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INPUT METHODOLOGIES REVIEW AND GAS DPP CONSULTATION

CROSS-SUBMISSION BY METHANEX NEW ZEALAND LIMITED

Methanex New Zealand welcomes the opportunity to make a cross-submission to the Commerce Commission in response to the submissions made on the Input Methodologies (IM) review draft decisions. Our cross-submission focuses on the submissions made by First Gas Limited in respect of the regulation of gas pipeline businesses (GPBs):

- 'Submission on Input Methodologies review draft decisions (excluding cost of capital)' (IM Submission)
- 'Submission on DPP for gas pipeline services from 1 October 2017' (DPP submission)
- 'Submission on Input Methodologies Review Draft Decisions: Cost of Capital Issues' (WACC submission).

Methanex does not make any use of gas distribution pipelines nor does it make use of the Vector gas transmission system. Consequently, the focus of our cross-submission concerns the regulation of gas transmission businesses (GTBs) and specifically the Maui Pipeline, now owned by First Gas Limited.

IM SUBMISSION

Cost allocation

In its IM submission First Gas has raised concerns over the draft decision (CA04) to require GTBs to justify using proxy allocators. We support the Commerce Commission's position that greater onus needs to be placed on suppliers to show that a causal approach is not suitable.

The example used by First Gas to illustrate its point is also unhelpful in this regard. We would not expect the purchase of office supplies to be seriously considered as a separate expenditure for allocation purposes. Even if it were, a simple justification would be expected to suffice to satisfy interested parties that a proxy allocator was appropriate in such a case.

First Gas has recommended that a materiality threshold is applied before additional disclosure is required regarding proxy and causal allocators. Methanex does not consider there is any need for a threshold to be specified. The draft decision does not by rule or implication suggest that excessive or costly disclosure is an expected or inevitable consequence. Where the rationale for proxy allocation is straight-forward we would expect that a simple justification would be sufficient and not impose a material burden on the GTB.

Asset valuation

The IM draft decisions include an option for electricity distribution businesses (EDBs) to apply to the Commission to reduce their asset lives by up to 15%, if they were at risk of stranding due to consumers' use of emerging technologies (AV17). First Gas' IM submission suggests that this should also be applied to gas pipeline businesses (GPBs).

We question the general principle of reducing asset lives in response to a conceptual future risk of asset stranding – such outcomes are not consistent with workably competitive markets. In any case, even if such treatment is considered appropriate for EDBs, we do not believe there is evidence that GPB's, and GTBs in particular, face the emerging technology risk that has been attributed to EDBs.

Treatment of taxation

First Gas' IM submission has raised the prospect of negotiating an outcome with the Commission in respect to an alternate tax treatment.

Methanex is not aware of the particular issue involved but we are concerned that decisions in this regard may have implications on allowable revenue and recoverable costs. We request that there is meaningful information disclosure and consultation with First Gas' customers, before the Commerce Commission gives consideration to a First Gas proposal in this regard.

Gas transmission pricing methodologies

First Gas' IM submission recommends transferring the responsibility for pricing methodologies for GTBs from the Commerce Commission to the Gas Industry Company (GIC), on the grounds that this would be a better fit with the GIC's evolving responsibilities in overseeing the development of a new gas transmission operating code.

We disagree that there is a prospect for conflict or divergent approaches between the distinct roles of the Commerce Commission and the GIC, or that the GIC's responsibilities should extend to taking over the setting of pricing methodologies for GTBs. In the interests of achieving regulatory efficiency we do see a greater role for the GIC to play in assuring that the pricing methodologies and principles set out in the IMs are applied in the development of a new GTB operating code.

We consider that the retention of pricing methodology IMs should remain a necessary component of the Commission's role in regulating GTBs. The pricing methodologies and pricing principles in the IMs remain appropriate, with the caveat that, as discussed in our previous submission, we recommend the Commission adds the principle that prices for individual customers should reflect the cost of service provided to that customer.

In particular, First Gas has suggested removing the CPP pricing methodologies IMs (GP05). We do not understand the argument that has been given by First Gas in this regard. Methanex considers that the CPP pricing methodologies are reasonable and First Gas has not proposed an alternative mechanism that would ensure appropriate regulatory requirements remain in place and ensure that, in particular, the underlying pricing principles continue to be applied. If, at the time First Gas applies for a CPP, there is an issue in relation to operating codes and determinations made by the GIC, First Gas has the option to propose an alternative pricing methodology.

Reconsideration of price-quality paths

First Gas' IM submission recommends that contingent project reopeners are available under the DPP as well as under the CPP.

As we stated in our previous submission, Methanex believes that for GTBs, contingent project DPP reopeners may be appropriate for modestly-sized replacement and renewal projects. This is subject to there being sufficient scrutiny of the expenditure to ensure it is reasonable and the project is justified, which may be manageable within the DPP. We consider that in the event that large, one-off, projects are contemplated, a CPP approach remains a suitable basis.

Therefore our support for a DPP contingent project reopener is dependent on the Commission setting a threshold to exclude significant projects from being permitted in a DPP reopener. The threshold, which could be a percentage of RAB value, should be specified within the IMs and all projects that fall above the threshold should only be accommodated within a CPP.

For projects that fall below the threshold, the Commission should also have some discretion to decline to approve a DPP reopener and suggest the GPB applies for a CPP instead. This could be where the project is not sufficiently large to exceed the cost threshold but has a material effect on other parts of the DPP (e.g. where the project would have consequential step-change impacts on revenues or quality performance).

DPP SUBMISSION

DPP price setting process

We note that First Gas has proposed an alternative approach to limiting price shocks that is intended to be less complex. However, it is not clear to us that the methodology it has proposed is any less complex than or otherwise superior to the Commission's proposal.

We also want to respond to the suggestion made by First Gas that because gas transmission prices are a small fraction of overall delivered gas costs there is little need for a volatility limit. Transmission costs are a significant expenditure and we don't consider that the relativity of transmission costs to overall delivered gas costs has a bearing on addressing the volatility limit or determining the cap and collar amounts. We also recommend that First Gas provides evidence to support its argument that a volatility limit in the 5-10% range is too low for GTBs.

In respect to an aggregate wash-up cap, we support the Commerce Commission's principle that suppliers bear some risk in respect to major demand events and consider that application of a wash-up cap is an appropriate means of addressing that.

WACC SUBMISSION

As a general principle we support the use of empirical evidence to determine the asset beta applied to GPBs where the sample set is broadly representative and unbiased. Oxera's analysis is influenced by removing companies that it considers to be outliers. This has resulted in removing firms such as Vector Limited and SP AusNet, which we consider to be more comparable to regulated energy companies in New Zealand than most other firms within the sample. Although the materiality of removing them is not clear, it is unfortunate that such comparable firms have been removed.

The effect of Oxera's approach is that the asset beta for GPBs would be determined on the basis of a sample of 15 companies – all of them based in the USA, while the asset beta for electricity lines businesses would be determined on the basis of a sample of 14 companies – also all based in the USA. We see value in having a larger sample of companies and including companies from different jurisdictions, preferably including Australia and New Zealand where the firms are more likely to be similar.

We also question whether the companies in Oxera's gas sample are as comparable to New Zealand GPBs as has been implied. Based on the summary of characteristics presented by First Gas to compare US GPBs (Table 2, page 7) with New Zealand counterparts we do not consider there is a close correlation.

Based on the Commission's description of these firms, we note that Oxera's selected firms are also engaged in a range of activities, including:

- gas retail
- natural gas exploration and production (including the company with the highest beta in the gas sample)
- sale of propane
- construction services to other utilities, including electricity utilities
- electricity marketing.

We are unconvinced that these firms are more similar to New Zealand GPBs than other energy companies just because they are exclusively or largely focused in gas sector activities.

On this basis we do not consider that First Gas has sufficiently demonstrated that GPBs should have a higher asset beta than EDBs.

Yours sincerely

Kevin Maloney
Managing Director
Methanex New Zealand Limited