Firstgas

10 February 2023

Charlotte Reed, Input Methodologies Manager
Commerce Commission
PO Box 2351
WELLINGTON

Sent via email: im.review@comcom.govt.nz

Dear Charlotte

Input Methodologies Review 2023 - Options to maintain investment incentives in the context of declining demand

This submission is made on behalf of First Gas Limited (Firstgas) and responds to the letter from the Commerce Commission of 20 December 2022 on options to maintain investment incentives in the context of declining demand and the accompanying options paper from the Commission. As a gas pipeline owner we are directly faced with the challenge of continuing to invest in regulated assets to maintain safe and reliable service, in the context of future expectations of lower demand.

Together with other regulated gas distributors Powerco and Vector, Firstgas engaged Frontier Economics to provide expert advice on the issues raised by the Commission's options paper. Frontier's report is attached to a joint letter from all three gas distributors and has been used to inform the views presented in this submission.

The existing input methodologies (as amended in 2022) remain fit-for-purpose

As stated in our submission on cost of capital issues, the Commission should retain existing input methodologies unless there is compelling evidence to change. This bias for stability is encouraged by the statutory purpose of the input methodologies themselves, which is "to promote certainty for suppliers and consumers" in regulated industries (section 52R of the Commerce Act).

The Commission amended the input methodologies for gas pipelines in 2022 as part of the process of resetting gas pipeline default price-quality paths (DPP). The process for making those amendments was thorough and included consultation on a process and issues paper in August 2021 and a draft decision in February 2022, before a final decision was issued in May 2022. The possibility of amending input methodologies to shorten asset lives was raised at each stage, and parties were provided with opportunities to make submissions and cross-submissions to inform the final decision.

Our views on how to maintain investment incentives in the context of declining demand have not changed since the gas DPP reset. To repeat the key points made in our submissions:[1]

- Accelerated depreciation is the most appropriate regulatory tool to address the risk of economy asset stranding because it is NPV neutral for suppliers and consumers;
- The Commission is well-placed to assess long term demand risk and adjust acceleration factors and the length of a regulatory period at each reset (rather than specifying these parameters in the input methodologies); and
- Getting these parameters right will strike a balance between long-term capital recovery and near-term consumer impacts.

[1] See First-Gas-Submission-on-Gas-DPP3-draft-decision-14-March-2022.pdf (comcom.govt.nz)

Given that the Commission has thoroughly considered these issues so recently (and the Commission's reasoning will be tested through a merits review process), we do not consider that the purpose of Part 4 or the purpose of the input methodologies would be promoted by further changes at this time. Instead, we suggest that the Commission lets the merits review process run its course before making any further amendments to the gas pipeline input methodologies.

Option B of the Commission's paper could be worth exploring at future reviews

For the reasons set out above, we do not support further changes to the gas pipeline input methodologies at the 2023 review to maintain investment incentives in the context of declining demand. However, we have considered the options put forward in the Commission's paper and provide our high-level evaluation in Table 1 below. In our view, Option B may have merit in the future in providing more flexibility to reflect actual market conditions – but could add to the cost of carrying out DPP resets by having each supplier explain and justify its GAAP depreciation approach and results. We expect that consumers, Boards and auditors would require robust analysis supporting any increase in depreciation rates, which means that in practice this would be similar to the approach adopted by the Commission at the last gas DPP reset.

Table 1: Firstgas Evaluation of Options in Commission's Paper

	Description	Firstgas Evaluation
Option A	Amend current approach to give suppliers discretion to set economic asset lives for new assets consistent with GAAP (retain current approach for existing assets)	This option would introduce complexity and compliance costs in requiring regulated suppliers to maintain separate registers for "new" and "existing" assets. Since new assets become existing assets over time, this option would also introduce the risk of confusion and error in how assets are classified and depreciated. We therefore do not see this option as improving on an approach where a single acceleration factor is applied to all assets based on the expected economic life remaining in the RAB.
Option B	Allow suppliers to propose updated economic asset lives (consistent with GAAP) for all existing assets at a DPP reset	When compared with the existing gas pipeline input methodologies (as amended in 2022), this option transfers who is responsible for assessing remaining economic asset lives from the Commission to suppliers. We would expect suppliers to apply a similar approach to that used by the Commission at the 2022 reset – exploring different scenarios for future gas use and determining depreciation rates that are consistent with recovering remaining asset values over the remaining economic life. We see value in the Commission undertaking this assessment at DPP resets as that provides independence and added legitimacy to the analysis and is more consistent with the low-cost intent of the DPP.
Option C	Applying a front-loaded depreciation method to individual assets	As noted in our submissions in the DPP process, we support the removal of RAB indexation for gas pipelines. Given the long term demand risk facing gas pipelines, revaluing assets for inflation exacerbates asset stranding risk and decreases the benefits that come from accelerated depreciation. In our view, the front-loading depreciation methods described in Option C are less preferrable than removing RAB indexation as they create more complexity.

	Description	Firstgas Evaluation
Option D	Mechanism to enable ex-ante compensation in DPPs	Ex ante compensation invariably involves estimation error, which is borne by regulated suppliers. If the Commission sets the rate of ex ante compensation too high, then regulated suppliers will receive additional profits (potentially in conflict with section 52(1)(d) of the Part 4 purpose statement). If the Commission sets the rate of ex ante compensation too low, then regulated suppliers will invest less than is optimal (potentially in conflict with section 52(1)(a) of the Part 4 purpose statement). Accelerated depreciation does not have these incentive problems, so we believe is clearly preferrable.
Option E	Allow stranded assets to be removed from the RAB (in conjunction with ex ante compensation)	This appears to add complexity and compliance cost with no benefit for consumers. Our experience as a regulated supplier facing long term demand risk is that ensuring the future ability to recover allowed revenues provides a strong incentive to efficiently manage network utilization and optimisation.

Frontier Economics also suggests some other measures that the Commission could adopt to improve consumer understanding of the pricing impacts of long term demand risk. We believe that existing disclosures (particularly AMPs and pricing methodologies) can incorporate the additional information suggested by Frontier, and our current review of transmission pricing is considering issues such as user willingness to pay – and this work will be shared with consumers as we consult on any changes to our gas transmission pricing methodology.

Conclusion

If you have any questions regarding this submission or would like to meet with Firstgas to discuss please contact me on 021 911 946 or via email at ben.gerritsen@firstgas.co.nz.

Yours sincerely

[redacted]

Ben Gerritsen
General Manager Customer and Regulatory