# Recommendation on Gas (Levy of Participants) Regulations 2010

**March 2010**

GAS INDUSTRY COMPANY LIMITED

152747.4

## About Gas Industry Co.

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

As such, its role is to:

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

## Authorship

This paper was prepared by Christine Southey and Peter Davies.

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# Executive summary

Section 43ZZB of the Gas Act 1992 (the 'Gas Act') enables Gas Industry Company Limited ('Gas Industry Co'), to recommend to the Minister of Energy that regulations be made requiring industry participants to pay a levy to Gas Industry Co. This paper presents recommendations on the amount, design, and implementation of the levy for the financial year ending 30 June 2011.

These recommendations were developed after consulting with stakeholders on strategic priorities; developing a work programme and budget that addressed the priorities established following the consultation; issuing a formal Consultation Paper on the levy proposal; and considering submissions on that paper and amending the proposed work programme and budget in the light of that feedback.

In FY2011 Gas Industry Co proposes to give priority to:

- fulfilling its statutory roles under the Gas (Downstream Reconciliation) Rules 2008, the Gas (Switching Arrangements) Rules 2008, the Gas Governance (Compliance) Regulations 2008 and the Gas Governance (Critical Contingency Management) Regulations 2008
- advancing a range of transmission access work streams
- completing its review of the efficiency of the downstream reconciliation rules.

Other GPS tasks will be afforded a lower priority and progressed as resources become available.

Based on this work programme, Gas Industry Co recommends to the Minister that:

- the current annual retail levy of $6.40 per ICP (installation control point), be paid by industry participants in respect of every ICP supplied by each retailer at the end of the previous month, be retained
- the current wholesale levy of 1.67 cents per gigajoule (GJ), paid by the buyers of all gas purchased from producers, be increased to 1.84 cents per GJ, to be calculated monthly on the buyer's total gas purchases up to and including the last day of the previous month
- these levies come into effect on 1 July 2010, replacing those levies established for FY2010.

The levies are estimated to meet Gas Industry Co's levy funding requirement of $4,299,216 for FY2011. Gas Industry Co's total work programme cost for FY2011 is estimated at $7,029,516.  The difference between the cost of the work programme and the levy funding requirement will be met from a combination of market fees, interest income and the application of past-year reserves. The increase in work programme costs reflects the proposed policy work on transmission access, which is funded by the wholesale levy.

# Contents

# 1 Background

## 1.1 Introduction

### Industry body

Part 4A of the Gas Act provides for the Government and an approved industry body to co-regulate the gas industry. Gas Industry Co was established by gas industry participants to fulfil the role of the industry body, and approval was received by Order in Council on 24 December 2004. Gas Industry Co is responsible for developing and recommending gas governance arrangements, which may include rules and regulations. These arrangements cover a range of areas relating to the gas industry including wholesale markets and processing, transmission and distribution networks, retail market development and consumer protection.

### Annual Work Programme

Each year the Company develops an indicative work programme and budget, consults on that work programme and budget and the associated levy funding requirements, and then makes a recommendation to the Minister requiring industry participants[1] to pay a levy to Gas Industry Co. The levy is to recover the estimated costs of Gas Industry Co exercising its functions as the industry body.

The main cost drivers for Gas Industry Co work programmes are the:

- complexity of the policy area being examined
- time taken to build consensus around the proposed governance solution, including exploring the possibility of non-regulatory options
- degree of interaction with MED and PCO on regulatory and accountability matters
- scale of the implementation required for approved arrangements
- range of roles established for the Company in the implemented arrangements

[1] Industry participants are defined in the Act as including gas retailers, distributors, producers, pipeline or meter owners, wholesalers, and major upstream buyers.

- degree of industry compliance with approved arrangements.

## Levy Principles

In considering how to set the levy in any given financial year, Gas Industry Co must consider its obligations under the Act and the GPS, and take into account the obligations on the Board under company law. The Board takes the view that each year's levy should cover the costs reasonably expected to be incurred by Gas Industry Co in that year.

A set of general principles covering levy setting has been developed by Gas Industry Co. The principles are available on the Gas Industry Co website and have been used to assess and determine the proposed structure and level of the FY2011 levy.

## Additional sources of funding

The Company also receives funds from its shareholders, which are used for reserves, and market fees made under specific regulations. The Gas (Switching Arrangements) Rules 2008, the Gas (Downstream Reconciliation) Rules 2008, the Gas Governance (Critical Contingency Management) Regulations, and the Gas Governance (Compliance) Regulations 2008 contain market fee provisions. These cover the costs of service providers and some external consultants and are taken into account in setting the annual levy funding requirements.

# 2 Work Programme

## 2.1 Government's Policy Objectives and Strategic Goals

The starting point for establishing the annual work programme is the April 2008 Government Policy Statement on Gas Governance (GPS), which lists the outcomes the Government wants Gas Industry Co to pursue and report against. The GPS, which is summarised below, formed a key input into Gas Industry Co's work programme for FY2011.

| Industry Sector | GPS Detail |
|---|---|
| Efficient wholesale market | • Efficient arrangements for the short-term trading of gas.<br>• Accurate, efficient and timely arrangements for allocating and reconciling upstream gas quantities. |
| Access to key infrastructure | • Gas industry participants and new entrants are able to access the following physical assets and related services on reasonable terms and conditions:<br>o third party gas processing facilities<br>o transmission pipelines<br>o distribution pipelines<br>o consistent standards and protocols apply to the operations relating to access to all distribution pipelines. |
| Efficient retail market | • The development of efficient and effective arrangements for the proper handling of consumer complaints.<br>• Effective and efficient customer switching arrangements that minimise barriers to customer switching.<br>• Accurate, efficient and timely arrangements for allocating and reconciling downstream gas quantities. |
| Consumer benefit | • All small gas consumers have effective access to a complaints resolution system.<br>• Contractual arrangements between gas retailers and small consumers adequately protect the long-term interests of small consumers. |

| Industry Sector | GPS Detail |
|---|---|
| Other outcomes | • Gas governance arrangements are supported by appropriate compliance and dispute resolution processes.<br>• Gas governance arrangements approved by the Minister of Energy are monitored by Gas Industry Co for ongoing relevance and effectiveness.<br>• Good information is publicly available on the performance and present state of the gas sector. |

## 2.2 FY2011 Work Programme

The work expected to be undertaken in FY2011 includes the fulfilling of various roles set out for the Company under existing regulation, implementing approved gas governance arrangements, and developing new policy recommendations in accordance with the Company's Strategic Plan. A draft Strategic Plan has been forwarded to the Minister together with this Recommendation. This plan divides the work programme into wholesale and retail work streams.

The wholesale work stream comprises arrangements relating to the sale and purchase of wholesale gas and its transmission through high pressure networks. It includes critical contingency management, administration of information disclosure with respect to gas processing facilities, access to transmission pipelines, and a wholesale trading platform. The transmission access work includes: balancing, interconnection, capacity, and title tracking.

The retail work-stream comprises activity relating to the supply of gas through distribution networks to end-users, including transportation and energy components of supply. It includes arrangements for customer switching, reconciliation and allocation of gas quantities between retailers, metering arrangements, customer information, governance of supply contracts, and consumer complaints resolution. In FY2011, a key focus is the review of the downstream reconciliation rules to improve the accuracy of the reconciliation rules using data obtained during the transition period.

Gas Industry Co also must meet various statutory reporting requirements and respond to requests for advice from the Minister on matters affecting the gas sector. Examples of the statutory actions to be taken by the Company include the publication of the Strategic Plan, presentation of a formal Annual Report to Parliament, convening an Annual General Meeting for shareholders under the Companies Act 1993, and undertaking consultation on the development of a levy recommendation for FY2012.

# 3 Consultation Process and Outcomes

## 3.1 Consultation on FY2010 Levy

Section 43ZZD(2)(b) of the Gas Act requires the industry body to consult with industry participants on its proposed levy. Gas Industry Co struggled to gain industry support for its FY2010 levy proposals. The Company originally developed a work programme to progress the GPS requirements expeditiously. This programme required a retail levy of $7.91/ICP and wholesale levy of 1.77 cents/GJ. It was not supported by the industry which recommended that expenditure of all types needed to be restrained and that the work programme be cut back in the light of the prevailing economic climate.

Officials advised Gas Industry Co that it needed to obtain stronger support from industry before a recommendation on the FY2010 levy could be made to the Minister. Gas Industry Co consequently issued an amended Consultation Paper on 2 March 2009, which reduced the proposed work programme and the retail levy to $6.40/ICP and the wholesale levy to 1.67 cents/GJ. Submissions on the amended consultation paper supported Gas Industry Co's efforts to review the FY2010 Levy and respond to stakeholders concerns. The amended levy recommendation was accepted by the Minister.

## 3.2 Consultation on FY2011 Levy

During the FY2010 levy round, Gas Industry Co also had requests for earlier engagement on its strategic priorities during the next levy process from both levy payers and officials. In response, the Company initiated a co-regulatory forum, held at its offices on 5 October 2009, with participation invited from both industry participants and officials. Attendees at the forum included Shell, Genesis, Vector, Methanex, and MED.

Forum participants received a presentation on Gas Industry Co's assessment of work required to be undertaken in FY2011 and the available sources of funding. At that time, the proposed Work Programme Costs (WPC) were $8,170,724 with a Levy Funding Requirement (LFR) of $5,378,834. Participants in the forum were generally supportive of the proposed work programme, but commented that they did not favour a levy increase of the size indicated. Officials shared this view.

In December 2009, Gas Industry Co released a Consultation Paper on the FY2011 Levy. The Consultation Paper:

- described the work that Gas Industry Co would undertake in FY2011 and the estimated costs
- outlined the calculation of the levy funding requirement for FY2011, and
- proposed the levy for FY2011.

The Consultation Paper proposed a lower WPC of $7,878,286 (a reduction of $292,438 from the estimate made to the co-regulatory forum), and an LFR of $5,075,300 (a reduction of $303,534 from the forum estimate). Gas Industry Co called for submissions from interested parties as a precursor to the formulation of a recommendation to the Minister of Energy for the required levy regulations. Submissions closed on 5 February 2010.

Gas Industry Co also undertook a series of bilateral discussions with selected levy payers as a further means of engaging with stakeholders on the levy proposal. Invitations to these discussions were issued to Contact Energy, Genesis Energy, Mighty River Power, Methanex and Vector. Acceptances were received from Contact, Genesis, Methanex and Vector, while scheduling difficulties prevented a meeting with Mighty River Power. The full set of initiatives to meet Gas Industry Co's strategic priority commitments was discussed, along with the funding mix.

The Company also held a levy workshop on 26 January 2010. Attendance at the workshop was poor, with only Powerco and Vector participating. It is thought that the bilateral discussions entered into with the major levy payers made many of them consider that attendance at the workshop was unnecessary.

The Consultation Paper was sent to a list of 31 key stakeholders[2] from the Company's database and published on the Company website. Submissions on the Consultation Paper were received from: Contact Energy; Genesis Energy; Methanex New Zealand Ltd; Mighty River Power; Nova Gas Ltd; Powerco; and Vector Ltd.

A number of themes emerged from these submissions:

- There is a concern about the size of the projected increase in levy funding requirements although the impact of the lack of reserves in FY2011 was acknowledged by some industry participants.
- There is also a concern about the impact of the size and pace of the work programme on industry participants, and a call for increased prioritisation.

[2] The list is available if required.

- Industry participants seek reassurance that Gas Industry Co is minimising costs, for example, its corporate and governance expenditure and adopts more causer-pays mechanisms wherever practicable.
- One industry participant is seeking more transparency about the nature of costs, including information in relation to the appointment of consultants and service providers, and outsourcing policy.
- Most industry participants consider the consultation process required to achieve funding for core obligations inefficient. However, their solutions vary: some want a two year levy (outside the Gas Act), others want to amalgamate market and annual fees.

A summary of the all of the issues raised in the FY2011 levy consultation submissions is set out in the Submissions Analysis Paper, which is provided with this Recommendation.

## 3.3 Proposed regulation amendments

The Consultation Paper sought the views of the industry on certain proposed amendments to the levy regulations that are intended to clarify or improve aspects of the regulations. These included:

- Addressing concerns that there may be uncertainty as to the point on the supply chain at which the levy becomes payable. Gas Industry Co proposes to work with the Parliamentary Counsel's Office (PCO) to clarify the wording in this respect.
- Clarifying that the levy is payable only once on gas purchases where that gas is then injected into a gas storage facility. That is, the levy is only payable once, either on the gas going in or on gas coming out of a storage facility.
- Clarifying that existing, yet-to-be extracted gas in a gas storage facility (the recoverable gas reserves) will be subject to the levy (in contrast to purchased gas injected into the facility, as above).
- Removing the exemption on Crown gas purchases now that the Maui gas legacy arrangements have expired.

Submissions expressed either no comment on this matter or support for the proposed amendments. Gas Industry Co will liaise with the PCO on the necessary drafting improvements.

## 3.4 Conclusion on consultation

In response to submissions, Gas Industry Co has made significant changes to its proposed work programme and budget. It also intends to consider the other matters raised by submitters before the FY2012 levy round. The revised work programme is explained in the draft Strategic Plan and the other steps proposed to be taken are described in the Submissions Analysis paper.

Gas Industry Co considers it has fulfilled its obligations to consult with industry participants on the proposed levy.

# 4 Budget and Levy

## 4.1 Indicative FY2011 Budget

Total expenditure for the FY2011 work programme described in the draft Strategic Plan, is estimated at $7,029,516, of which $4,299,216 is required to be funded by the annual levy. The following table compares the estimated FY2011 Budget with the FY2010 Levy Budget estimates, the FY2010 Business Plan and the FY2010 Reforecast. This range is provided because the FY2010 Levy Budget numbers were superseded by subsequent events.

***Levy Budget:*** The levy budget was adjusted in the second round of consultation, in order to meet levy payers expectations of a significantly reduced levy. As part of this exercise some work streams were cut (for example, Wholesale Market and policy work on consumer issues).

***Business Plan Budget:*** In response to a subsequent Ministerial request, these workstreams were reinstated and a revised budget was approved by the Board as part of the Company's internal business planning processes.

***Reforecast:*** More recently the Board has requested a reforecast of the current year's expenditure. This information was not available at the start of the levy consultation round, but is the best available information to assess the reasonableness of the FY2011 levy funding requirement.

Key matters to note when comparing the reforecast with the proposed FY2011 budget are:

- The increase in critical contingency management expenses reflects the first full year operation of the critical contingency management regulations (service provider costs were only incurred for a part-year in FY2010).
- The FY2010 and FY2011 expenditure on balancing and transmission access workstreams are broadly similar, reflecting the ongoing nature of these significant workstreams.
- Savings from the completion of the work on Consumer Complaints and Retail Contracts (Consumer Issues) and the Direct Use of Gas project (Other Policy Advice), has been offset by an increase in costs for the scheduled review of the downstream reconciliation rules and the reinstatement of the distribution workstream.

| | FY2011 Budget | FY2010 Reforecast | FY2010 Business Plan | FY2010 Levy Budget |
|---|---|---|---|---|
| | YE 30/06/11 | YE 30/06/10 | YE 30/06/10 | YE 30/06/10 |
| **Wholesale Work Programme** | | | | |
| Critical Contingency | 762,794 | 499,765 | 677,991 | 753,411 |
| Gas Processing | 7,581 | 8,484 | 7,484 | 13,369 |
| Compliance | 81,070 | 81,824 | 76,343 | 53,104 |
| Balancing | 421,296 | 406,171 | 440,512 | 424,771 |
| Other Transmission Work | 292,808 | 258,319 | 167,320 | 248,332 |
| Industry Facilitation | 213,229 | 200,038 | 211,352 | 244,347 |
| Wholesale Market | 258,659 | 282,962 | 258,656 | 120,709 |
| Other Policy Advice | 81,700 | 128,861 | 94,000 | 174,991 |
| ***Total Wholesale Costs*** | ***2,119,137*** | ***1,866,424*** | ***1,933,658*** | ***2,033,034*** |
| | | | | |
| **Retail Work Programme** | | | | |
| Switching | 581,022 | 561,365 | 645,488 | 481,390 |
| Reconciliation (Statutory Role) | 1,162,562 | 1,110,765 | 1,223,665 | 1,066,344 |
| Compliance | 324,281 | 327,295 | 305,374 | 212,415 |
| Distribution Contracts | 30,324 | 0 | 0 | 0 |
| Reconciliation (Policy Review) | 338,704 | 208,554 | 271,692 | 132,500 |
| Consumer Issues | 131,400 | 234,483 | 223,000 | 223,598 |
| Retail Industry Performance | 68,254 | 51,838 | 151,366 | 38,682 |
| Other Policy Advice | 131,700 | 265,234 | 200,000 | 50,000 |
| ***Total Retail Costs*** | ***2,768,247*** | ***2,759,534*** | ***3,020,585*** | ***2,204,929*** |
| | | | | |
| Board | 290,000 | 286,707 | 300,460 | 327,342 |
| Corporate | 1,852,132 | 1,880,283 | 2,318,003 | 2,154,666 |
| ***Total Corporate Costs*** | ***2,142,132*** | ***2,166,990*** | ***2,618,463*** | ***2,482,008*** |
| | | | | |
| **Total Expenses** | **7,029,516** | **6,792,948** | **7,572,706** | **6,719,971** |

## 4.3 Levy Calculation

The following allocation methodology has been used to calculate the levy:

- Direct costs are allocated to the retail or wholesale areas of activity.
- Indirect costs are allocated between the retail and wholesale areas of activity on a proportional basis.
- Costs recovered through dedicated fees are deducted from the relevant areas of activity.
- Levy over-recoveries are allocated to the area of activity to which they relate.
- The retail and wholesale levies are set to recover the allocated costs in each area.
- Based on information from the Switching Registry, the Company will continue to assume an ICP count of 255,000 for the purposes of the levy calculation.
- Wholesale volumes for the FY2010 year were estimated at 145PJ for the purposes of levy calculation. Year to date figures, submitted to Gas Industry Co as part of the levy returns, indicate this volume is likely to be marginally exceeded. Gas Industry Co considers it prudent to maintain an estimated wholesale gas volume of 145PJ for the purposes of the levy calculation.

Based on the above allocation methodology, the Company's levy funding requirement of $4,299,216 results in the following levies.

| | FY2011 | | |
|---|---|---|---|
| | Retail | Wholesale | Total |
| Direct Costs | 2,768,246 | 2,119,138 | 4,887,384 |
| *Proportion of Direct Costs to Total Costs* | *56.6%* | *43.4%* | |
| Indirect Costs | 1,096,634 | 1,045,497 | 2,142,132 |
| **Total Work Programme Costs** | **3,864,880** | **3,164,636** | **7,029,516** |
| Deduction of Market Fees | (1,405,120) | (750,280) | (2,155,400) |
| Under (Over) Recovery of Levy | (463,215) | 252,119 | (211,096) |
| Depreciation on Industry Assets | (363,804) | - | (363,804) |
| | **(2,232,139)** | **(498,161)** | **(2,730,300)** |
| **Total Levy Funding Requirement** | **1,632,741** | **2,666,475** | **4,299,216** |
| Volume Units | *ICPs* | *GJ* | |
| Volume | 255,000 | 145,000,000 | |
| Levy Unit | *$/ICP* | *¢/GJ* | |
| **Levy Rate** | **$6.40** | **1.84¢** | |
| **Projected Levy Revenue** | **1,632,741** | **2,666,475** | **4,299,216** |

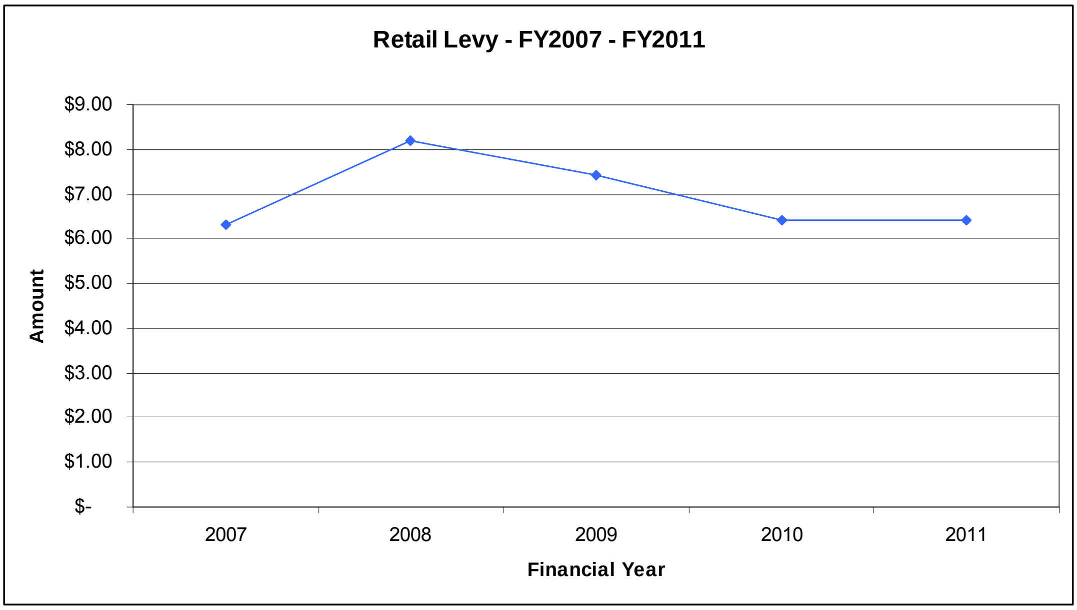
## 4.4 Conclusion

Gas Industry Co considers that the proposed levy is reasonable, having regard to the Company's Strategic Plan, Annual Report, indicative work programme and budget, the GPS objectives and outcomes, submissions from industry participants and past expenditure.

# 5 Other Information

## 5.1 Past Levies

The following graphs sets out the retail and wholesale levies for the last five years (including the levies proposed in this recommendation). They show a plateau in the retail levy and a rise in the wholesale levy for FY2011.

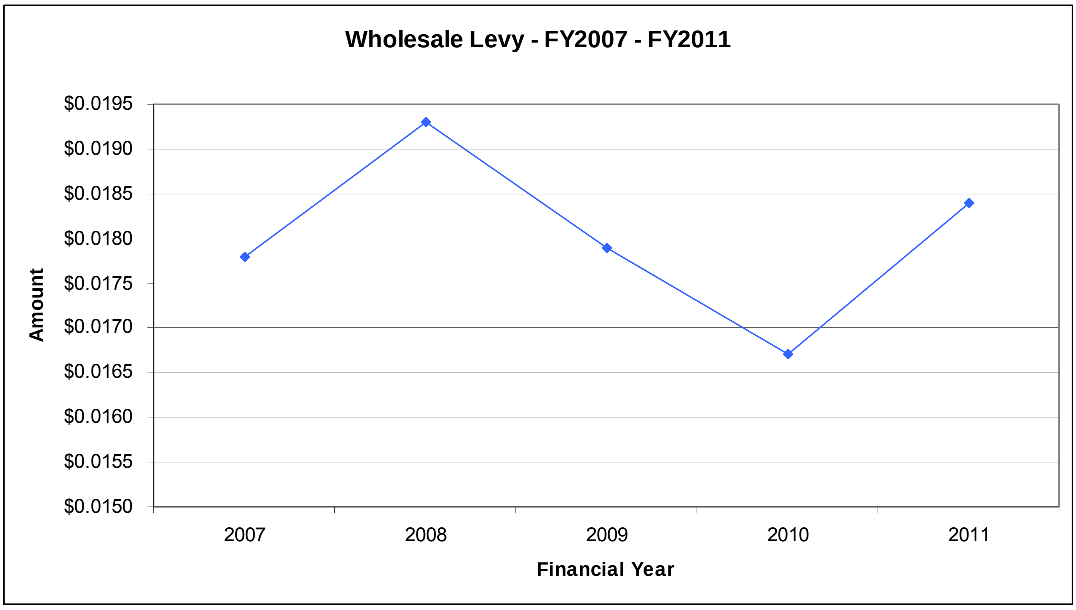



There are two factors behind the rise in the wholesale levy.

The first factor relates to fluctuations in wholesale gas levy revenues. In FY2009 and FY2010, the costs of the wholesale work programme were mitigated through the availability of large reserves built up in FY2007 and FY2008. These reserves were achieved mainly as a result of the unexpectedly large volumes of gas being purchased from producers in those years. For example, in FY2007 Gas Industry Co estimated the total volume of gas purchased from producers would be 124PJ. The actual figure was approximately 148PJ. In FY2008, Gas Industry Co estimated the total volume of gas purchased from producers would be 145PJ, while the actual figure was approximately 161PJ. Estimated gas volumes for FY2009 (145PJ) were much closer to the actual volumes achieved (148PJ) resulting in a lack of reserves available for the FY2011 work programme.

The second factor was an overspend on wholesale work stream activity of approximately $250,000 in FY2009, which needs to be recovered in the FY2011 levy. The overspend was the result of an overspend in the Transmission Access work stream of $420,000, partially offset by an underspend in the Wholesale Market work stream of $140,000.

These two factors are responsible for an increase of approximately $640,000 to the wholesale levy funding requirement when compared to FY2010. In terms of the FY2011 levy this has added approximately 0.44c/GJ to the proposed wholesale levy. Without these two factors, the levy would have been approximately 1.4c/GJ, a decline of 16% on FY2010.




## 5.2 Impact on consumers

While the total amount of levies is significant, the effect on individual consumers is not large. The following tables provide an estimate of the effect of the proposal on an average gas bill if the levies are entirely passed through to customers.

| User Type | Residential | Commercial | Industrial |
|---|---|---|---|
| Typical Annual Usage (GJ) | 25 | 1,000 | 1,000,000 |
| Estimated Annual Gas Bill | $780 | $10,500 | $7,000,000 |
| Annual Retail Levy | $6.40 | $6.40 | $6.40 |
| Annual Wholesale Levy | $0.46 | $18.40 | $18,400 |
| **Total Annual Levies** | **$6.86** | **$24.80** | **$18,406.40** |
| % of Gas Bill | 0.88% | 0.24% | 0.26% |

# 6 Recommendation

Gas Industry Co recommends to the Minister that levy regulations be made by the Governor-General under section 43ZZE of the Gas Act 1992 for the financial year from 1 July 2010 to 30 June 2011 requiring payment in each month of that year:

- From every gas retailer who is an industry participant on the last day of each month a retail levy of $6.40 per annum for each ICP for each retail customer.

- From every person who is an industry participant on the first day of each month a wholesale levy of 1.84 cents on each gigajoule of gas purchased by the industry participant directly from gas producers during the previous month.

The Company further recommends that the new regulations:

- make it clear that the wholesale levy is payable where gas producer is supplying gas to a related party operating as a gas wholesaler or gas retailer, including making it clear from which gas producer that gas has been purchased

- provide clarity on issues relating to gas storage facilities by making it clear the wholesale levy should not be payable on purchases from a gas storage facility

- enable the Company to recover levies on remaining recoverable gas in gas storage facilities

- delete the phrase 'but in respect of Maui gas means the Crown' from the interpretation of gas producer in Regulation 4.