GAS INDUSTRY COMPANY LIMITED

LEVY DISCUSSION PAPER

February 2006

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2006/07 LEVY DISCUSSION PAPER

1 Executive Summary

The Gas Act provides for the Gas Industry Company Limited (Gas Industry Co) to recover its costs through levies on industry participants. Such levies are to be struck each year. This consultation document:

- reviews last year's levy development process;
- addresses the general principles of setting levies;
- discusses outstanding and new issues pertinent to the 2006/07 levy;
- describes the work which the Gas Industry Co will undertake in the 2006/07 year; and
- proposes levy options for the 2006/07 levy.

All proposed levy options are intended to recover the Company's budgeted revenue requirement of $3.8m (see Section 7.5). This is very similar to the revenue which will be collected through this year's levy but, since the delivered volumes are predicted to fall, the per GJ levy rate will increase.

Levy Option 1 is a pragmatic option which gives weight to administrative simplicity and low year-on-year volatility. It proposes that the retail levy be left unchanged and that the balance of the required revenue be recovered through the wholesale levy. Taking the forecast volume changes into account, this leads to an increase in the wholesale levy from 1.5 cents/GJ to 1.74 cents/GJ.

Options 2, 3 and 4 use the same cost allocation methodology as was used last year to set the existing levy. This methodology involves allocating the directly attributable costs to each of the wholesale and retail work programmes and equally sharing all other costs between those programmes.

Applying this cost allocation methodology to the 2006/07 budget projections produces a greater shift in the balance of costs between retail and wholesale than Option 1. Compared to the current year, the retail cost allocation reduces from $1.8m to $1.6m (an 11% reduction), and the wholesale cost allocation increases from $1.8m to $2.2m (a 22% increase).[1]

Where Options 2, 3 and 4 differ is in the way the retail levies are set. Option 2 proposes that the current arrangement - where half the allocated cost is recovered on a per GJ levy and half on a per ICP levy - is retained. Option 3 proposes that the allocated cost is recovered from a single per GJ levy. Option 4 proposes that the allocated cost is recovered from two levies – a Residential per GJ levy and a Commercial per GJ levy.

Note that the projected GJ and ICP numbers for the 2007-08 year used in levy calculations are estimates. The Gas Industry Co is currently seeking new volume estimates from participants. These may alter the final calculations.

[1] The comparable figures for Option I are that the retail cost allocation remains at $1.8m, and the wholesale cost allocation increases from $1.8m to $2.0 (an 11% increase).

2 Recommendation

Having considered the issues, but at this stage without the benefit of submissions from interested parties, the Gas Industry Co's view is that Option 1 should be adopted. It involves leaving the Retail levy at its current level of 6 cents/GJ and $4/ICP, but increasing the Wholesale levy from 1.5 cents/GJ to 1.74 cents/GJ. This increase is partly due to increased costs and partly due to reduced wholesale volumes.

Although this option does not rigorously follow the cost allocation approach which was used last year, it is pragmatic. It recognises that there is still a degree of uncertainty around the work programme and costs, but allows the increased cost of the wholesale work programme and reduced wholesale volumes to be reflected in an increased wholesale levy.

3 Introduction and call for submissions

Comment is invited on the levy options and various other aspects of this paper. For convenience the matters on which we are seeking comment are listed below:

1. The appropriateness of the levy setting principles set out in Section 5;
2. Any other matter which should be considered in recommending appropriate levies;
3. Whether your organisation would support a move from the current <u>annual</u> levy determination, to a <u>two year</u> levy determination period as discussed in Section 6.1;
4. The conclusions in relation to the retail levy fixed/variable split as set out in Section 6.2;
5. Any thoughts on how the structure of the retail levy might be improved, given the benefit of experience since its implementation;
6. The theoretical suitability of the suggested "no-step" retail levy function discussed in Section 6.3;
7. The practicality of introducing a "no-step" retail levy function;
8. The time required for retailers to provide a distribution of end user consumption information for the previous gas year to the Gas Industry Co if a "no-step" retail levy function were to be introduced;
9. Any other alternatives which may be more appropriate than the "no-step" function suggested in Section 6.3;
10. Whether basing the levy on historic GJ and ICP data, as discussed in Section 6.4, is a significant issue;
11. Whether you would support a move to using more recent reference quantities;
12. Any other ways you would support to address the timing issue;
13. Which, of Section 8 Options 1, 2, 3 or 4 you prefer;
14. Why you prefer that Option;
15. Whether there are any other options that you think the Gas Industry Co should be considering.

Following consultation the Gas Industry Co will issue a final Levy Discussion Paper which will summarise the submissions, review the information and set out a final levy structure. The levy recommendation will then be sent to the Minister with a view to Levy Regulations being given effect before the start of the 2006/07 financial year.

Gas Industry Co invites submission on the proposal by **5pm** on **17 March 2005**. Please note that submissions received after this date may not be able to be considered.

The Gas Industry Co's preference is to receive submissions in electronic form (Microsoft Word format and pdf) and to receive one hard copy of the electronic version. The electronic version should be emailed with the phrase "Submission on Gas Levy Proposal" in the subject header to info@gasindustry.co.nz, and one hard copy of the submission should be posted to the address below:

Ian Wilson
Gas Industry Co
PO Box 10-646
Wellington

The Gas Industry Co prefers to undertake its functions with a high degree of transparency. Accordingly, please be aware that any information provided to the Company may be discussed with, or provided to, other parties UNLESS you specify that information is provided to the Company as 'Commercial in Confidence', in which case you should specify the information that is confidential and the reasons.

Submissions will be published on the Gas Industry Co website.

4 Review of 2005/06 Levy Development

By Order in Council dated 18 July 2005, the Gas (Levy of Industry Participants) Regulations 2005 were passed into law and came into effect 28 days later. The process which led to this outcome involved:

- Gas Industry Co working with economic consultants (Castalia) and an industry advisory group to develop a discussion document;
- interested parties commenting on the discussion document;
- consultation on the issues raised;
- further work by Gas Industry Co and its advisors to develop a levy proposal;
- presentation of the levy proposal to interested parties;
- interested parties commenting on the proposal;
- further consultation on the issues raised;
- Gas Industry Co finalising the levy proposal and working with officials to develop draft Regulations;
- Gas Industry Co submitting the levy recommendation to the Minister for approval;
- The Minister granting approval and submitting the Regulations to Cabinet for approval; and
- Gazetting of the Regulations following Cabinet approval.

This process extended over <u>eight months</u>. The final form of levy for the 12 month period from 30 June to 1 July 2005 was:

Wholesale Gas Levy

1.5c/GJ payable by purchasers on all gas purchased from producers.

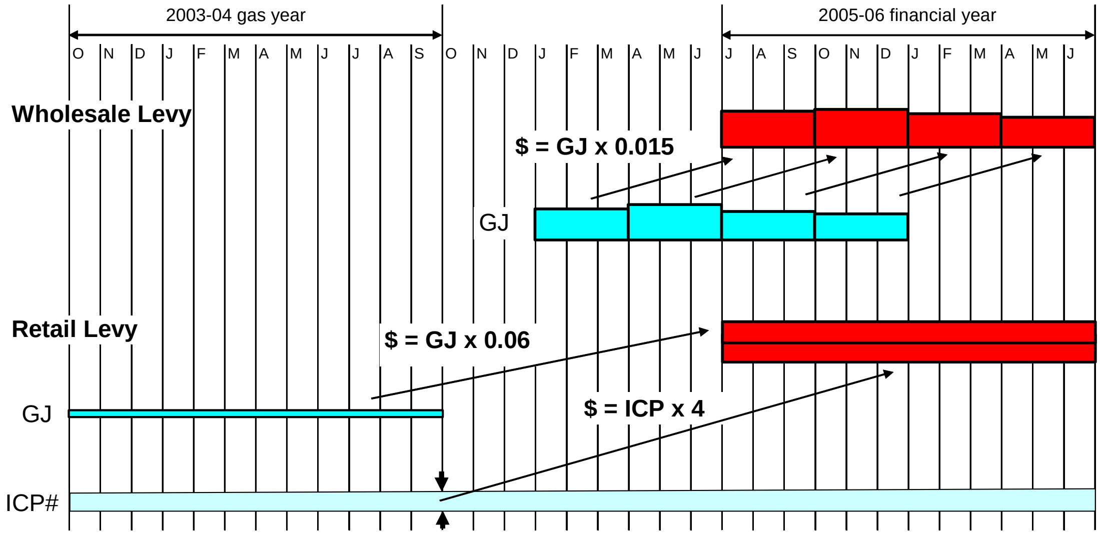
Retail Gas Levy

6c/GJ and $4/ICP payable by retailers on all gas supplied to customers taking < 10TJ/annum.

The amount of wholesale levy payable by each contributor is calculated each quarter based on quantities of gas purchased in “the quarter before the last completed quarter” (ie Q3 payments are calculated using Q1 wholesale gas purchases, Q4 using Q2 and so on). The total amount payable in each quarter is collected in equal monthly payments.

The amount of retail levy payable by each contributor is calculated as an annual amount and collected in equal monthly payments. The GJ amounts are the quantities of gas supplied by retailers in the previous gas (October) year. The ICP numbers are those attributable to each retailer at the end of the previous gas year.

These levy arrangements are illustrated below.



It was anticipated that levies would raise $3.6m in the 2005-06 financial year, half from the wholesale levy and half from the retail levy. From the illustration it might be thought that all of the information necessary to determine exactly how much revenue will be obtained in the 2005-06 financial year is available now. However, while this is true of revenue from the retail levy, we are dependent on GJ information from the parties paying the wholesale levy before the final quarter's revenue can be determined. This information is not provided until the due date for the first payment in that quarter.

Since the wholesale quantities for the months of October, November and December 05 will not be advised until April 06, there will be some uncertainty of the total amount of levy revenue until that time.

Subject to the uncertainty discussed above, we expect the total levy revenue to be slightly more than the $3.6m budgeted.

5 Principles of Levy Setting

In its consultation paper "Consultation Regarding Levy of Industry Participants under Section 172ZC of the Electricity Amendment Act 2001" the Ministry of Economic Development has set out the principles it believes are appropriate to an overall levy structure. Although these were applied in the context of the electricity market, the principles are general to the setting of levies and can be reasonably adopted for our purposes. The principles are:

Economic efficiency:

- the levy structure should promote efficient market behaviour (or at least not materially detract from it).

User/causer pays:

- where the causes of the costs of providing certain services are identifiable, levies should be structured on a causer pays basis.

Rationality:

- where levies are to recover costs that are allocated to participants or participant classes, there should be a relatively strong logical nexus between the participants to whom a levy is imposed and the costs being recovered through that levy.

Simplicity:

- the levy structure should not create undue transactions costs for the Commission [/organisation], which implements and administers it, or for the participants who must pay it;
- the levy structure should consist of as many individual levies as necessary to recover the costs in an efficient manner taking account of all other criteria; and
- the fee structures should be transparent to industry participants.

Equity:

- users in similar situations should pay similar amounts; and
- competitive neutrality should be preserved. Within a class of participants the allocation of costs should not competitively advantage one participant over another.

Comprehensiveness/revenue sufficiency:

- the levies (together with other sources of revenue, such as penalty payments) need to be sufficient to recover the costs borne by the Commission [/organisation].

These principles neatly capture the essential elements of the Treasury Guidelines[2], Audit Office Guidelines[3] and Standing Order 382, in respect of the setting of levies.

[2] Treasury Guidelines for Setting Charges in the Public Sector, December 2002
[3] Guidelines on Costing and Charging Public Sector Goods and Services, May 1989

The Treasury Guidelines promote equity, efficiency and cost minimisation by helping to identify the relevant economic considerations. They set out a framework for evaluating charging options.

The Audit Office Guidelines are intended to assist in identifying the preferred user charge option. They provide a checklist of issues on which to base a sound analysis and range of charging options. Like the Treasury Guidelines, they encourage the efficient allocation of resources and minimising the cost of supply and transactions, and dealing equitably with those who benefit from the output and/or those whose actions give rise to it. They also promote stakeholder consultation and participation in the charge review process wherever possible.

Standing Order 382 provides that a Committee (such as the Regulations Review Committee) should draw the attention of the House to where it considers that a Regulation:

a. is not in accordance with the general objects and intentions of the statue under which it was made;

b. trespasses unduly on personal rights and liberties;

c. appears to make some unusual or unexpected use of the powers conferred by the statute under which it is made;

d. unduly makes the rights and liberties of persons dependent upon administrative decisions which are not subject to review on their merits by a judicial or other independent tribunal;

e. excludes the jurisdiction of the courts without explicit authorisation in the enabling statute;

f. contains matter more appropriate for parliamentary enactment;

g. is retrospective where this is not expressly authorised by the empowering statue:

h. was not made in compliance with particular notice and consultation procedures prescribed by statute;

i. for any other reason concerning its form or purport, calls for elucidation.

Last year a number of submissions referred to one or more of these documents in critiquing the Gas Industry Co's levy proposal. In particular, one noted that Section 6 of the Treasury Guidelines states that: "The integrity of charging practices is underpinned by the robustness of cost recognition and allocation methodologies…". And, similarly, the Audit Guidelines state that: "A separate charge must be calculated for each output produced by an organisation. If the costs of a service are recovered directly from consumers, the outputs should be identified at a low level."

One submission also noted that section 2.5 of the Audit Guidelines states that: "Indirect costs should be allocated to outputs based on the extent to which the indirect cost contributes to, or was caused by, the output", but that "Where a beneficial or causal relationship is not readily identifiable … the costs should be allocated systematically among the outputs." The submission proposed that the Gas Industry Co might be open to criticism for not disclosing sufficient information to allow the proper assessment of these criteria.

To address these matters the Gas Industry Co has included budgeted costs of the various workstreams, and of common costs, in this document.

Another matter raised in submissions related to the need to be transparent about any cross-subsidies that may exist. It was noted that the Regulations Review Committee has previously pointed out that: "Any cross-subsidisation in the provision of particular services should be authorised by primary legislation [which is not the case here] and be transparent: cross-subsidisation that is not transparent may be inequitable and unfair." Matters of possible cross-subsidisation are discussed where they arise, in particular where the options for avoiding a step change between the levies attributable to <10TJ and >10TJ end users.

In its considerations, the Gas Industry Co is also very aware of a number of informal comments received from retailers and consumers expressing concern about year on year volatility. Change brings with it costs associated with the need to amend systems and contracts and to understand and explain what the change is and why it is necessary. Some judgement must be exercised to ensure that the solution is not "overcooked".

Gas Industry Co invites comments on:

1. The appropriateness of the principles set out above; and
2. Any other matter which should be considered in recommending appropriate levies.

6 Outstanding and New Issues

6.1 Annual levy review process and volatility

The levy is a very small component of the price of delivered gas. It might therefore be thought that an annual adjustment to the levy would not be too disruptive since it would have a minimal effect on the price. However, a number of submissions received last year pointed out that any change to the levy or volatility of the levy was of real concern to participants. The levy change process is costly. It consumes time and resources which could be used more productively. This is particularly true when the size and significance of any change is minor.

Consider what is involved in the levy change process:

a) Preparation of levy discussion paper

The Gas Industry Co must use its own staff or external consultants to prepare a levy discussion paper. Allowing for briefing, preparation, staff review and board consideration, this would cost of the order of $30,000.

b) Promulgation and presentation of the discussion paper

The Gas Industry Co will hold a forum to present the paper to interested parties. It will also visit parties most likely to be affected by levy changes to explain why the changes are necessary and how it will affect them. Assuming attendance of, say, 15 people at a 4 hour forum, and 4 visits to affected parties, this will cost around $10,000.

c) Consideration of paper and preparation of submissions

Some participants will need to prepare submissions on the paper which will require consideration and sign-off within their organisations. Suppose that in total 20 representatives read this paper (2 hours) and that 10 of them prepare submissions (6 hours) and that these are considered by 10 more senior managers (1 hour). This could also cost in the order of $10,000.

d) Consideration of submission and reaching a final determination

On receiving submissions the Gas Industry Co will read them, collate them, seek legal opinion if required, prepare recommendations to its board and arrive at a final determination (assuming that none of the issues raised are of sufficient magnitude to justify a second round of consultation). The cost of this is estimated at a further $20,000.

e) Preparing and issuing a final determination and briefing papers

Once a determination is reached, the justification will be set out in a final determination. Government officials will be then be briefed on the changes which are necessary to the Levy Regulations. The cost of this is estimated at $5,000.

f) Producing and promulgating Regulations

There is quite an involved process involving various Government departments and committees. The cost of this is unknown.

g) Effecting changes in customer accounts

The parties responsible for paying the levy may choose not to pass on any changes, but, assuming that they do, alterations to customer accounts will be required together with some explanation of why the changes were necessary and what their effect will be. The cost is estimated at $20,000.

So, rather conservatively we believe, the annual opportunity cost of changing the levy is of the order of $100,000. It could be considerably more if a second round of consultation is justified. The time and resources spent on this could be very usefully redirected to the Gas Industry Co work programme.

Section 43 ZZE (3) of the Gas Act 1992 states that the levy regulation must apply only to the financial year in respect of which the levy regulations are made.

For the reasons discussed above, and considering the uncertainty around the exact timing and content of the Work Programme (see Section 7), the Gas Industry Co wishes to canvas views on the possibility of moving to a two yearly levy determination. If this proposal were to receive wide support from the industry, Gas Industry Co would discuss with officials what legislative changes would be required, if any, and whether any changes need to made to the Company's existing budgeting processes to provided sufficient fiscal assurance for a multi-year levy.

If a two year levy determination period were adopted, the earliest it would be introduced would be for the 2007/08 financial year. In other words the levy struck for the 2006/07 financial year would continue, without adjustment, through the 2007/08 financial year.

Gas Industry Co invites comments on:

3. Whether your organisation would support a move from the current annual levy determination, to a two year levy determination period.

6.2 Retail Levy fixed/variable split

One matter which was extensively discussed last year was to what extent the retail levy should be recovered as a fixed charge per customer (a per ICP basis) or on a variable charge based on consumption (a per GJ basis). If the levy is applied solely by ICP it will be a fixed amount for each customer regardless of how much gas that customer uses. If it is applied on a per GJ basis, the amount payable in respect of each customer will be proportional to the amount of gas that customer uses.

Of course, it is not the customer who pays the levy in the first instance, but there is a presumption that the structure of the charges will be reflected through to the customer. If this was not so, a retailer would be exposed to its competitors. Imagine that a retailer recovered a variable cost as a fixed charge across all its customers. Then that retailer's low usage customers would be cross-subsidising its high usage customers. In that case the retailer's competitors should see an opportunity to offer these customers a lower price more closely reflecting the true (variable) cost. So cross-subsidy should be driven out of a very competitive market.

Given the Government's keen interest in the level of fixed charges faced by customers, and the experience we now have of how the levies are being passed through to customers, it is worth revisiting this issue.

The Gas Industry Co's first (24 March 2005) levy discussion paper proposed a fully variable retail levy of 12 cents/GJ. Most submitters believed that a per ICP charge would be more appropriate:

- NGC suggested that an ICP based levy would give the Gas Industry Co greater control over which customer class pays the levy.
- Contact Energy, after consideration of the incidence of benefits and cost causation, concluded that a per ICP charge was more equitable. It noted that this was how the Electricity Commission recovered its costs[4].
- MRP considered that a retail levy calculated on a per ICP basis would be the most administratively efficient approach.
- Wanganui Gas believed that a per ICP levy was preferable from the viewpoint of simplicity, equity, gas competitiveness and ease of verification.
- The Major Electricity Users Group suggested that retail switching mechanism costs were independent of volume and that a volume charge would lead to larger consumers subsidising smaller consumers.

Others who commented on the retail levy were either supportive of the fully variable rate or neutral:

- Powerco believed that to apply the retail levy on a per GJ basis was the pragmatic decision but suggested that very small consumers should be excluded.
- Vector, while generally supporting the fully variable retail levy proposal, did cite a number of Australian examples (GMCo, REMCO and Vencorp) where some proportion of the charges were fixed by participant rather than being volume based.
- Genesis Energy believed the levy is too small in percentage terms to distort the market for gas.

Consumer advocates had no view on this matter.

On consideration of the submissions the Gas Industry Co decided that a 50/50 fixed/variable split of the retail levy was most appropriate. This was the position set out in the second levy discussion paper (22 April 2005). Of the submissions received on that paper a few still thought the compromise did not go far enough. The Major Electricity Users Group considered the proposal would still lead to larger households and commercial gas consumers subsidising small gas consumers. And MRP remained convinced that a per ICP retail levy remained the most administratively efficient.

How should we determine if levies should be fixed (per ICP) or variable (per GJ)? Broadly there are two ways of looking at the issue. One is to consider to what extent costs are influenced by either ICP numbers or volumes. The other is to consider whether the benefits that arise from the costs are shared equally across all ICPs or are proportional to volume. Regrettably neither approach provides a clear answer, hence the wide diversity of views on the matter.

[4] The Electricity Commission's Registry and Switching Levy is on a per ICP basis, but all its other levies are per MWhr.

As an example, take the work which is being done on the development of a registry. The registry is a database of all ICPs which records information such as who the retailier is at any time and when the customer switches from one retailer to another. From a cost point of view, the cost of developing a registry is not correlated with either the number of ICPs that the registry will contain or the volume of gas delivered to those ICPs. Rather it is related to the functionality which the software is required to provide. So this approach does not lead to a clear answer.

Now, looking at this example from a benefits point of view, it can be said that efficient registry arrangements will reduce transaction (switch) costs and facilitate retail competition. Reduced transaction costs do not relate directly to volume. However, the benefit of the improved competition should lower per GJ prices and is, therefore, related to volume. So this approach does not lead to a clear answer either.

Even where it is clear that the benefit of a particular activity accrues to each customer, independent of whether they are small or large, it does not necessarily follow that those customers will put the same value on that benefit. For example, it could be argued that each user will benefit from the availability of a model contract, regardless of whether that user is small or large. However, these users might value that benefit in relation to their overall bills. A $300/year residential customer may value a model contract at $3 while a $100/year customer may value the same benefit at $1. Each thinks of the benefit in relation to the size of their consumption. So what appears to be a per ICP benefit is in fact a volume related benefit.

The analysis is also complicated to some extent because the Gas Industry Co's retail activity comprises several different workstreams. Broadly these are:

- Switching and Registry;
- Compliance and Enforcement;
- Reconciliation;
- Consumer Issues; and
- Distribution Contracts.

The incidence of costs and benefits between these workstreams is not necessarily similar.

A further aspect to this debate is whether it matters how the levies are being passed through to the end users. It was mentioned above that in a very competitive market it would be expected that fixed costs would be passed through as fixed charges; otherwise cross-subsidies would exist. When the levies were set last year this was not a matter which was discussed. However, now there is some evidence of how the tariff is being passed through to end users we can look at the matter.

Appendix A reviews how the wholesale and retail levies are being passed on by the parties who are responsible for paying them in the first instance. It is clear from this that there is no consistency in the way, and the extent to which, the costs are being passed through. In most cases the per ICP component of the retail levy is being passed through to end users on a per GJ basis.

It could be argued that it doesn't matter how the costs are being passed through to end users. After all, the behaviour of the users will not affect the costs. For example, if the levies were passed through to end users as fully fixed per ICP charges, some may decide to stop using gas. But this reduction in ICP numbers would not affect the costs. Similarly, if the levies were passed though to end users as fully variable per GJ charges, some may decide that the cost is so significant that they reduce their consumption. But this reduction in GJ usage would not affect the costs either.

From the above discussion a number of conclusions may be drawn:

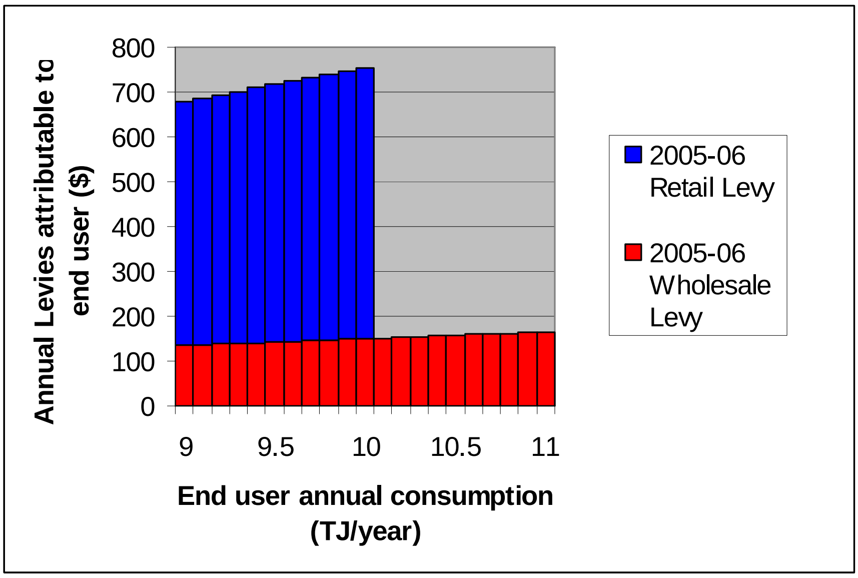
1. There is no clear cut case that either the costs or benefits of the Gas Industry Co's retail activities relate to ICP numbers or to the volumes of gas used. However, at a high level it might be assumed that the benefits will be reflected in improved competition and lower per GJ prices.
2. Because neither the per ICP nor the per GJ approach is theoretically correct, more emphasis should be given to adopting the most administratively simple (lowest transaction cost) solution. This was a conclusion reached by some submitters last year.
3. The levies are set to recover costs, not to influence end-user behaviour. So it does not matter how parties pass on the levies. (Assuming that the market is sufficiently competitive to ensure efficient prices.)
4. The quantum of the levy in relation to other components of the total price is so small as to render differences in charging methods virtually meaningless to end users. Average gas prices vary widely depending on customer size and location, but an average residential customer is likely to pay more than $25/GJ. The average residential levy component is of the order of $0.2/GJ, or less than 1% of the price.

Gas Industry Co invites comments on:

4. The conclusions set out above; and
5. Any thoughts on how the structure of the retail levy might be improved, given the benefit of experience since its implementation.

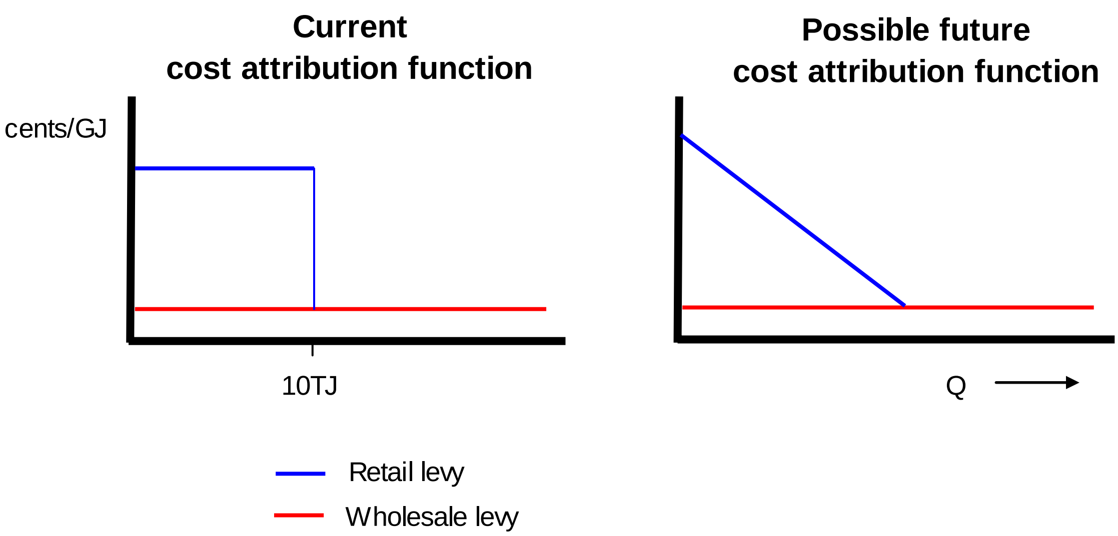
6.3 10TJ limit to Retail Levy

Several submitters last year drew attention to the apparent unfairness caused by the retail levy only applying in respect of end users taking less that 10TJ of gas per year. In the 2005-06 year, the amount of retail levy attributable to a 10TJ/year user was $4 + 10,000 GJ × $0.06/GJ = $604. The amount of retail levy attributable to a user taking slightly more than 10TJ/year would be nil. This anomaly is illustrated in the diagram below. It shows the total amount of levy, both wholesale and retail, which could be considered to be attributable to a particular end user.



How can this 10TJ anomaly be addressed? If we accept the principle that costs should be attributed to the parties giving rise to them then it does seem appropriate that the cost of the retail activities (switching and registry etc.) are attributed to the "mass market". This is because the costs arise from the complexity of handling large quantities of data efficiently. If there were only a few hundred large end users, the switching and reconciliation functionality could probably be provided at lower cost by using a few analysts working with spreadsheets. However, there comes a point when this approach is no longer viable. It is certainly not viable for 240,000 end users.

So there is some amount of "retail" cost to be allocated to the "mass market" and other costs which are legitimately shared by all customers. Can this be done by some cost allocation function which avoids the kind of saw-tooth anomaly exhibited by the current levy arrangements? Yes it can. In fact it is quite simple to draw the kind of function which would achieve this:



However, although the function is easy to draw and describe in words, the function may be quite difficult for retailers to apply. It might look something like:

Retail Gas Levy

Max(0, (15,000 – Q)) x 0.001 c/GJ calculated for each ICP, where Q = annual consumption at that ICP in GJ/annum.

Notice that with the current retail levy, all that the retailer needs to know to calculate the amount of levy due is the total quantity of gas sold to all <10TJ customers in the previous gas year, and the number of ICPs supplied at the end of that year. With the possible future “no step” retail levy, the retailer would have to calculate the levy attributable to each individual end user and sum them all up to determine the total amount of levy due. This might be quite administratively burdensome.

Since the effect of the function is to move the cost burden to smaller users, it is likely that it would need to extend beyond the 10TJ limit to avoid too high a burden on small users. In the sample tariff shown the function extends to 15TJ/annum users.

Another difficulty with the approach is that the Gas Industry Co would need to have much more detailed information about the distribution of end user consumption before it could accurately predict the amount of revenue the “no step” levy would generate.

Gas Industry Co invites comments on:

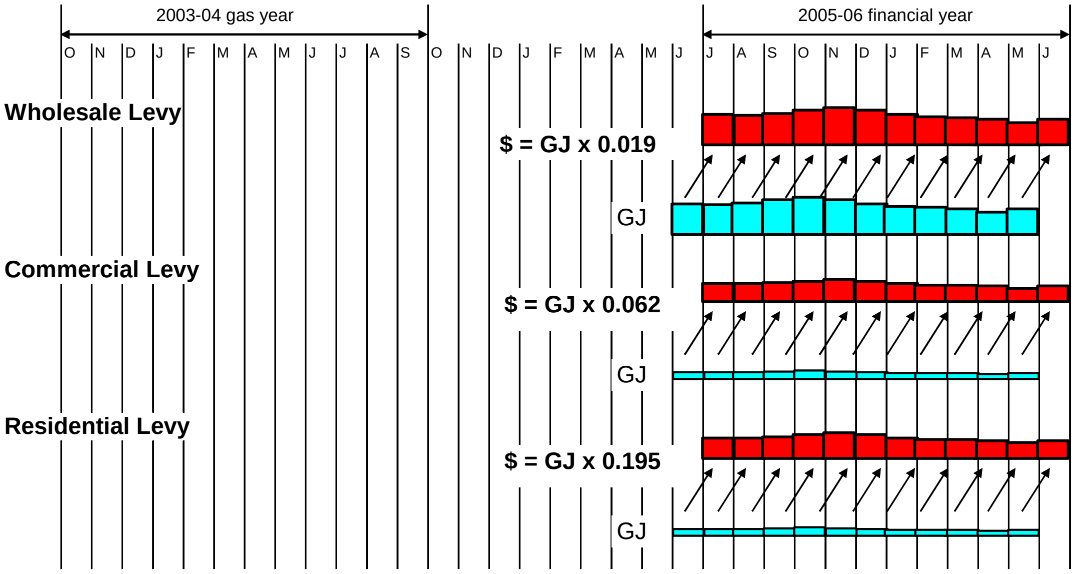
6. The theoretical suitability of the suggested “no-step” retail levy function;
7. The practicality of introducing a “no-step” retail levy function;
8. The time required for retailers to provide a distribution of end user consumption information for the previous gas year to the Gas Industry Co; and
9. Any other alternatives which may be more appropriate than the “no-step” function suggested.

6.4 Reference quantities

As discussed in the Review of 2005-06 Levy Development section, the current allocation base (ie the GJ’s and ICP numbers on which the levy was based) is historic. The wholesale levy is calculated each quarter based on quantities of gas purchased in “the quarter before the last completed quarter”. The retail levy is calculated based on quantity of gas sold to <10TJ end users in the previous gas (October) year and the number of ICPs at the end of the previous gas year.

This lag, between the levy allocation numbers and the actual GJs and ICP numbers relevant to the particular billing period in which the levy is being passed through to end users, may become an issue. One situation which might arise is where one retailer loses a substantial market share to another retailer. In that circumstance the losing retailer would complain about an unfair burden of levy which related to past sales and did not equitably reflect its current customer base.

Is there a simple way of avoiding the kind of situation described above? The ideal outcome would be if the application of the levy was based on current GJ and ICP information. That way the incidence of the levy would match the customer base against which the retailer is recovering the levy. This approach is illustrated below using Option 4 levies as an example, although it could equally be applied to the other Options.



This diagram should be compared to the diagram in the Review of 2005-06 Levy Development section which illustrates how the current levy was calculated.

Adopting this "most recent data" approach has some disadvantages. These are:

- There is much greater uncertainty for the Gas Industry Co in the relation to the quantum and timing of its levy revenue. In effect, it is subject to the same weather and market volatility that the retailer faces.
- Historic data is relatively stable. The most recent data is more likely to be subject to correction in the next month.
- The Gas Industry Co's monthly levy invoice could only be calculated after all other gas transactions have been invoiced (or at least when the data for those transactions has been prepared).

Gas Industry Co invites comments on:

10. Whether basing the levy on historic GJ and ICP data is a significant issue;
11. Whether you would support a move to using more recent reference quantities; and
12. Any other ways you would support to address the timing issue.

7 Gas Industry Co 2006/07 Work Programme and Budget

7.1 Mandate for Work Programme

New Zealand's gas sector is governed by a co-regulatory governance arrangement. Co-regulation entails an industry body, the Gas Industry Co, which has standing to recommend non-regulatory arrangements, rules or regulations on a number of gas matters to the Minister of Energy.

The co-regulatory regime for gas has a number of similarities with more traditional regulatory regimes, but also some important differences. Key features of the regime are:

- The Minister is restricted in what regulations or rules he/she can make in a number of areas without first having a recommendation from the industry body, or at least providing a reasonable opportunity for the industry body to make a recommendation;
- The Minister can accept or reject a recommendation;
- The industry body can recommend regulations/rules or non-regulatory arrangements where these are the most practicable option;
- There is an expectation of input from industry participants to the development of arrangements through working groups and consultation processes;
- The industry body is a private company; and
- Directors of the industry body, the majority of whom are independent, are appointed by industry voting.

The Gas Industry Co was formed to act as the co-regulatory partner to the Government to oversee the development of the gas industry and, in particular, to establish arrangements and rules for the operation of gas markets, and to administer, monitor compliance with, and enforce rules. The Gas Industry Co is an industry-owned entity, which was incorporated in July 2004 and approved as the industry body by order in council on 22 December 2004.

The combination of the Gas Act, any Gas Policy Statement (GPS) which the Minister may issue from time to time, and the Constitution of the Gas Industry Co provide the framework within which the Gas Industry Co is required to operate in developing gas market arrangements. They set out a clear role that involves leadership for the gas sector in developing pan-industry arrangements in areas where a common approach to certain issues is more efficient, and more readily facilitates achieving government objectives for the sector.

7.2 Government Policy Statement on Gas Governance

In October 2004, the Government issued a GPS on Gas Governance, which replaced the previous Statement and provided for:

Wholesale Markets and Processing

- *The development of protocols and standards applying to wholesale gas trading, including quality standards, balancing and reconciliation;*
- *The development of a secondary market for the trading of excess and shortfall quantities of gas;*
- *The development of a secondary market for the trading of excess and shortfall quantities of gas;*
- *The development of capacity trading arrangements;*
- *Protocols that set reasonable terms and conditions for access to gas processing facilities.*

Transmission and Distribution Networks

- *The establishment of an open access regime across transmission pipelines so that gas market participants can access transmission pipelines on reasonable terms and conditions;*
- *The establishment of consistent standards and protocols across distribution pipelines so that gas market participants can access distribution pipelines on reasonable terms and conditions;*
- *The establishment of gas flow measurement arrangements to enable effective control and management of gas.*

Retail and Consumer Arrangements

- *The standardisation and upgrading of protocols relating to customer switching, so that barriers to customer switching are minimised;*
- *The development of efficient and effective arrangements for the proper handling of consumer complaints;*
- *The development of model contract terms and conditions between consumers and retailers.*

7.3 Role of Gas Industry Co

The Gas Industry Co is charged with the task of developing pan-industry arrangements governing the gas industry.

To meet these objectives, the Gas Industry Co has the following tools available:

Power	Description
Recommend Governance Regulations & Rules	• The Gas Industry Co's present role is principally to recommend gas governance regulations and rules, in relation to pan-industry arrangements, to the Minister. • In certain areas, including wholesale markets, transmission and distribution networks, regulations and rules cannot be made by the Government except in accordance with a recommendation of Gas Industry Co.
Industry Arrangements	• The Gas Industry Co could develop pan-industry arrangements (not supported by rules or regulations), subject to the terms of its constitution and to any necessary approvals of the Commerce Commission under the restrictive trade practices provisions of the Commerce Act, without being required to obtain Government approval.
Reports to the Minister	Section 43ZL(2)(f) of the Gas Act requires Gas Industry Co to report regularly to the Minister on: • the performance and present state of the New Zealand gas industry; and • Gas Industry Co's performance and achievement of its objectives; and • any other matters the Gas Industry Co thinks fit or the Minister requests in writing, which currently includes access arrangements to transmission pipelines.

It is in the context of the co-regulatory model and the specific policy objectives described above that the Gas Industry Co presents the following Work Programme. The Board of the Gas Industry Co has approved the programme which it believes will effectively deliver on its obligations under the Gas Act and GPS.

7.4 Work Programme

The Work Programme set out below provides a narrative description of the various workstreams which comprise the programme, and a presentation of the major milestones in tabular form. For ease of reference the four quarters of the 06-07 year are highlighted in the table. For continuity, columns are also included for the last two quarters of the current financial year and for the whole 07-08 year. The table is divided into three categories: Corporate, Retail, and Wholesale.

For brevity the quarters of the 06-07 financial year are referred to as Q1 to Q4.

A Corporate Work Programme

A1 Accountability Framework

The Corporate section of the Work Programme consists of the various activities which arise because the Gas Industry Co is a private company with certain statutory and constitutional obligations. A large part of this is the monthly, quarterly and annual reporting of the company activities.

Section 43ZQ of the Gas Act requires the Gas Industry Co to prepare a strategic plan each year for that financial year and at least the 2 following financial years. There is also a requirement to report on the efficiency and performance of the energy sector. To do so, a Baseline Review will be developed against which subsequent reviews can be referenced.

The Gas Industry Co will operate in an open and inclusive way. This involves pro-active communication with interested parties on the activities of the company and current issues. This will partly be achieved through regular industry forums. It is likely that the format of these will be flexible. For example in late February a forum will be held to present this work plan and levy paper to industry and consumer group representatives, ahead of submissions being made. Later, in Q1, it is anticipated that a forum will be held for industry participants with an interest in the open access review. At least one other forum is likely in that year but the topic will depend on how the various workstreams are progressing and what issues are emerging.

A2 Levy Process

Although it could be viewed as another component of the Accountability Framework, the Levy Process has been identified as a separate workstream because of the need for a disciplined process leading to the timely release of levy regulations. The Levy process is an annual one which begins around the middle of each financial year when work plans and budgets are prepared for the next financial year. The process ends with the Gazetting of Regulations which then come into effect 28 days later. Unfortunately, for the current year, the arrangements were not Gazetted until mid-July and needed to be applied retrospectively. In future it is expected that the arrangements will be Gazetted before they are due to come into effect, as illustrated in the table.

B Retail Work Programme

B1 Switching and Registry

In Item 11 of the GPS the Gas Industry Co is invited to make recommendations regarding “The standardisation and upgrading of protocols relating to customer switching, so that barriers to customer switching are minimised.” The Switching and Registry workstream has already progressed through a consultation on options. By the beginning of the 06-07 financial year, the Gas Industry Co will have published its decision on the preferred Registry option, developed a Registry functional specification and preliminary rules. Consultation on the proposed rules and the appointment of a service provider will then take place in Q1. This appointment will be subject to Ministerial approval of the registry solution and rules which is expected in Q2. There will then follow a period when Registry participants will need to develop business systems to interact with the Registry, and to clean data ready for populating the Registry. A generous amount of time has been allowed for this. It is anticipated that the registry will then go live in Q4.

B2 Compliance and Enforcement

An ongoing issue in the industry is how to ensure compliance with new arrangements. In relation to the switching and registry workstream, an essential component of any solution will be effective arrangements to ensure that industry participants comply with data provision and quality standards. Accordingly, it is intended to develop a compliance regime which will initially ensure that the Registry rules are complied with but may later prove suitable for use with other new arrangements. The Compliance and Enforcement workstream will involve developing an appropriate regime, consulting on its suitability and, in Q2, making recommendations to the Minister.

B3 Reconciliation

The Gas Industry Co is expected to propose “… the development of protocols and standards applying to… balancing and reconciliation” (Item 9 of the GPS). The industry is currently working on a number of “short-term fixes” to both the upstream (Gas Transfer Code) and downstream (Gas Reconciliation Code) allocation and reconciliation arrangements. It is anticipated that the revised codes will come into effect in Q1.

Meanwhile the working groups will have progressed the work on long term reconciliation arrangements. In Q2 longer term proposals for reconciliation will be issued and consulted on. It is expected that recommendations on these matters can be made to the Minister in Q4.

B4 Consumer Issues

Among other objectives, Item 5 of the GPS includes “The quality of gas services and in particular trade-offs between quality and price, as far as possible, reflect customer’ preferences”. In addition, Item 11 of the GPS invites the Gas Industry Co to make recommendations regarding “The development of model contract terms and conditions between consumers and retailers.” The preferred governance approach on these matters has been consulted on and it is intended that a recommendation be made to the Minister before the end of the year. The Gas Industry Co will be holding a Consumer Issues Forum before the end of this financial year with input from this forum assisting the preparation of a consumer issues report to the Minister in Q2.

Item 11 of the GPS also invites the Gas Industry Co to make recommendation regarding "The development of efficient and effective arrangements for the proper handling of consumer complaints. In April 2005, gas was added to the electricity complaints scheme creating the Electricity and Gas Complaints Commission. A joint project team between the Gas Industry Co, Transpower and the Electricity Networks Association is currently looking at extending the scheme to include landowner / occupier disputes. It is anticipated that landowner / occupier disputes will be added to the scheme in April 2006.

B5 Distribution Contracts

Item 9 of the GPS calls for recommendations on "… The establishment of consistent standards and protocols across distribution pipelines so that gas market participants can access distribution pipelines on reasonable terms and conditions." An industry review will be conducted this year and will report on the issues in Q1. In Q3 proposals on distribution arrangements may be issued for comment. Following consultation, the Gas Industry Co will make recommendations to the Minister in Q4.

C Wholesale Work Programme

C1 Open Access Review

One of the GPS Item 5 objectives is "The facilitation and promotion of the ongoing supply of gas to meet New Zealand's energy needs, by providing access to essential infrastructure…". In response it is intended that an issues paper will be released before the end of the current financial year which will then be consulted on in Q1. Following consultation, the Gas Industry Co will report back to the Minister in Q2. Depending on the outcome of the issues review, there may be a need to develop recommendations. If this is required, a paper will be issued for consultation in Q3 with a view to making preliminary recommendations to the Minister in Q4.

C2 Wholesale Market Development

Among the matters which Item 9 of the GPS calls on the Gas Industry Co to make proposals on is "The development of protocols and standards applying to wholesale gas trading…" Considerable progress is being made in the current year towards the development of a wholesale market. In the current quarter concept design options will be reported on and, following consultation, the design will be refined before the end of the year. Once the form of market is determined work can begin on developing and consulting on market arrangements. This will take place in Q1. In Q2 these arrangements will be refined, consulted on, and the progress reported to the Minister. At that point a Request for Proposals will be issued for a service provider. In Q3 the service provider will begin development of the trading platform. A consultation on the trading platform design and detailed arrangements will follow. In Q4 Gas Industry Co will recommend trading rules to the Minister. The market will then open for trading in the 07-08 year once the rules are gazetted.

C3 Access to Processing Facilities

Another GPS Item 9 objective is the development of "Protocols that set reasonable terms and conditions for access to gas processing facilities". The Gas Industry Co is currently preparing proposals on the issue of access to upstream facilities. Before the end of the current year it will consult on possible arrangements for doing this, including whether these arrangements are best contained in a code of practice or in rules.

Depending on the outcome, the code of practice or rules will be written and consulted on in Q1. Recommendation on access rules or protocols will be presented to Minister in Q2. The preferred option will be implemented in Q4.

C4 Gas Outage Contingency Plan

An overall Government objective, included in Item 5 of the GPS is that “Risks relating to security of supply, including transport arrangements are properly and efficiently managed by all parties”. Before the end of the current year the Gas Industry Co will have developed options for addressing the commercial issues which arise during contingency events, and will have consulted on these options. In Q1 the chosen option will be shaped into suitable arrangements – possibly integrating them into the current contingency plan (the NGOCP). Following consultation and some possible refinement of the solution, the final arrangements will be recommended to the Minister in Q3. It is anticipated that some time will be required to give the arrangements legal effect and allow the affected parties to adjust their commercial positions. Accordingly, it may not be possible to implement the arrangements until the 07-08 year. The timeline allows for the option of either encapsulating the new arrangements in statutory rules or creating an industry arrangement to which participants need to be bound.

C5 Quality Standards

Among other matters related to Wholesale Markets and Processing, Item 9 of the GPS refers to “… quality standards…”. A review of the New Zealand Specification for Reticulated Gas (NZS 5442) has been conducted and will shortly be consulted on. It is important that the specification provides a balance between technical requirements and the need to facilitate the commercial tradability of gas. It is anticipated that any recommendations which are made on this matter will be made to the Minister by the end of this financial year. Implementation is scheduled for Q2.

Work Programme Summary

Notes:

1. These tables should be read in conjunction with the work stream descriptions provided above.
2. In setting the programme it has been assumed that each workstream will involve consultation which may lead to recommendations being made to the Minister which require new arrangements to be implemented by rules or regulations. Actual outcomes may differ from these assumptions. In particular consultations may be short or protracted depending on the issues raised, and it may be that some matters do not require a pan industry arrangement and others may be addressed by non-regulatory arrangements. Accordingly, while the outcomes may be written for brevity as "Report on issues" or "Implement arrangements" addition of the words "… where required" should be assumed.
3. Government may, from time to time, issue requests or Policy Statements which cause the Gas Industry Co to alter its work programme.

A - Corporate Work Programme

	Jan-Mar 06	Apr–Jun 06	Jly–Sep 06 (Q1)	Oct–Dec 06 (Q2)	Jan–Mar 07 (Q3)	Apr–Jun 07 (Q4)	2007-08
A1 Accountability Framework	Issue Quarterly and Board Reports.	Issue Quarterly and Board Reports.	Issue Quarterly and Board Reports.	Issue Annual, Quarterly and Board Reports.	Board and Quarterly Report.	Board and Quarterly Report.	Board and Quarterly Report.
		Develop and issue Strategic Plan.	Develop and issue Baseline Review.			Develop and issue Strategic Plan.	
				Develop 2007-08 Budget.			
	Hold Industry Workshop.		Hold Industry Workshop.		Hold Industry Workshop.		Hold Industry Workshop.
A2 Levy Process	Invoice levies monthly. Develop and consult on 06-07 Levy Proposals.	Invoice levies monthly. Recommendations to Minister on 06-07 Levy. Gazetting of Levy arrangements.	Invoice levies monthly. New levy arrangements implemented.	Invoice levies monthly. Forecast Levy Revenue.	Invoice levies monthly. Develop and consult on 07-08 Levy Proposals.	Invoice levies monthly. Recommendations to Minister on 07-08 Levy Proposals. Gazetting of Levy arrangements.	Invoice levies monthly. New levy arrangements implemented.

B - Retail Work Programme (subject to Government policy direction, consultation outcomes and funding)

	Jan-Mar 06	Apr–Jun 06	Jly–Sep 06 (Q1)	Oct–Dec 06 (Q2)	Jan–Mar 07 (Q3)	Apr–Jun 07 (Q4)	2007-08
B1 **Switching and Registry**	Publish decision on preferred Registry development option	Develop Registry functional specification and rules. Develop service provider role specification and engagement proposal.	Consult on Registry arrangements and conduct Cost Benefit Analysis. Issue RFP for Service Provider (the appointment of which will be conditional on Ministerial approval of the proposals).	Recommendation on registry arrangements to Minister.		Registry goes live.	Review Registry Operation.
B2 **Compliance and Enforcement**			Develop and consult on proposal.	Recommendations to Minister.			
B3 **Reconciliation**	Develop and consult on short term upstream reconciliation amendments (Gas Transfer Code revisions).	Develop and consult on short term downstream reconciliation amendments (Reconciliation Code revisions).	Short term fixes implemented (Revised Gas Transfer Code and Reconciliation Code operational).	Develop and consult on proposals for long term reconciliation arrangements.		Recommendations on reconciliation to Minister.	Implement new reconciliation arrangements.
B4 **Consumer Issues**		Hold Consumer Issues Forum. Recommendations on consumer contracts to Minister. Landowner disputes added to EGCC scheme.	Develop and consult on Consumer Issues Report.	Initial Report on Consumer Issues to Minister.		Hold Consumer Issues Forum.	
B5 **Distribution Contracts**	Identify any issues with the existing contracts.		Publish issues report.		Develop and consult on Distribution proposals.	Recommendations on Distribution Contracts to Minister.	Implement recommendations (if required).

C - Wholesale Work Programme (subject to Government policy direction, consultation outcomes and funding)

	Jan-Mar 06	Apr–Jun 06	Jly–Sep 06 (Q1)	Oct–Dec 06 (Q2)	Jan–Mar 07 (Q3)	Apr–Jun 07 (Q4)	2007-08
C1 **Open Access Review**		Issues Review released.	Consult on issues review.	Report to Minister on Issues Review.	Recommendations paper issued for consultation (if reqd.).	Preliminary recommendations presented to Minister (if reqd.).	
C2 **Wholesale Market Development**	Develop Concept Design for Wholesale Market.	Consult on and refine Concept Design.	Develop and consult on market arrangements.	Revise arrangements, consult on revision and report outcome to Minister. Issue RFP for Service provider.	Appoint Service Provider and begin development of trading platform. (The appointment of which will be conditional on Ministerial approval of the proposals.) Consult on trading platform design and detailed arrangements.	Recommendation on trading rules presented to Minister.	Wholesale market open for trading.
C3 **Access to Processing Facilities**		Consult on options to achieve GPS outcomes.	Define and consult on preferred option.	Recommendation on access rules or protocols presented to Minister.		Implementation of preferred option.	
C4 **Gas Outage Contingency Plan**	Develop commercial options for contingency situations. Consult on above and compliance with existing Contingency Plan (NGOCP).		Develop and consult on solutions for contingency events.		Recommendation on contingency arrangements presented to Minister.		Implementation of preferred option.
C5 **Quality Standards**	Consult on Gas Specification Issues.	Recommendations on Specification Issues to Minister.		Implement recommendations.			

7.5 The 2006/07 Budget

Budget projections for the 06/07 financial year are presented in the table below, categorised by workstreams. Other Corporate Costs ($0.6m rent, board, office etc.) and balance sheet adjustments ($0.2m loan repayments etc.) are added to this. Finally, we recognise that the Gas Industry Co does have some other sources of income ($0.1m from member fees, interest etc.). The remaining balance is the total amount which has to be raised through the levy ($3.8m).

06/07 Financial Year Budget Projections

	06/07 Budget ($'000)
Accountability Framework	578
Levy Process	60
Corporate Work Programme	**638**
Switching & Registry	248
Compliance and Enforcement	192
Reconciliation	267
Consumer Issues	125
Distribution Contracts	71
Retail Work Programme	**903**
Open Access Review	575
Wholesale Market Development	621
Access to Processing Facilities	126
Gas Outage Contingency Plan	191
Quality Standards	20
Wholesale Work Programme	**1,533**
Total Work Programme Costs	3,074
Other Corporate Costs	629
Loan repayments etc.	195
Total Cash Requirement	3,898
less Non- levy income	(119)
Total Levy Revenue Requirement	**3,780**

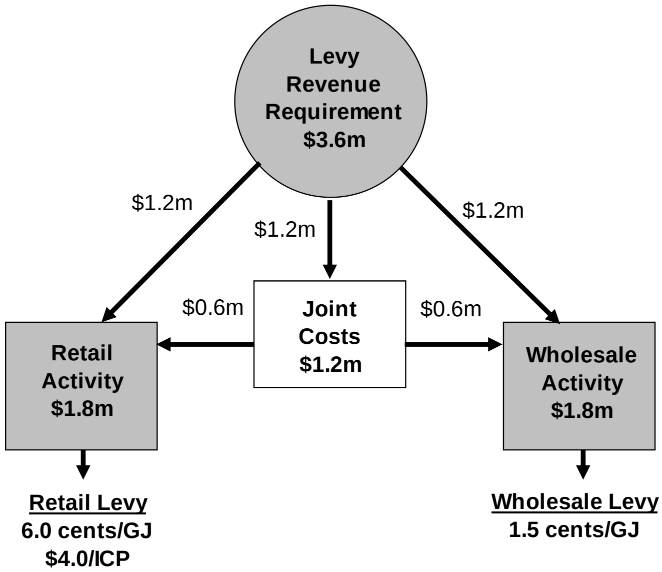
The increase in budgeted costs from $3.6m budgeted for the current year to $3.8m budgeted for the 2006/07 year is largely due to the various workstreams entering periods of high activity.

8 Levy Options

The existing levies are based on an allocation methodology which:

- Allocated direct costs to Retail or Wholesale areas of activity;
- Split the shared costs evenly between the Retail and Wholesale areas of activity; and
- Set Retail and Wholesale levies to recover the allocated costs in each area.

When the levies were set for the current 2005/06 year, the Gas Industry Co had just commenced business and, on the information available at the time a 50:50 split of anticipated costs between wholesale and retail was thought to be appropriate. It was explained as illustrated:



It is clear from the budget presented in Section 7.5 that more cost is now budgeted in the wholesale area than in the retail area. In this section various levy options are described together with a brief commentary on how each proposal impacts on different end user categories and how it accords with the levy setting principles. When reviewing the options it should be borne in mind that they are all projected to provide the same aggregate levy amount - $3.8m – **and differ only in how that amount is recovered between user categories**.

Although the Gas Industry Co's Work Programme is now much better defined, actual outcomes may differ from the programme as a result of shorter or more protracted consultations, and whether final recommendations involve arrangements, rules or regulations. In short, the Work Programme and Budget reflect our current view of outcomes, but these may change.

It is also important to note that projected GJ and ICP numbers for the 2007-08 year used in levy calculations are estimates. The Gas Industry Co is currently seeking new volume estimates from participants. These may alter the final calculations.

8.1 Option 1 – Only adjust Wholesale Levy

Option 1 proposes that the retail levy be left unchanged and that the balance of the required revenue be recovered through the wholesale levy.

The Budget (Section 7.5) shows that the direct costs allocated to Retail and Wholesale have moved from the $1.2m:$1.2m ratio used to set the 2005/06 levy to a $0.9m:$1.5m ratio. A rigorous approach to the cost allocation would require that the shift in projected costs is immediately reflected in a re-casting of the levies. This approach is presented as Option 2. However, here as Option 1 we propose a more pragmatic alternative.

Considering:

- The uncertainty over how the actual costs for the 2005/06 year will split between retail and wholesale (see Section 5);
- The cost to industry participants in communicating changes to the levy and putting those changes into effect (particularly the retail levy); and
- The cost increases, and volume reduction are occurring in the wholesale area.

Under Option 1, the retail levy remains unchanged and that all variations in cost and volumes are accommodated through an adjustment of the Wholesale levy. Using this approach the resulting levies would be as follows:

Retail Levy (no change)		
per GJ levy	6.00	Cents/GJ
per ICP levy	4.00	$/ICP
Retail Projections		
Volume	13,586	TJ
Connections	240,000	ICPs
Retail Levy Revenue	$1.775	Million
Required Levy Revenue	$3.780	Million
Wholesale Levy Revenue	$2.005	Million
Wholesale Projection		
Volume	115,000	TJ
Wholesale Levy		
Wholesale levy	1.74	Cents/GJ

As shown in the table, the Retail levy would remain at 6 cents/GJ and $4/ICP. On the basis of the projected volumes and connection numbers, this would bring in an annual revenue of $1.775m. From the Section 7.5 Budget, the required levy revenue is $3.780m which leaves $2.005m to be collected through the Wholesale levy. On a projected wholesale volume of 115,000TJ, this requires a Wholesale levy of 17.43 cents/GJ.

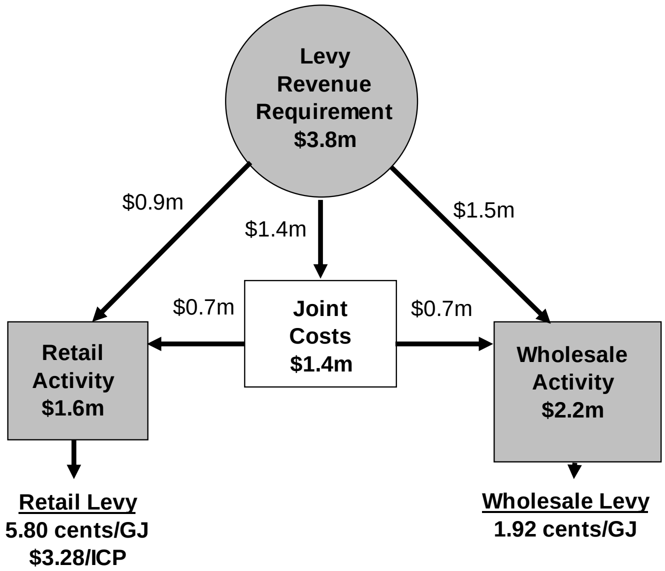
Notice that using this approach there has been a shift to recovering more through the Wholesale levy than the Retail levy ($2.005m compared to $1.775m), but not as much as would be required by the more rigorous cost allocation used in Option 2 below ($2.205m compared to $1.575m).

8.2 Option 2 - No change to current allocation methodology

The cost allocation methodology underlying the current year's levy attributed costs directly where possible and split common costs equally between the Retail and Wholesale activities.

Using the same methodology as was used last year, but updated with the 2006/07 financial year budget projections for costs and volumes, the resulting levies would be calculated as follows:

These cost allocations are summarised in the diagram below:



Retail Allocation Base		
Volume	13,586	TJ
Connections	240,000	ICPs
Retail Cost Allocation		
Cost Allocation	$1.575	million
Retail Levy (assuming 50:50 fixed variable split)		
Variable (per GJ) levy	5.80	cents/GJ
Fixed (per ICP) levy	3.28	$/ICP
Wholesale Allocation Base		
Volume	115,000	TJ
Wholesale Cost Allocation		
Cost Allocation	$2.205	million
Wholesale Levy		
Wholesale levy	1.92	cents/GJ

The cost allocation provided in the table is as shown in the diagram. For example the Retail Cost Allocation of $1.575m is calculated by adding the budgeted direct costs to Retail, of $0.903m, to half of the shared costs. The shared costs are all the costs which are not direct, i.e. $3.780m less $0.903m of retail direct costs less $1.533 of wholesale direct costs. This give shared costs of $1.344, and adding half of this to the retail direct costs gives: $0.903m + $0.672m = $1.575m.

Notice that the allocation to Wholesale activity has increased from $1.8m to $2.2m, a 22% increase, as the various Wholesale worksteams take off. However the resulting levy has increased from 1.5 cents/GJ to 1.92 cents/GJ, a 28% increase. The reason that the levy has increased more than proportionately to the costs is that the volume on which the levy is based has decreased due to the loss of Methanex. The downside of a variable levy base is that, while the Gas Industry Co's costs might be substantially fixed, its revenue is subject to year on year market volatility.

8.3 Option 3 – Fully Variable Retail Levy

Option 3 proposes that the allocated cost to the retail levy is recovered from a single per GJ levy and that the wholesale levy remains as calculated for Option 2.

As previously discussed, the rationale for the split between the fixed (per ICP) and variable (per GJ) retail levies is not strong. It could reasonably be argued that the major benefit of the Gas Industry Co activity will be a more competitive retail market. In this case the benefit would be reflected in lower prices per unit volume and it would be reasonable to also allocate the costs in that way.

In addition, a fully variable levy may be easier for retailer to recover, as it does not require the calculation of a fixed and variable component. This suggests that it would be more efficient to allocate retail costs on a fully variable basis.

Using this approach the resulting levy would be as follows:

Retail Allocation Base		
Volume	13,586	TJ
Retail Cost Allocation		
Cost Allocation	$1.575	Million
Retail Levy		
Retail levy	11.59	cents/GJ

This approach would lead to a variable retail levy of 11.59 cents/GJ. (The wholesale levy would remain as calculated in Section 8.2, at 1.92 cents/GJ.)

If this option were adopted the effect of the change would be quite different for small and large users as illustrated in the table below. Both options 2 and 3 are included for reference.

	GJ/annum	Current Levy $/year	Option 2 Levy $/year	Option 3 Levy $/year
Retail Levy				
Small Residential User	5	4.30	3.57	0.58
Medium Residential User	25	5.50	4.73	2.90
Large Residential User	40	6.40	5.60	4.64
Small Commercial User	25	5.50	4.73	2.90
Medium Commercial User	5,000	304.00	293.28	579.50
Large Commercial User	10,000	604.00	583.28	1,159.00

Notice that the cost to all Residential and small Commercial users is reduced, but the cost to Medium and Large Commercial users is increased. In fact large Commercial users – up at the 10TJ/year boundary – would pay almost twice as much as at present - $1159/year instead of $604/year. This is a concern because there is a step change at 10TJ/year – users who take more than that don't pay the retail levy at all. Option 3 makes this step change twice as bad.

8.4 Option 4 - Split retail levy into fully variable Residential and Commercial levies

Option 4 proposes that the retail levy is recovered from two levies – a Residential per GJ levy and a Commercial per GJ levy, and that the wholesale levy remains as calculated for Option 2.

This approach is a hybrid between the current fixed/variable allocation of the retail levy and the fully variable approach. One major retailer already uses this kind of approach when passing the levy through to its customers. In it involves a two step allocation. First, half the cost is allocated by ICP numbers and half the cost by GJs. Second, the resulting cost allocations are converted into variable (per GJ) levies. The results are:

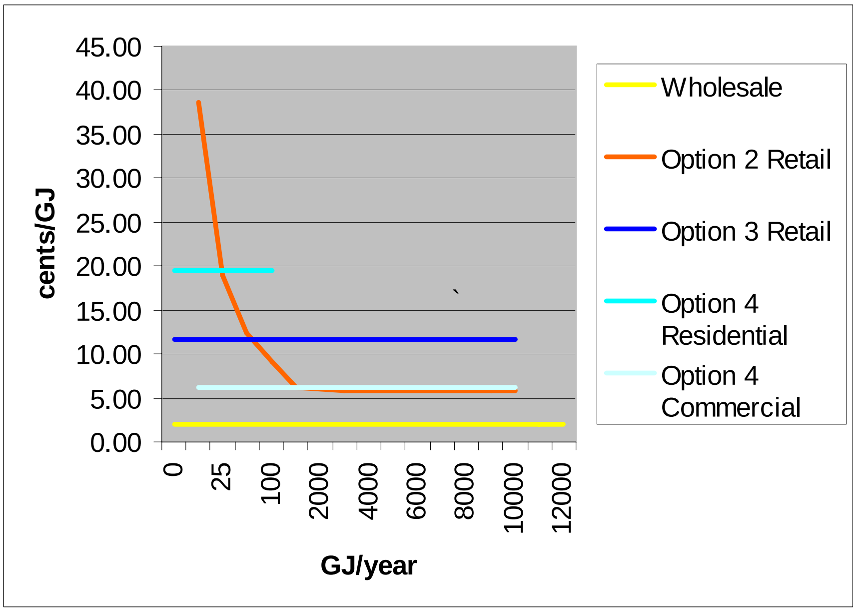
Retail Allocation Base			
	Residential Connections	230,000	
	Residential Volume	5,520	TJ
	Commercial Connections	10,000	
	Commercial Volume	8,066	TJ
Retail Cost Allocation			
	Residential Allocation	$1.074	million
	Commercial Allocation	$0.500	million
Retail Levies			
	Residential levy	19.45	cents/GJ
	Commercial levy	6.20	cents/GJ

To illustrate the calculation, start with the total cost allocated to Retail, as in 8.2 and 8.3 above, of $1.575m. Allocate half of this in proportion to ICP numbers and half in proportion to volume. So, for example, the Residential Allocation is $0.787m × (230,000/(230,000+10,000)) = $0.754m, plus $0.787m × (5,520/(5,520+8,066)) = $0.320m. Adding these gives $0.754m + $0.320m = $1.074m. Now dividing this by the retail volume gives the Residential Levy = $1.074m/5,520GJ = 19.45 cents/GJ. (As in Options 2 and 3, the wholesale levy would remain as calculated in Section 8.2, at 1.92 cents/GJ.)

The benefits of this approach are possibly twofold. The levy is arguably simpler for the retailer to pass on since there is no fixed (per ICP) charge and there is a separate Residential category, just as there is in all retailers' tariffs. Also, the step change at the 10TJ/year limit is much less than in Option 2, as is shown in the following table:

	GJ/annum	Current Levy $/year	Option 2 Levy $/year	Option 3 Levy $/year	Option 4 Levy $/year
Retail Levy					
Small Residential User	5	4.30	3.57	0.58	0.97
Medium Residential User	25	5.50	4.73	2.90	4.87
Large Residential User	40	6.40	5.60	4.64	7.78
Small Commercial User	25	5.50	4.73	2.90	1.55
Medium Commercial User	5,000	304.00	293.28	579.50	310.00
Large Commercial User	10,000	604.00	583.28	1,159.00	620.00
Wholesale Levy					
Small Wholesale Purchaser	1,000,000	15,000.00	19,200.00	19,200.00	19,200.00
Medium Wholesale Purchaser	5,000,000	75,000.00	96,000.00	96,000.00	96,000.00
Large Wholesale Purchaser	20,000,000	300,000.00	384,000.00	384,000.00	384,000.00

The differences between Options 2, 3 and 4 are shown graphically below. Note that the horizontal axis is not linear but has been stretched out at the low end to better illustrate the small user prices:



One issue with Option 4 which the above table and graph make clear is that small residential customers will pay more than small commercial customers. An average Residential customer would consume around 25GJ/year and would pay $4.87/year if the levy was passed through unaltered by its retailer. A Commercial customer of the same size, 25GJ/year, would only pay $1.55. Yet this kind of small commercial customer, perhaps a small dairy or office, would be expected to gain just as much from the facilitation of competitive markets. Since the result is for some users in similar situations to pay markedly different contributions, this Option 4 may breach the equity principle. However, the difference - $3.32/year – is a relatively small amount in practice.

Gas Industry Co invites comments on:

13. Which, of Options 1, 2, 3 and 4, you prefer;
14. Why you prefer that Option;
15. Whether there are any other Options that you think the Gas Industry Co should be considering.

8.5 Evaluation of Options

The Gas Industry Co appreciates that the options put forward in this section are reasonably complex. At the risk of over-simplifying, the following table is offered as a summary of why the options are worthy of consideration and some difficulties which might be involved if they are to be introduced.

Option 1 – Only adjust Wholesale levy Option 1 proposes that the retail levy be left unchanged and that the balance of the required revenue be recovered through the wholesale levy.	
Benefit	• No change in retail levy • Minimal changes required to Regulations • Goes some way towards recovering more through the Wholesale levy (but not as far as the rigorous cost allocation provided for in Option 2)
Possible Issues	• It could be argued that there is some cross subsidisation between Retail and Wholesale, but considering the benefit retail customers derive from the wholesale activities any such cross subsidy is likely to be very minor.
Option 2 - No change to current allocation methodology Option 2 proposes that costs of the wholesale and retail work programmes are attributed directly to the wholesale and retail levies respectively, and that current arrangements for the retail levy – where half the allocated cost is recovered on a per GJ levy and half on an per ICP levy – is retained.	
Benefit	• Objective cost allocation
Possible Issues	• Without any damping, it could bring significant year on year volatility of levies.
Option 3 – Fully Variable Retail Levy Option 3 proposes that the allocated cost to the retail levy is recovered from a single per GJ levy and that the wholesale levy remains as calculated for Option 2.	
Benefit	• Simple levy structure
Possible Issues	• From current price structure there is a significant shift of cost from small users to large users.
Option 4 - Split retail levy into fully variable Residential and Commercial levies Option 4 proposes that the retail levy is recovered from two levies – a Residential per GJ levy and a Commercial per GJ levy, and that the wholesale levy remains as calculated for Option 2.	
Benefit	• Levy structure matches retailers' tariff structures i.e. separate levies for Residential and Commercial.
Possible Issues	• To provide a robust allocation methodology for the future, costs will need to be divided between Residential, Commercial and Wholesale.

Appendix A - How the levy is being passed on

Parties paying the wholesale and retail levies are free to pass them on to the extent and in the manner they think fit. There is no regulatory prescription as to how this should be done. However, it is of interest to see how the levy is being passed through, and it may influence the view on how the levy is best structured.

In the 2005-06 financial year, a party buying gas from a producer must pay a wholesale levy on that gas at a rate of 1.5 cents/GJ. All but one of the parties paying the wholesale gas levy is either an end user, or is directly selling to end users. The one exception is NGC who on sells gas to retailers. NGC separately invoices its retail customers for the wholesale gas levy because the calculation of the levy is based on a different quantity (ie it is based on volumes purchased in the quarter before the last quarter).

Some retailers do not pass on the wholesale levy as an explicit line item on their invoices to end users. Those who do so ignore the timing difference and apply the 1.5 cents/GJ to volumes used in the current billing period, although this is technically incorrect.

Turning to the retail levy, some retailers itemise the retail levy in both its fixed (per ICP) and variable (per GJ) components on invoices to end users. Others convert the levy into a fully variable (per GJ) rate and itemise that. To minimise cross-subsidy that results between small and large users, one retailer calculates a different variable rate for its residential customers. (This is the approach proposed by Option 3 in this paper.) Other retailers have chosen not to itemise the retail levy on consumers' gas bills. In all cases the levy shown on the customer's bill is based on the most recent consumption data which, technically, is not correct.

As a result of these different approaches, a customer of one retailer might see the levies represented in a different way to a customer of another retailer. This could potentially cause confusion or, more significantly, be considered as mis-representation.

The Gas Industry Co is not aware of any complaints on these matters to date, either from parties responsible for paying the levy in the first instance, or from end-users.