

28 September 2016

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

Dear Tricia,

[Submission on policy for setting price paths and quality standards in 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 30 August 2016 titled "Policy for setting price paths and quality standards" (the 'policy paper').

Overview

We appreciate the Commission's efforts to make the DPP for the next regulatory period more reflective of gas industry dynamics in New Zealand. This is a welcome evolution compared to the approach used for setting the initial gas DPP, which at the time appeared to be only a small variation on the approach used for Electricity Distribution Businesses. For this DPP reset, the Commission has dedicated more time and resources to understanding the specifics of gas pipeline businesses, which are materially different from EDBs.

We broadly support the approaches proposed by the Commission to:

- set opex and capex allowances for each gas pipeline business based on scrutiny of individual Asset Management Plans (AMPs);
- apply a more tailored approach to forecasting Constant Price Revenue Growth (CPRG) for gas distribution businesses (GDBs);
- introduce a quality standard that requires additional reporting after a major interruption.

We accept that setting expenditure allowances based on AMPs will lead to additional scrutiny of our forecasts in order to build confidence that they are prudent and reasonable. However, this leads to challenges for determining the appropriate level of scrutiny and discretion under the DPP. We consider that review processes should focus on gaining comfort that supplier forecasts are reasonable based on the information available, rather than focusing on introducing different assessments of required expenditure.

With respect to introducing new quality standards we are concerned about the proposal that any major interruption be automatically deemed to be a breach of DPP requirements. Without having any guidelines or interpretation of the potential enforcement actions under section 87, we consider this would create uncertainty for suppliers for the response to events that may be outside their control.

Our submission is structured under the same headings used for chapter titles in the policy paper.

Forecasting expenditure

We accept that using Asset Management Plans to set expenditure allowances will involve more scrutiny

We appreciate the Commission's proposed approach to use our AMPs as a starting point for setting opex and capex allowances. Considerable effort goes into preparation of our AMPs, and they provide the best information we have available on the prudent and reasonable level of expenditure required. We therefore consider they provide the most reliable basis for setting expenditure allowances under the DPP.

We accept that using supplier AMPs will require the Commission to be comfortable with the basis for the expenditure forecasts presented. We support the concepts put forward by the Commission for its approach to DPP tailoring and implementing the proportionate scrutiny principle in its assessment framework. In particular, we support the Commission's proposed approach to escalating its quantitative and qualitative assessment of our expenditure forecasts if the need arises. We understand this approach may impose greater scrutiny on us than was applied for the initial DPP determinations. We consider this a reasonable cost to incur for the benefit of more tailored and more appropriate DPP determinations for the upcoming regulatory period.

Determining proper scrutiny leads to several challenges under the DPP

Each of the stages in the Commission's escalating assessments has its own challenges.

We consider that Business-As-Usual variance checks are a good starting point in the Commission's approach (after checking compliance). However, this immediately leads to the following issues that need to be resolved. The following issues are problematic:

- The use of metrics and ratios. We are not sure to what extent the proposed metrics can be reliably applied to GDBs. The Commission has already acknowledged that the ratios and metrics are unlikely to be useful for our gas transmission business (GTB).
- The Commission's choice of boundaries for ratios and metrics. In the absence of any clear quantitative evidence for setting such boundaries, we agree that the Commission needs discretion and an ability to tailor the boundaries for each supplier. However, this also leads to uncertainty on where further information is warranted – potentially creating scrutiny where it is not needed.
- The selection of a reference base period for comparison. In the case of GDBs we can see a justification for using the most recent year as a reference period. GDB expenditures are driven to at least some degree by scale. For those types of expenditures that do depend on scale factors it may indeed be appropriate to reference the most recent year for which information is available. In the case of our GTB, however, scale factors are largely irrelevant while expenditures are more lumpy and difficult to predict from year to year. In that case the results from comparing expenditures on an annual basis with reference to a single base year are unlikely to provide the most useful guidance. An appropriate approach for our GTB would be to compare expenditure forecasts over a multi-year period against historical expenditures over a multi-year period. That would at least smooth out lumpiness from the review, and reduce spurious results from selecting any single base year.

We support scrutiny of Asset Management Plans as the next level for the Commission's assessment framework. In view of the issues listed for the BAU assessment we expect the Commission will almost inevitably be progressing to this level; particularly for our GTB.

We must caution the Commission, however, that for certain types of expenditure it may simply be impossible for an AMP to demonstrate that all non-BAU activity is well understood and supported. For our GTB, for example, we will include an estimate of the costs for replacing OATIS (our Open Access Transmission Information System) in the capex forecasts in our AMP. At this stage, however, while still exploring options for the design of a future Gas Transmission Access Code, we do not yet know the specific requirements for the replacement system. Therefore, we do not know if those requirements can best be met through a custom-built system requiring capex or an off-the-shelf system which would presumably lead to an annual license fee classified as opex.

As a result, we expect there is a high likelihood – at least for our GTB – that the Commission will need to apply supplier scrutiny.

Realistic expectations are needed on the information available through supplier scrutiny

We are concerned that the Commission, or its consultants, may be expecting more information from supplier scrutiny than is actually available. The policy paper states that the Commission is “expecting a level of information from suppliers that is equivalent to a board-level assessment or business case”. This level of information will usually exist for projects scheduled in the first year or two of an AMP. However, projects required later in the regulatory period will not yet have that level of supporting information. For example, the OATIS replacement mentioned above will not have firm expenditure forecasts available until early 2018, despite clearly being needed within the regulatory period. In many cases, forecasts for future years are simply based on reasonable estimates and plausible assumptions, but may not yet have the level of information the Commission is indicating.

As a result, the Commission needs to apply supplier scrutiny based on information that is or can reasonably be made available. A low level of information does not automatically imply that a forecast is insufficiently prudent – but rather that the uncertainty bounds around the efficient level of expenditure are higher. Levels of supporting information will naturally taper off for later years of any forecasting period.

We support a flexible approach that can also accommodate project expenditure

We strongly support the Commission’s view that scrutiny for the DPP forecasting assessment can be based on a flexible supplier-driven approach. An alternative CPP-like scenario is indeed likely to lead to unnecessary complexity and compliance costs.

We support the Commission’s statement (at paragraph 3.34.1 in the policy paper) that “a DPP is not required to be a ‘one-size-fits-all’ process”. This is even more relevant for our GTB, where the DPP only needs to be determined for one supplier. In that case, the DPP can and should already meet the particular circumstances of the single supplier for which it is being determined. In these circumstances, the main distinction between a CPP and DPP is the cost, complexity and scope of scrutiny that is applied.

We consider that there is no need for a ‘bright line’ setting that determines the size of a project that can be accommodated within the scope of a DPP. We agree that with increased scrutiny of our forecasts it should indeed be possible to deal with bigger projects within a DPP. We consider this also a benefit for consumers because it avoids the project delays and high costs associated with a CPP. We understand that some projects are too complex to be sufficiently scrutinised within the context of a DPP. Where proportionate and appropriate scrutiny can be applied, however, the Commission should strive to accommodate as many projects as possible within a DPP framework.

We strongly support the Commission's view that its assessment framework should also accommodate forecast expenditure that is contingent on future events or where the cost and timing is uncertain. We look forward to the Commission's approach for implementing this approach.

With respect to unforeseen projects, we maintain the view, expressed in our previous submissions, that there should be an option to accommodate those projects as part of a DPP reopener – particularly in the case of our GTB – whenever possible and practical. We see no principled justification for limiting reopeners to catastrophes only.

The expenditure objective for DPP assessment should be the same as for a CPP

The Commission's proposed expenditure objective for the DPP assessment is slightly different from that for a CPP. It leaves out the references to "appropriate service standards" and managing expected demand that are included in the CPP expenditure objective. We consider those considerations are relevant for a DPP determination as well, and we suggest that the Commission should adopt the CPP expenditure objective without changes.

Fall-back options require further consideration

We acknowledge that the Commission is able to use a variety of fall-back options if it considers that forecasts in an AMP are not sufficiently explained to meet its objectives.

However, given the level of subjectivity and discretion involved in making those assessments, we disagree with the idea that fall-back options should be weighted one way or another (as expressed in paragraph 3.119 of the policy paper that "... fall-back options, under excluded expenditure, should be potentially at the lower range of possible outcomes ...").

The process the Commission has proposed is 'new ground' under the DPP. While there potentially are benefits in the Commission's proposed approach, we are concerned about the incentives on suppliers to participate in this new approach when the consequences of the Commission not gaining comfort in a supplier's forecasts are wide open. This is relevant to the selection of fall-back options, since some of the options clearly create greater certainty (and therefore more willingness from suppliers to engage) than others.

Forecasting constant price revenue growth

We support the Commission's proposed approach to forecasting CPRG. In particular, we support the more tailored approach for regional forecasting based on the Concept Consulting report.

We acknowledge that the Commission will need to tailor its CPRG forecasts for GasNet to accommodate its investment into a Bay of Plenty distribution network. Considering the geographical overlap with the region for our GDB, this means that our forecasts will need to be tailored as well. We assume that the resulting increases in demand and ICPs for GasNet's CPRG forecast will be matched with corresponding reductions for our CPRG forecasts.

Setting standards for quality of service

We support retention of the RTE standard

We support the retention of the Response Time to Emergencies (RTE) standard as a quality measure. While that measure may not always be useful, systems and processes for measuring it are in place and continuing to operate those is not particularly costly. Therefore, we suggest leaving the measure as it is and avoiding changes to it.

We support a new information-based quality standard applying after a major interruption.

We support the concept of introducing a new quality standard that applies after a major interruption of gas transmission or distribution services. However, the scope and consequences for such a standard need to be carefully considered.

We would support a contingent standard that requires suppliers to provide information after a major interruption occurs. In such a scenario, we would expect to produce a report for internal purposes in any case. We therefore support the preparation of a report for the Commission and for external stakeholders as well.

We expect the purpose for our information reporting should be to provide all stakeholders with clear and timely information about the cause of the interruption, its impact on the supply of gas transmission or distribution services, and whether similar events are likely to occur in the future. Its scope could include:

- the cause(s) of the interruption;
- whether the risk of the interruption had been identified in advance, and any steps taken to reduce or mitigate that risk;
- the duration of the interruption;
- our estimate of lost transmission or distribution revenues arising from the interruption;
- our costs incurred for dealing with the interruption (including repair costs);
- our actions taken or planned to avoid similar interruptions in the future.

A requirement to produce such a report within six months after a major interruption is reasonable. Under normal circumstances we expect this should provide adequate time. Because a compliance statement may be due at an earlier stage we agree with the Commission that the timing of the report should be independent of the timing of compliance statements; and the report need not form part of it. We would appreciate the possibility to obtain an extension of the timing requirement if unusual circumstances arise.

We expect that our report can be subject to certification requirements similar to those that would apply if it were part of a compliance statement. Given the nature of the report, however, we see little justification for an audit requirement and it may be difficult in practice to design and implement an audit assurance process for it. If audit assurance is required then its scope should probably be limited to the costs we have incurred.

Our reporting requirement should be limited to information that we have

The scope of information that we must provide should be limited to information that is actually available to us. This leads to the following considerations.

- We do not expect that we will be able to reliably determine the number of customers affected by an interruption. In the case of a transmission interruption we would only have information on the number of Shippers and Welded Points affected by the interruption, but our GTB will not have any direct information on downstream customers. In the case of a distribution interruption we may have information on the number of our directly affected ICPs, but may still not have information on the exact number of customers.
- We should not have an obligation to estimate the cost of an interruption to consumers. We do not hold information that would enable such estimates. If the Commission or any other stakeholder, including GIC or MBIE, wishes to obtain an economic impact estimate then the most appropriate approach would be for an independent review to take place.

We agree that the scope and intent for our interruption report would be different to that of any report prepared under the Gas Governance (Critical Contingency Management) Regulations 2008, if applicable.

A major interruption should not automatically be a breach of quality standards

While we support a contingent standard to provide information after a major interruption, we are concerned about the concept that such an interruption can automatically be deemed to be a breach of DPP requirements. As the Commission has recognised, pipeline interruptions are rare events in any case. This means that they are largely unpredictable.

We accept the need to provide information since any major interruption is a serious event. If any interruption constitutes a breach of a quality standard by itself, however, then we are immediately exposed to risk of enforcement action under section 87 for every event. In view of the unfettered discretion that the Commission has to pursue actions under section 87, and the lack of any guidelines for that, we consider that this would expose us to higher levels of risk and uncertainty than we already bear. It could also be in contradiction to the view expressed by MGUG, and shared by us, that the quality measures chosen for the DPP should not “impose additional burdens on suppliers”.

The Commission listed the many requirements already imposed on us as part of the regulatory environment for gas pipeline quality in table 5.2 of its policy paper. Most relevant in terms of preventing major interruptions are the processes we have in place to obtain a Certificate of fitness under the Health and Safety (Pipelines) Regulations 1999, and to comply with the AS/NZS 2885 standard. If we failed to meet our requirements in that regard then we could understand that consequences could include enforcement under section 87. This would require development of a process quality standard. If a major interruption occurs despite our proper compliance with those process requirements, however, then it does not seem reasonable that the interruption by itself should be considered a breach of quality standards.

A major interruption can already have financial consequences for us

Even without the threat of section 87 enforcement actions we are already likely to suffer financial consequences from a major interruption.

- In our gas distribution business we would lose current revenue; and reputational damage might impact our future revenue opportunities as well. Under a weighted average price cap we have no ability to compensate for that lost revenue.
- In our gas transmission business we would lose revenue and may be required to provide rebates under the existing transmission codes. We acknowledge that we could recover the lost revenue under a ‘pure’ revenue cap. We therefore agree that it is reasonable for the Commission to design DPP compliance arrangements that would prevent such lost revenues and rebates from being included in any revenue wash-ups. The lost revenue estimates in our report after a major interruption can provide necessary information for such arrangements.

The definitions and scope for an interruption quality standard need to be drafted carefully

With respect to the definition for ‘interruption’ we are inclined to retain the definition used for Information Disclosure. We suggest there is no need to link the definition to critical contingencies. If a critical contingency leads to cessation of supply then it would be captured under the existing definition already. The most recent critical contingency on 24 May 2016, however, did not lead to any cessation or curtailment of supply. That critical contingency by itself did not have an impact on the quality of our gas transmission service.

With respect to defining 'major interruption' we expect that transmission and distribution will need to be treated differently. Using the current definition for 'interruption' based on cessation of supply, we accept that any transmission interconnection point suffering cessation of supply can be considered as a major interruption. For distribution ICPs, however, this standard should be more refined and relaxed. It may be necessary to distinguish between industrial users and residential users. We suggest that cessation of supply to a single household should be unlikely to be classified as a major interruption.

With respect to the scope of the quality standard it is important to limit application to circumstances where the major interruption is caused by failure or damage of the assets owned by the regulated supplier. This obviously means that upstream interruptions, such as the Pohokura production station outage causing the critical contingency on 24 May 2016, should be outside the scope of a pipeline quality standard.

We accept that events caused by third parties inflicting damage to our assets can be included in a quality standard that requires the provision of information. The resulting report would then identify the cause and potential actions taken or planned by us to avoid similar interruptions in the future. If an interruption caused by third parties were to be considered a breach of the standard by itself, however, then it should be excluded from the scope. Unless there is a clear link with our actions, we do not consider that we should be exposed to the risk of suffering consequences under section 87 from actions by third parties.

We do not support other new quality standards

We agree that SAIDI and SAIPI type of standards are not suitable for gas pipeline businesses. At very low frequencies of interruptions such standards become practically meaningless.

We do not support additional quality standards based on pressure, gas specification or odourisation.

- With respect to pressure, we generally do not provide a pressure service to our customers. We do manage pressure in our pipelines within certain bands, but this is subject to a wide range of requirements for different parts of our transmission and distribution systems, and may also be subject to specified or negotiated requirements at individual points. Pressure management is a highly complex activity. We doubt that it can be conveniently operationalised into a system wide quality measure.
- The composition of gas in our pipelines is mostly outside of our control. It is managed by production stations injecting gas into our transmission system. We are required to avoid contamination (e.g. by dust or oil), but we cannot actually change the composition of gas entering our systems. We do not consider this a suitable quality standard for a gas pipeline business.
- The odourisation of gas for odourised pipelines (the Maui and SKF transmission pipelines are unodourised) is within our control. This could hypothetically form part of a quality standard, but we do not expect it will be particularly meaningful or impactful.

Assessing compliance with the price path

Our main comments under this heading relate to issues around restructuring of prices.

- We do not have existing views on the Commission's approach to restructuring of prices for our GDB and do not have any experience with the restructuring approach applicable for EDBs. We agree that any restructuring process should be as straightforward as possible, while minimising risks of non-compliance with our price path. More prescriptive requirements might be helpful in that regard, but could also lead to a loss of flexibility.

- For our GTB, we agree that the introduction of a new Gas Transmission Access Code will inevitably lead to a significant restructuring of gas transmission prices. The two existing codes currently have very different pricing structures. Facilitating greater price flexibility (including auction-based pricing) is among the reasons why we support a 'pure' revenue cap for our GTB.
- As we have submitted previously, the GTB compliance and wash-up arrangements under a 'pure' revenue cap should not include any elements based on weighted-average price changes. This means there should be no need to rely on historical price quantities and no need to have any provisions for restructuring of GTB prices.

Other comments

We support keeping the X-factor at zero. It seems unlikely that productivity or the structure of the New Zealand economy has materially changed over the last 5 years. It is also unlikely that reliable evidence for an X-factor materially different from zero could be found this time if previous studies were refreshed as part of the current reset process. More importantly, perhaps, the Commission is not rolling over existing prices but using a building blocks approach instead. Therefore, any X-factor should make no difference to the Net Present Value calculations anyway and the Commission might as well leave it at zero.

We agree that other regulated income is not a relevant input to the financial model.

- Any unregulated income for our GTB is likely to be trivial in any case, but if it is included in the wash-up process for our revenue cap there is no need to make forecasts for it at all.
- We do not expect to have other regulated income for our GDB. We note that Vector's reporting of other regulated income for its GDB over 2014 and 2015 only related to recovery of bad debt. For forecasting purposes we expect these values can be set at zero.

We agree that gains/losses on disposals of assets are very unlikely to have any material impact and can be set at zero for forecasting.

We note the Commission has included a discussion of risk disclosures in Asset Management Plans, with particular reference to those for the Maui Pipeline. We are certainly willing to engage with consumers and with the Commission on approaches to clarify the disclosures in our AMP. However, we expect such discussions will be beyond the scope of the 2017 Gas DPP reset.

Conclusion

We appreciate the opportunity to provide this submission. We would be happy to provide additional clarifications and information. 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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