Firstgas

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4 August 2016

Ms. Tricia Jennings
Project Manager, Gas DPP 2017 reset
Regulation Branch
Commerce Commission
Wellington

Dear Tricia,

Submission on DPP for gas pipeline services from 1 October 2017

This is a submission by First Gas on the Gas DPP 2017 reset paper, published by the Commission on 28 June 2016 with the subtitle "Implementing matters arising from proposed input methodologies changes". Our submission is structured similarly to that of the Commission's paper.

Price setting process

We support a price setting process for our GTB based on forecast revenue from prices actually being set.

- We expect that we should be able to make reasonable one-year forecasts of pricing quantities for this purpose. Even when transmission prices are restructured – which is likely to occur after implementation of a new gas transmission operating code – we expect we can make forecasts on the basis of quantities that are known or reasonably predictable in the short term.
- We agree that we would not be able to make reasonable forecasts prior to the start of a pricing year for other regulatory revenues and for other types of non-priced income that could be introduced in a new gas transmission operating code. Such non-priced income could include capacity auction revenues and congestion management charges. It is indeed a practical solution to treat such income in a wash-up arrangement as a negative recoverable cost (with an appropriate time-value-of-money adjustment).

We support the intention to limit price shocks to consumers. However, we do not support the Commission's currently proposed approach for achieving this. We believe a more practical and less complex approach can be developed.

- The Commission currently proposes to use a cap on an increase in weighted average prices. This effectively combines a revenue cap with a weighted average price cap. In our view this is a highly undesirable approach. Any need to calculate weighted average prices based on historical quantities is an impediment to price restructuring and would negate some of the benefits of moving to a 'pure' revenue cap.
- The Commission proposes to combine that approach with a cap and collar on drawdowns from revenue wash-ups. This leads to a complex mechanism with a double cap.

- We suggest that the most relevant quantity for volatility reduction is the forecast revenue from prices. If price volatility for consumers is to be limited then it is only necessary to limit increases in that quantity from year to year.
- This could be achieved by deducting a 'smoothing adjustment' from the forecast allowable revenue if it is increasing by more than a specified limit from its smoothed value for the previous year.
- The calculation (as quasi spreadsheet formulas) could be as follows:

  smoothing adjustment = Max (0, forecast allowable revenue(t) –
  smoothed allowable revenue(t-1) * (1 + volatility limit))

  smoothed allowable revenue(t) = forecast allowable revenue(t) –
  smoothing adjustment

- This calculation only requires three inputs instead of a weighted average price increase calculation covering all pricing quantities. It should achieve the same effect for consumers. The forecast revenue from prices should not exceed the smoothed allowable revenue.
- Any non-zero smoothing adjustment for each year would then be added to the revenue wash-up pool.
- The forecast allowable revenue in each year would include the full wash-up pool (prior to that year's smoothing). There would be no need to make separate calculations for a cap or collar on drawdowns from this pool.
- Smoothing adjustments would be subject to time-value-of-money adjustments on the same basis as all other recoverable costs.
- The process would need to be slightly amended if the Commission also wishes to limit volatility from reductions in revenues. We have not yet developed views on whether that should be desirable.
- As part of transitioning from the current regulatory period we do not expect the process in our suggested approach to include a smoothing adjustment in its first year. We do not expect this to be necessary, but a transition arrangement could be designed if desired.

With respect to setting the volatility limit we submit it should not be too low. To provide some flexibility, the value should be set in the applicable price-quality path determination. We consider the limits of 5% or 10% mentioned for EDBs as clearly inappropriate for our GTB. Our transmission prices are a small fraction of delivered gas costs, and do not have a material impact on overall supply and demand for gas. MDL has submitted previously[1] that transmission fees for the Maui pipeline are less than the daily standard deviation for gas prices traded on the emsTradepoint spot market. From that perspective, even a volatility limit of 100% could be considered manageable. In practice, assuming that smoothing adjustments can be recovered over one or more later years if necessary, we would not be that aggressive with price increases. In order to accommodate potential fluctuations from auction revenues, however, as well as fluctuations that could be caused by 'dry' years versus 'wet' years, the limits should not be too small either.

The size of the volatility limit would also impact our views on the need to limit volatility from reductions in revenue. We can accept a reasonable degree of downside risk in any given year if this can be compensated with price increases over later years. If we are severely limited in the wash-up of revenue shortfalls, however, then we would also want to be protected against potential requirements to drop our forecast revenues by a large percentage at the start of a year.

1 Cross-submission dated 13 April 2016 on the "Default price-quality paths for gas pipeline services from 1 October 2017" process and issues paper.

With respect to determining CPI forecasts, we would welcome clarification by the Commission on the acceptable sources for such forecasts. For example, in setting Maui pipeline prices for July-June pricing periods MDL has previously used CPI forecasts obtained from the Half Year Economic and Fiscal Update published by the Treasury in December of each year. It would be helpful to know if the Commission considers that acceptable or if it intends to prescribe acceptable sources.

Wash-up process

We support the treatment of revenue wash-ups as a recoverable cost.

We do not support the concept of an aggregate cap on amounts that can enter the wash-up pool. If elements of the wash-up are justified, for example the difference between forecast and actual CPI, then it would be odd to allow them only under limited circumstances. The price shock risk faced by consumers is already addressed by imposing a limit on volatility. We do not agree that we should be faced with a risk that a legitimate recoverable cost suddenly becomes irrevocably unrecoverable because an artificial wash-up cap has been exceeded.

Having said that, we do understand that the Commission may be concerned by unconstrained recovery of revenues lost for any reason. A risk that we consider appropriate to accept is the loss of revenue from unavailability or curtailment of our gas transmission services. This is a risk we already face. Under the Maui Pipeline Operating Code (MPOC) we obtain revenue from Approved Nominations, and do not obtain revenue if we have to curtail or cannot approve nominations. Section 10.4 of the Vector Transmission Code (VTC) requires that each Shipper shall be provided with an appropriate rebate:

> "... for the loss or reduction of transmission service as a result of the period of curtailment or shutdown, except to the extent that the Shipper has caused or contributed to any event or circumstance giving rise to such curtailment or shutdown."

We can support a mechanism that eliminates or prevents such losses or rebates from entering the wash-up pool, if applicable.

We support the Commission's proposal to set the rules for wash-up adjustments (draw downs and top ups) in the applicable DPP or CPP determination. If our suggestion for price setting with a smoothing adjustment is followed then there is no need to calculate caps or collars for such adjustments.

We support the application of time-value-of-money adjustments to all balances in the wash-up pool. We agree that the appropriate rate for such adjustments should be the same as the WACC rate used for setting the DPP in each period.

We would appreciate clarification of the treatment of historical pass-through and recoverable costs incurred during the current regulatory period. On 1 October 2017 those will not yet have been included in prices, and may not even be fully known yet. Perhaps some of those outstanding costs need to enter the wash-up pool as well. If so, the appropriate time-value-of-money adjustments for those costs need to be considered. It could be the case that pass-through and recoverable costs from the current regulatory period will not be included in prices until the pricing year starting on 1 October 2018.

Compliance process

We support a process for ex-ante price path compliance, prior to prices taking effect, based on forecast quantities.

We agree that price restructures should not require any particular compliance actions. In our view this is a contributing reason to avoid the use of a weighted average price cap as part of calculations to limit volatility when setting prices.

We have not yet formed a view on assurance for the ex-ante compliance. (We assume the Commission will continue to require a report signed by an Auditor for ex-post Compliance Statements required after each assessment period.) We are aware that MDL previously engaged an audit firm each year to provide an assurance report on price path compliance prior to setting prices for the Maui pipeline. However, the scope for such engagements was limited. We do not expect an audit firm could express an opinion on all input parameters used for setting prices. It may also lead to unnecessary expense to have both ex-ante and ex-post Auditor opinions.

Pass-through and recoverable costs

We support the alignment for GDBs with the approach for pass-through and recoverable costs currently used for EDBs. We assume the drafting of required provisions can indeed be similar to current determinations for EDBs.

We have included comments on the proposed treatment of compressor fuel costs as a recoverable cost for our GTB in our submission on Input Methodologies review draft decisions (excluding cost of capital) dated 4 August 2016. We refer to those. We understand that recoverable costs cannot be included in opex forecasts for the DPP. The problem to be solved is to establish which proportion of compressor use is a substitute for balancing. For the Mokau compressor station on the Maui pipeline we can identify circumstances in which its compressors are clearly run for balancing. Indeed, we consider that is now the case for most of the time. In general, however, we currently do not have a 'bright-line test' to distinguish in all situations whether any particular compressor is used for balancing or for other reasons. We agree that treatment of compressor fuel costs is best addressed in a price-quality path determination.

We support the introduction of a capex wash-up for GDBs and our GTB. We appreciate that this will be similar to current arrangements for EDBs. We concur that the wash-up amount for this should be calculated with the same financial model as used for setting the DPP.

We support the potential inclusion of new criteria-based pass-through costs for GDBs and our GTB in price-quality path determinations. We are not aware of any new pass-through costs the Commission needs to consider now. Our only suggestion is to ensure that costs for the Electricity and Gas Complaints Commissioner Scheme remain included after changes that it is pursuing for its organisation.

Draft financial model

Due to time constraints we have not undertaken a detailed review of the Commission's draft financial model. From a cursory review, however, we can make the following suggestions.

- It may be more practical and less complex to have separate spreadsheets for transmission and for distribution.
- We expect the GTB spreadsheet only needs to calculate a single price path for First Gas. We do not anticipate, and do not support, a need for separate price paths for the Maui pipeline and the former Vector transmission pipelines.

With respect to information requirements, we appreciate the exemption provided to us by the Commission for preparing our next Asset Management Plans on the basis of disclosure years ending on 30 September. The forecasts in those plans will be aligned with and should be usable for the forecasts that the Commission needs to make.

With respect to other information disclosures (outside of our AMPs) we are liaising with Commission staff on timing and approaches for this. For our GDB and GTB we strongly support disclosure years aligned with price-quality path assessment periods ending on 30 September of each year. Implementing that does require a transition from the disclosure years that applied to Vector and MDL ending on 30 June and on 31 December respectively. If the Commission needs to amend determinations to enable a 30 September disclosure year for us, with any required transition arrangements, then we would welcome the development of those at the earliest opportunity.

Conclusion

We appreciate the opportunity to provide this submission. We would be happy to provide additional clarifications and information if this is helpful. Please feel free to contact me at any time at jelle.sjoerdsma@firstgas.co.nz or in our Wellington office on (04) 460 2535.

Yours sincerely

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