.

Benefits related to use

Gas users are likely to be the principal beneficiaries of improved market infrastructure. In general, users could be expected to benefit in proportion to their consumption of gas. On this basis, it could be argued that households would only receive 6% of the benefit, since they are estimated to consume 6% of gas in New Zealand.

Small user benefits

On the other hand, small users are likely to impose a larger share of regulatory and market infrastructure costs, as much of the infrastructure is dedicated to supporting small scale retail competition. Hence the allocation of costs among industry participants cannot be entirely in proportion to their gas sales, but also needs to reflect the types of customers they sell to.

In particular, comprehensive retail switching mechanisms like a customer registry will benefit small consumers and the retailers serving them. Thus the recovery of the GIC's costs related to retail market structure should reflect the numbers of small users served by retailers. The Electricity Commission recovers the costs of the customer registry through a per connection (ICP) levy.[11]

Benefits upstream and downstream

With a relatively small number of upstream players, open access and wholesale trading could lower costs and benefit both consumers and wholesalers. In the future, new producers will also gain. Existing producers are likely to have locked in their returns through bulk contracts with 'first point of sale' customers. For these reasons, the GIC considers it sensible not to attempt to levy existing producers.

Networks

For network owners, the extent of the benefit derived from the planned regulatory activity is not so 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 improve network utilisation but 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

[11] ICP stands for "installation control point" and is the accepted measure of customer numbers.

capped by bypass pipeline costs which might also decline somewhat with improved wholesale and retail competition, so again the benefit would be passed on.[12]

Proposal

The GIC proposes that its costs are recovered from:

- upstream suppliers, in proportion to market share as beneficiaries of reduced costs and enhanced wholesale markets, and
- retailers to small users, in proportion to market share as beneficiaries of the promotion of retail competition and consumer protection.

The GIC seeks comment on this proposed cost allocation.

4. Proposed coverage

The GIC takes the view 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.[13] 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.

The GIC seeks comment on this proposal to recover its costs from those selling both specification and non-specification gas.

5. Relating costs to activities

Distinguishing wholesale and retail activities

The Government Policy Statement sets specific targets for the GIC for 2005, with an emphasis on the development of wholesale and retail markets and consumer protection. After initial rules are defined this year, the GIC role may move more towards enforcement, with occasional efforts to refine rules.

[12] 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.

[13] e.g. Waihapa to TCC and New Plymouth. Kapuni to Fonterra at Hawera.

For the initial levies, the GIC estimates that half of its expected costs should be attributed to wholesale market enhancement and half to promotion of retail market mechanisms and consumer protection. The consequences of this choice will become apparent in the discussion below of who to collect the levy from. The levy is to be reviewed annually and the allocation can be adjusted as activities evolve.

The GIC seeks comment on initial attributions of costs.

6. Proposed levy bases and collection points

Wholesale

Where benefits are gained in proportion to consumption, the GIC considers a uniform cents per GJ levy is required. The GIC is of the view that costs related to wholesale market enhancement should be recovered in this way.

Given that the incidence of the levy is largely independent of where it is collected and outside GIC control, the GIC's focus has been to find the most cost effective collection option. This appears to be to collect the levy from owners of gas at offtake points from the Maui and NGC transmission grids, and from other transmission pipelines. The intention is that this will cover all suppliers to generators, major users and retailers.

The GIC proposes that the wholesale levy is determined monthly, with a penalty for late payment. The GIC also proposes the levy regulations will provide it with the right to obtain verification of the relevant amounts of gas from the transmission system operator – if there is one – or otherwise by some other independent means. It is proposed the first wholesale levy accrue on 30 June 2005 with payment by or on 20 July 2005.

Retail

As discussed above, the costs of promoting retail market mechanisms and consumer protection are more attributable to smaller users, so some degree of differentiation may be warranted in the levies that recover this portion of the GIC's costs. The simplest approach is to recover retail-related costs from retailers in respect of their sales to small users below 10 TJ pa.

Because some of the complexities of retail switching mechanisms are required only to deal with the relatively large number of very small users (households and small commercial enterprises), suppliers to smaller users could be levied more per GJ than those supplying larger users. This could also be achieved through per customer charges that are higher for suppliers to larger customers, but not in proportion to consumption. Both of these approaches would require aggregate data about customer numbers and sales volumes in consumption bands for each retailer.[14]

The GIC understands network owners know the numbers of connections associated with each retailer and tend to apply some variable charges to retailers according to consumption classes. These categorizations are not standardized across networks so some reworking would be required to match new levy classes.

Another possibility would be to rely on information from the allocation agent who reconciles volumes at shared offtake points on the transmission network.

However, in the absence of such centrally collected information about retailer customer distributions, the GIC proposes to adopt for the first year levy a simple approach and recover retail-related costs using a cents/GJ levy on retailers based on their sales to small (<10 TJ pa) users.

The GIC also proposes the retail levy is determined monthly, with a penalty for late payment. The GIC will propose the regulations incorporate a method of verifying the relevant volumes of gas. It is proposed the first retail levy accrue on 30 June 2005 with payment to be made by or on 20 July 2005.

The GIC seeks comment on the practicality of levying retailers on the basis of sales to small (<10TJ pa) users. Comment is also sought on the points of application of the levy and means of verification.

7. Indicative levies

Levy options are clearer with actual dollar values. The following estimates are based on the GIC's preliminary budgeted costs of $3.6m[15] and the 50/50 attribution of this cost to wholesale and retail competition enhancements. The levies would therefore be set to recover $1.8m from each area.

Wholesale

$1.8m would be recovered with a 1.5 c/GJ levy on all owners of gas at transmission grid offtake points.[16] The levy would effectively be shared between suppliers and users depending on users' demand responses.[17] This levy would effectively raise:

---

[14] The consumption bands would include at least households and the smallest commercial users up to 250 GJ pa, and other small (commercial & industrial) users up to 10 TJ pa.

[15] Including the partial recovery of costs incurred since 22 December 2004, which will be recovered over a two year period.

[16] It is assumed total gas use is around 120 PJ pa

[17] The supplier of a major primary processor using 6 PJ of gas per year would face a levy of $90,000. This would be only about 0.15% of the supplier's revenue from that user, or of the user's gas bill, but if the user were regarded as likely to cease gas consumption as a result of the

- 6% of the $1.8m from sales to households;[18]
- 7% from sales to small industrial & commercial users;[19] and
- 87% from sales to major users (including generators and co-generators).

Retail

The other $1.8m would be recovered from suppliers in a number of ways. With an estimated 235,000 small gas consumers using 15 PJ pa of gas, the obvious choices are $7.66 pa per customer or 12c/GJ on retailers on sales to small (<10 TJ pa) users.

Within this group, households account for about half the volume but practically all the connections. The per customer levy would attribute most of the $1.8 million cost to retailers serving these smallest users.

If user consumption classes were accurately known, it would be possible to tailor different levies for sales to small customers in different consumption bands and get an intermediate allocation. But since the aggregate amounts per retailer are small, since retailers' small customer distributions are probably fairly similar, and since it is not clear if and how levies will be passed on to consumers, the GIC considers that the 12c/GJ option is preferable. This levy would be expected to raise:

- 47% of the second $1.8m from retailers on sales to households; and
- 53% from sales to small industrial & commercial users.

Retail sales to an average household consuming 25 GJ pa will be levied $3, and sales to the average 1 TJ pa small industrial & commercial user, $120.

The GIC seeks comment on the balance between fairness and practicality in finding a levy mechanism. Comment is also sought on the wholesale/retail split in characterising the GIC's activities, the cost shares proposed, and the relativity between residential, small industrial & commercial, and major user contributions.

levy – either by switching fuels or switching countries – then in this case, the supplier would be unable to pass on the levy.

[18] Residential sales are around 7 PJ pa.

[19] Small industrial and commercial sales are around 8 PJ pa.

8. Revenue variability

As mentioned earlier, the legislation requires that the levy be reviewed each year. Such reviews will be necessary to account for changes in expected aggregate gas sales. Such shifts in offtakes could be considerable, with Methanex gas use being potentially quite variable and the precise timing of new gas production being somewhat unpredictable. Hence, per GJ levies may need to be adjusted from time to time to meet the GIC funding requirement. Similarly, as customer numbers fluctuate, any per customer charge may need to be varied.

9. Consultation

The GIC invites you to comment on this proposal, the wholesale/retail split in characterising the GIC's likely activities, the cost shares proposed, the collection method, and any other issue raised by the paper. Please send your comments by Friday, 15 April to:

The Secretariat
Gas Industry Company Limited
P O Box 10 646
WELLINGTON.

Attention: Richard Longman

or email richard.longman@gasindustry.co.nz