



# Recommendation on Gas (Levy of Participants) Regulations 2011

February 2011







## **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 Peter Davies.



# Executive summary

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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 2012.

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. In FY2012 Gas Industry Co expects the following work to be undertaken:

- 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;
- assessing the viability of regulatory measures to address the short-term problem of loss of competition to supply existing North Pipeline end users. In conjunction with this activity, Gas Industry Co will also undertake further work related to Vector Gas Limited's (Vector) transmission security standards, demand forecasts, investment analysis process, and Vector Transmission Code (VTC) changes to adopt new access arrangements;
- developing a statement of proposal with respect to improving shipper information (Daily Allocations);
- preparation of a statement of proposal for a comprehensive update to the Gas (Downstream Reconciliation) Rules (the 'Reconciliation Rules');
- reviewing the Gas (Switching Arrangements) Rules (the 'Switching Rules') against the revised rules for switching in the electricity sector, and considering whether there is a need for better alignment to address the needs of dual-fuel retailers.
- following recommendations from the Rulings Panel, Gas Industry Co expects to recommend a range of changes to the Gas Governance (Compliance) Regulations;
- providing advice on sector issues such as demand forecasting, disclosure rules for access to private pipelines, and input into the MED's industry performance review if required.

The levies are estimated to meet Gas Industry Co's levy funding requirement of \$3,961,665 for FY2012. Gas Industry Co's total work programme cost for FY2012 is estimated at \$6,089,841. The difference between the cost of the work programme and the levy funding requirement will be met from a combination of market fees and the application of reserves.



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# 1

## Background

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### 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 for regulations requiring industry participants<sup>1</sup> 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.

#### Levy Principles

Setting 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 FY2012 levy.

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

## **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 2008, 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

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## 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, therefore forms a key input into Gas Industry Co's work programme for FY2012.

Industry Sector	GPS Detail
Efficient wholesale market	<ul style="list-style-type: none"> <li>• Efficient arrangements for the short-term trading of gas.</li> <li>• Accurate, efficient and timely arrangements for allocating and reconciling upstream gas quantities.</li> </ul>
Access to key infrastructure	<ul style="list-style-type: none"> <li>• Gas industry participants and new entrants are able to access the following physical assets and related services on reasonable terms and conditions:               <ul style="list-style-type: none"> <li>○ third party gas processing facilities;</li> <li>○ transmission pipelines;</li> <li>○ distribution pipelines;</li> <li>○ consistent standards and protocols apply to the operations relating to access to all distribution pipelines.</li> </ul> </li> </ul>
Efficient retail market	<ul style="list-style-type: none"> <li>• The development of efficient and effective arrangements for the proper handling of consumer complaints.</li> <li>• Effective and efficient customer switching arrangements that minimise barriers to customer switching.</li> <li>• Accurate, efficient and timely arrangements for allocating and reconciling downstream gas quantities.</li> </ul>
Consumer benefit	<ul style="list-style-type: none"> <li>• All small gas consumers have effective access to a complaints resolution system.</li> <li>• Contractual arrangements between gas retailers and small consumers adequately protect the long-term interests of small consumers.</li> </ul>

Industry Sector	GPS Detail
Other outcomes	<ul style="list-style-type: none"> <li>• Gas governance arrangements are supported by appropriate compliance and dispute resolution processes.</li> <li>• Gas governance arrangements approved by the Minister of Energy are monitored by Gas Industry Co for ongoing relevance and effectiveness.</li> <li>• Good information is publicly available on the performance and present state of the gas sector.</li> </ul>

## 2.2 FY2012 Work Programme

The work expected to be undertaken in FY2012 includes the fulfilling of various roles set out for the Company under existing regulations, managing approved gas governance arrangements, and developing new policy recommendations in accordance with the Company's Strategic Plan<sup>2</sup>.

This plan divides the work programme into wholesale and retail workstreams. The wholesale workstream comprises arrangements relating to the sale and purchase of wholesale gas and its transmission through high pressure networks. In FY2012, the Company intends to give priority to transmission pipeline capacity, interconnection, and daily allocations. It will also continue to work on industry-initiated activities including: facilitating industry forums on contentious issues; commissioning expert reports; developing and issuing best practice guidelines; and performing its rule change roles under the Maui Pipeline Operating Code (MPOC), and the VTC. There is also an ongoing statutory role under the Gas (Processing Facilities Information Disclosure) Rules 2008.

The retail workstream 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 and governance of supply contracts.

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 FY2013.

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<sup>2</sup> A draft Strategic Plan has been forwarded to the Minister together with this Recommendation.

# 3

## Consultation Process and Outcomes

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### 3.1 Consultation on FY2012 Levy

During the FY2011 levy consultation, Gas Industry Co initiated earlier engagement on its strategic priorities with both levy payers and officials. The FY2012 levy process was undertaken on the same basis.

Initially, a letter from the Chair to all industry participants was sent towards the end of October 2010, asking for their assessment of the three key strategic priorities they thought Gas Industry Co should be concentrating on during FY2012. From those responses, Gas Industry Co was comfortable that its indicative work programme was addressing all the key issues raised by the industry. Any matters that were not included in the work programme were either outside the Company's mandate (such as encouraging or promoting the direct use of gas), or will be acted upon in this current financial year (such as a review of 'lessons learned' from the E-Gas liquidation).

The letter from the Chair was followed up with a co-regulatory forum in November with participation invited from both industry participants and MED officials. Forum participants were taken through a presentation of Gas Industry Co's assessment of work required to be undertaken in FY2012 and the available sources of funding. The Company noted that this meeting was to learn about the industry priorities, which would then have to be balanced with government requirements. Feedback during the forum, while instructive, did not provide any specific direction on how the Company might differently prioritise its work plan.

As with the written responses, the forum attendees confirmed the suitability of the work programme; no item was seen as unnecessary or irrelevant, nor were any new work items suggested.

In December 2010, Gas Industry Co released a Consultation Paper on the FY2011 Levy. This paper:

- described the work that Gas Industry Co would undertake in FY2012 and the estimated costs;
- outlined the calculation of the levy funding requirement for FY2012; and

- proposed the levy for FY2012.

The consultation paper proposed a Work Programme Cost (WPC) of \$6,089,841 (a reduction of \$939,675 from FY2011), and a Levy Funding Requirement (LFR) of \$3,961,665 (a reduction of \$337,551 from FY2011). Gas Industry Co called for submissions from interested parties as a precursor to the formulation of a recommendation to the Minister for the required levy regulations. Submissions closed on 4 February 2011. The consultation paper was sent to a list of 31 key stakeholders 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; Mighty River Power; Powerco; and Vector.

The Company also held a levy workshop on 20 January 2011. Attendance was excellent with 17 industry participant organisations represented.

Submitters on the consultation paper generally expressed satisfaction with the decrease in the levy and were broadly supportive of the work programme. This was in line with views expressed by industry participants who attended the November 2010 Co-regulatory Forum. A summary of all of the issues raised in the FY2012 levy consultation submissions is set out in the Submissions Analysis Paper, which is available from the Gas Industry Co website.

### **3.2 Proposed regulation amendments**

Gas Industry Co proposed a number of legislative amendments to improve the operation of the levy collection process. These were to bring the Levy Regulations within the scheme of the existing Compliance Regulations, to abolish the requirement for industry participants to submit Retail Levy Returns, and to introduce an audit process for verifying Wholesale Levy Returns.

Submitters generally supported these amendments. With respect to the audit of Wholesale Levy Returns, some submitters provided suggestions as to how this process might operate, and sought clarity on the scope and purpose of the audits. We will, where possible, accommodate these suggestions when discussing the drafting of the Levy Regulations with the PCO.

### **3.3 Conclusion on consultation**

The consultation process has appropriately tested Gas Industry Co's proposed work programme and budget. Gas Industry Co considers it has fulfilled its obligations to consult with industry participants on the proposed levy.

# 4

## Budget and Levy

### 4.1 FY2012 Budget

Total expenditure for the FY2012 work programme described in the draft Strategic Plan is estimated at \$6,089,841, of which \$3,961,665 is required to be funded by the annual levy. The following table compares the FY2012 Levy Budget with the FY2011 Levy Budget.

	FY2012 Budget	FY2011 Budget
	YE 30/06/12	YE 30/06/11
Critical Contingency Management	624,507	762,794
Gas Processing	16,604	7,581
Compliance	70,029	81,070
Capacity Trading	260,674	0
Balancing	109,529	421,296
Gas Quality	63,019	0
Demand Forecasting	71,402	0
Interconnection	108,019	0
Other Transmission Work	0	292,808
Industry Facilitation	78,019	213,229
Upstream Reconciliation	178,150	0
Wholesale Market	0	258,659
Other Policy Advice	0	81,700
<b>Total Wholesale Costs</b>	<b>1,579,952</b>	<b>2,119,137</b>
Switching	535,748	581,022
Reconciliation	982,161	1,162,562
Compliance	280,118	324,281

Distribution Contracts	46,415	30,324
Rule Changes	190,277	338,704
Consumer Issues	42,272	131,400
Performance Measures	29,571	68,254
Other Policy Advice	0	131,700
<b>Total Retail Costs</b>	<b>2,106,562</b>	<b>2,768,247</b>
Board	282,460	290,000
Corporate	2,120,867	1,852,132
<b>Total Corporate Costs</b>	<b>2,403,327</b>	<b>2,142,132</b>
<b>Total Expenses</b>	<b>6,089,841</b>	<b>7,029,516</b>

### 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 FY2012 were estimated at 150PJ for the purposes of levy calculation.

Based on the above allocation methodology, the Company's levy funding requirement of \$3,961,665 results in the following levies.

	FY2012		
	Retail	Wholesale	Total
Direct Costs	2,106,561	1,579,952	3,686,514
<i>Proportion of Direct Costs to Total Costs</i>	<i>57.1%</i>	<i>42.9%</i>	
Indirect Costs	890,465	1,512,862	2,403,327
<b>Total Work Programme Costs</b>	<b>2,997,027</b>	<b>3,092,814</b>	<b>6,089,841</b>
Deduction of Market Fees	(1,165,372)	(599,000)	(1,764,372)
Amortisation on Industry Assets	(363,804)	-	(363,804)
	<b>(1,529,176)</b>	<b>(599,000)</b>	<b>(2,128,176)</b>
<b>Total Levy Funding Requirement</b>	<b>1,467,851</b>	<b>2,493,814</b>	<b>3,961,665</b>
Volume Units	<i>ICPs</i>	<i>GJ</i>	
Volume	255,000	150,000,000	
Levy Unit	<i>\$/ICP</i>	<i>¢/GJ</i>	
<b>Levy Rate</b>	<b>\$5.76</b>	<b>1.66</b>	
<b>Projected Levy Revenue</b>	<b>1,467,851</b>	<b>2,493,814</b>	<b>3,961,665</b>

#### 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

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### 5.1 Reserves

Gas Industry Co's equity balance as at 30 June 2010 was made up of three components: the first is the Industry Advances Reserve of \$1,574,072; the second is the Industry Amortisation Reserve of \$1,591,476; and the third is Retained Earnings of \$270,000 (comprising shareholder fees).

The Industry Advances Reserve represents the net over-recoveries of levies from previous years and has traditionally been used to offset levies in subsequent financial years, as provided for in the Act (section 43ZZC(3)). While the Act provides this as a mechanism for returning over-recovered levies, it is not a mandatory provision.

Although this policy has generally suited Gas Industry Co by providing a method to return overpaid levies without undue risk to its liquidity, it has also reduced the transparency of its costs to the industry. For example, the change in the FY2011 levy was disproportionate to the change in Gas Industry Co's underlying costs because of the fluctuating level of reserves. Therefore, Gas Industry Co considers it is more practicable to refund overpaid levies as soon as the annual accounts have been received by shareholders at the AGM. This is also consistent with the treatment of over-recoveries collected under the various Market Fee arrangements. Gas Industry Co is of the view that this policy will encourage a predictable and stable levy by removing from the levy calculations any variability resulting from a fluctuating level of reserves. Accordingly, refunds of approximately \$1.5m were made to levy payers at the end of November 2010 and no adjustment has been made to the FY2012 levy.

The Industry Amortisation Reserve represents the unexpended amortisation on capital items purchased with market fees, such as the Switching Registry and Downstream Reconciliation system. There is an ongoing annual amortisation cost of \$363,804 associated with these assets. This annual cost will be met from the amortisation reserve and, over time, the value of the assets and the reserve will both reduce to zero.

Retained earnings are the accumulation of the shareholders' annual fees, set aside as a reserve against future contingencies and do not impact on the levy calculation.

## 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	\$5.76	\$5.76	\$5.76
Annual Wholesale Levy	\$0.42	\$16.60	\$16,600
<b>Total Annual Levies</b>	<b>\$6.18</b>	<b>\$22.36</b>	<b>\$16,605.76</b>
% of Gas Bill	0.79%	0.21%	0.24%

# 6 Recommendation

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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 2011 to 30 June 2012 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 \$5.76 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 1.66 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:

- Abolish the requirement for industry participants to supply Retail Levy returns in Regulation 10. It will instead invoice responsible retailers based on the number of ICP's with a status of ACTIVE-CONTRACTED in the Gas Registry Database as at the last day of the applicable month.
- Allow for the performance of audits of Wholesale Levy Returns where Gas Industry Co had reasonable grounds to believe that an industry participant's Wholesale Levy was inaccurate, which belief would derive from reference to the publically available allocation data, published by the Allocation Agent.

Provisions regarding an audit process would include;

- Gas Industry Co to appoint independent auditor(s) as required for ad hoc audits of Wholesale Levy returns.
- Gas Industry Co to determine when ad hoc audits should occur at its discretion.
- The industry participant that is being audited must pay the costs of the auditor.
- Participants will be required to provide an auditor with information. However, requirements to provide information may include exemptions for information subject to legal privilege.
- Final audit reports (with confidential information redacted) will be published on Gas Industry Co's website.

- Auditors will be able to audit a period of up to three years prior to the date on which the audit was requested.
- Audit reports may be used for a variety of purposes.