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10 March 2017

Dear Tricia

Draft Decisions on Gas DPP Reset for 2017-2022

This submission is made on the draft Default Price-quality Path (DPP) reset decisions for 2017-2022 on behalf of First State Investments (FSI). We have a material interest in how gas pipelines are regulated through our ownership of First Gas. We have read the submission made by First Gas on the draft decisions (and the expert report prepared by Chris Harvey), and we support their findings and recommendations for the final DPP reset decisions.

As a long-term investor, FSI plans to invest significant capital in First Gas to maintain and improve asset integrity, enhance the network capacity and improve service standards to our customers. The level of investment that is required is clearly presented in First Gas' Asset Management Plans. As the Commission is aware, we have recently acquired the businesses now combined in First Gas, and we therefore see the DPP reset process as an important component to the regulatory regime that provides the right incentives to deliver on these objectives. We believe that our objectives are well aligned with the purpose of Part 4 of the Commerce Act.

We are concerned that the draft decisions have the potential to undermine the objectives that the Commission aims to achieve (the long-term interests of consumers):

- The draft decision has disallowed significant expenditure forecast by First Gas, notwithstanding evidence provided that the expenditure is required to maintain system resilience, meet customer service requirements, ensure the efficient network maintenance, and keep the assets in a condition that meets long-term performance expectations. These planned outcomes are articulated in First Gas' AMPs and subsequent submissions. Based on our experience with other similar acquisitions, and knowing that we have a longer investment horizon than the vendors, we were aware that expenditure may need to increase above the levels seen in recent years to address identified risks and maintain these important gas infrastructure assets. This has been borne out in the First Gas AMPs. A significant portion of the expenditure disallowed by the Commission directly impacts on asset integrity and hence asset risk profile, such as routine corrective maintenance and inspection opex and asset replacement and renewal capex. For example, geo-hazard risks were identified as a major risk through our due diligence, and the recent Kaikoura earthquakes have again highlighted these risks. We are concerned that the draft decisions suggest that the Commission does not share our view of the critical nature of these expenditure items, contrary to what we regard as good industry practice and prudent long-term asset management. We believe that the approach signalled in the draft decisions does not serve long-term consumer interests because much-needed expenditures would be avoided or delayed for what appear to be short-term and unsustainable price reductions.

- The draft decisions will reduce First Gas revenue by up to $120 million across five years, or around 17% per annum. Most of the reduction is the result of the Commission's recent Input Methodologies (IMs) decisions, which materially reduced the rate of return on our investment. The draft DPP decisions risk further dampening investment incentives by not enabling tariffs to fund a significant portion of forecast expenditure. In trying to keep prices as low as possible for consumers (average tariffs are estimated to fall by 18% across gas pipelines as a result of the draft DPP), we believe that the draft decisions fail to find the right balance between keeping prices low while maintaining system integrity, and therefore put at risk providing sufficient incentive for re-investment in the network.

- A further likely impact of the draft decisions is to increase the cost of existing and new debt and new equity financing for First Gas. This is because the revenue reduction proposed in the draft decisions is significantly greater than anticipated, implying a higher investment risk profile. This is not solely explained by changes in the regulated or observable cost of capital. Material and unexpected changes to the IMs and the DPP create regulatory uncertainty, which is unwelcome to capital providers in assessing the risk profile of First Gas. An increase in the required cost of capital from capital providers is not in the interest of consumers since fewer investments will pass the required hurdle rate and may either not proceed or be deferred.

We understand that the Commission is exploring new regulatory approaches at this DPP reset and trust that providing an investor's perspective on this important regulatory decision is useful. We support the recommendations made by First Gas on how to improve the final DPP decisions to better deliver on the Commission's objectives.

Yours sincerely,

Gavin Kerr,
Director
First State Investments