POWERCO

10 February 2023

Input Methodologies Review team
Via email im.review@comcom.govt.nz

Tēnā koutou

## The Commission's approach to addressing increased stranding risk for gas pipeline businesses is pragmatic and flexible to changing circumstances

Aotearoa New Zealand is preparing to rapidly evolve as the country embarks on an adaptation and mitigation path in response to our global climate change commitments. The energy sector is delicately balancing how we can do play our critical role in enabling Aotearoa to meet its emission reduction targets, with consumer expectations for a reliable and continuous supply of energy at an affordable price, and commercial realities around infrastructure investment in an uncertain regulatory environment. Powerco is one of Aotearoa's largest gas and electricity distributors, supplying around 340,000 (electricity) and 112,000 (gas) urban and rural homes and businesses in the North Island. These energy networks provide essential services and will be core to Aotearoa achieving a net-zero economy in 2050.

### Incentives to invest with declining gas demand – both important and complicated

It is fair to say the consultation[1] paper's topic is technical. It is also important as it links the economic incentives on our gas business with how and when we invest to meet the needs of customers over our 6000km network. For many customers gas is an essential energy source which requires our on-going investment to provide a safe and reliable supply. Our 2022 asset management plan update[2] outlines our plans for the next ten years, indicating Powerco's forecast network capital expenditure is around $18m pa on a range of quality of supply, renewal, and growth projects across the motu. It the incentives on this investment which is at the centre of the Commission's consultation.

This submission assumes some familiarity with the topic and regulatory framework. A useful starting point is the 2022 Default Price-Quality Path (DPP) reset for gas networks which included an accelerated depreciation mechanism for existing and new assets. This was to better reflect the remaining economic life of network assets, given uncertainty about the rate at which natural gas use will decline over time and the detail of future policy settings. And it is NPV-neutral. That reset (and each reset) is a crucial

[1] IM Review - Options to maintain investment incentives in the context of declining demand
[2] https://www.powerco.co.nz/who-we-are/disclosures-and-submissions/gas-disclosures

input to ensuring gas infrastructure can meet its safety and reliability obligations as a lifeline utility and support New Zealand's emissions targets over the medium and long term.

The Commission's 'options' paper builds on the work done in 2022 to address the same issue and for the same reasons. Any subsequent changes will be part of the Input Methodologies (IM) review which is underway and concludes late 2023. These IM settings are then used to inform the DPP resets following this date, with the next one due in 2026. In our submission[3] on the draft DPP determination we emphasised that there are other regulatory settings which need to be considered in the IM review for gas networks. This included moving to a revenue cap and removing RAB indexation because they are both aligned with managing price impacts on consumers in an NPV-neutral manner. While these are outside the scope of the options paper, they are inter-related.

The rest of this submission summarises our comments on the options and how the timing of regulatory decisions and reviews interact. Our views are informed by an expert report prepared by Frontier Economics on behalf of Firstgas, Powerco, and Vector. It's a well-written review of the options and context.

## The options

Underpinning this consultation is how regulatory settings promote the purpose of gas network regulation (Part 4 in the Commerce Act). The long-term benefit of consumers is promoted through suppliers having incentives to invest in assets used to deliver the gas network service. Frontier observe that the IM's should seek to minimise the risk of asset stranding for the benefit of consumers, not suppliers. Regulatory settings that preserve the expectation of a return on investment (FCM) serve the interests of consumers because it supports investment in continuing to supply gas safely and reliably. Frontier articulate this nicely in para 47 of their report:

> *Regulated suppliers will only agree to commit large amounts of capital and wait patiently to recover those investments over multiple regulatory periods if there is a strong commitment within the regulatory framework to provide suppliers with a reasonable expectation of recovering those costs fully*

The Commission proposes five options of possible IM changes which are intended to promote Part 4 and address the allocation of risk between networks and consumers. Frontier observes that all five of the options are consistent with the ex-ante FCM principle.

**[A]** GPB discretion to set the economic life for new assets consistent with GAAP

**[B]** GPB discretion to propose an updated economic life for existing assets consistent with GAAP

**[C]** Apply front-loaded depreciation to individual assets (possibly differentiate between existing and new assets)

**[D]** Allow ex-ante compensation facility in the IMs for stranding risk.

**[E]** allowing and removal of stranded assets from the asset base if they are underutilised.

Our position on these options is guided by our view that:

- the regulatory model reflects an assessment of the economic lives of the asset base as a whole
- GPBs can provide that assessment if it's practical for all parties
- Making NPV-neutral changes like removing RAB indexation and moving to a revenue cap mechanism is a priority

Given this, our view on the options equates to:

[3] https://www.powerco.co.nz/who-we-are/disclosures-and-submissions/submissions

- **supporting option (A+B)** where gas networks propose economic asset lives of the network consistent with GAAP[4]. This essentially involves tweaking the current approach. We are confident any material concerns about data transparency can be mitigated. Powerco could implement this at the next gas DPP reset. Frontier's assessment is to combine A and B for a range of reasons. In simple terms: the expected life is for the network (or parts of), not the assets built at a point in time, so treat it that way.
- **Supporting option C in principle**, though the effects and interactions with other mechanisms would need to be considered. This option adds complexity and may not align with the low-cost approach to setting a DPP. Frontier suggest the rationale for front-loading cost recovery is aligned with removing indexation of the asset base. We agree.
- **Suggest options D and E be deferred, or if needed, implemented as an out-of-cycle IM change**. These options make provisions in the IMs to set an ex-ante allowance and the removal of assets from the RAB if stranded. Unlike options A-B-C, the mechanisms and modelling appear more complicated. For option D, the potential for windfall gains/losses from a regulatory modelling exercise make this option less appealing. Frontier discuss option E discount it with a key reason being that it does not promote efficient network investment, and therefore isn't align with the purpose of Part 4.

We see value working through the potential implementation of an A+B solution (and potentially an A+B+C) to ensure any IM drafting, audit requirements, processes, and assumptions is workable for all parties.

Frontier has outlined other measures the Commission might consider in section 4 of their report. We support these options which include:

- Better information from the Commission to consumers to help them plan future investments and consumption
- Informed limits on annual price adjustments via willingness to pay studies
- Other mechanisms for managing price volatility and the cost burden on future users including tariff structures and Government targeted assistance. The observe that "…*when amending the IMs the Commission should be alive to the fact that there are solutions available beyond the regulatory framework—so a radical reallocation of long-term demand risk between consumers and suppliers may not be required*."

## Timing considerations

The Commission is right to explore the interaction between the frequency and length of price-quality resets, IM reviews, and policy settings. The upshot is that with nothing changed, the 2023 IM review framework will apply to gas networks until 2034. We agree with the Commission's thinking to include any tools potentially needed up to this period into the 2023 IMs to deal with declining demand and to give Gas Pipeline businesses confidence that the principle of ex-ante FCM is maintained. Doing so avoids the need for continual IM amendments like those applied to the 2022 Gas DPP reset.

The figure below illustrates the regulatory timelines if the decision for a 4-year DPP period for gas networks and a 7-year period for IM reviews remains.

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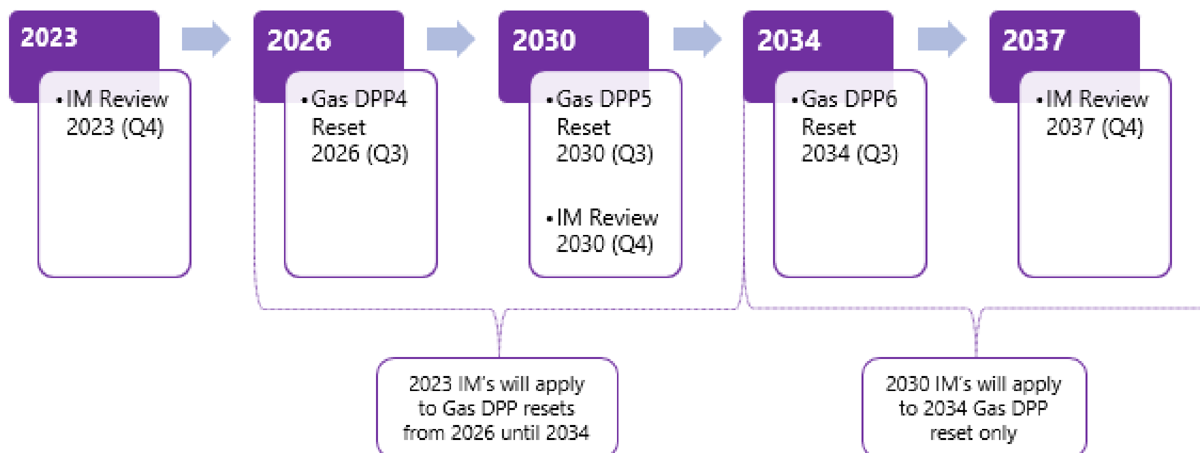
[4] Option A also has a potential implementation difficulty to address. The concept is that " At the time of a price reset, we could require suppliers to disclose the economic asset life assumptions used for assets commissioned within the regulatory period that is coming to an end" (3.61). That means a change in the 2030 reset could only be applied if the economic life assumptions have been established from the prior regulatory period (2026) because the 2022-26 period has specified asset live reduction/accelerated depreciation calculated to reach a target depreciation amount - not necessarily the GPB's view of the economic life.




This suggests that:

- changes made in the 2023 IM review will apply to the next two Gas DPP resets. The period from October 2026 to September 2034. The 2030 reset will occur during the 2030 IM review, so any changes in the review would not be included in the reset. The electricity DPP5 reset would also miss these IM changes because it would be decided in November 2029 for the 5-year period starting April 2030.
- From the October 2034 gas reset the 2030 IMs will apply.

As outlined in the Commission's consultation paper there is policy to be developed following the final decision for the 2023 IM review that we expect will have some impact the gas industry before the following IM review in 2030. These developments include the Gas Transition Plan 2023, Energy Strategy 2024, and second emissions reduction plan (2026). If nothing changes, this places increased importance on the 2023 review as this will shape and define the options available for gas network resets for the next decade.

Some options to address the timing mismatches include:

[1] Targeting a 2029 IM review. This could inform the 2030 gas reset (assuming 4-year reset in 2026).

[2] Targeting a 2028 IM review which would also allow application of any IM changes to the DPP4 electricity reset over 2029.

[3] Setting a 5-year gas DPP reset period at the 2026 reset so that it falls after the 2030 IM review.

From a simple timing and sector-wide perspective, **option 2** looks worthy of further consideration by the Commission. This timing would also leave a decent amount of time for any refinement and outcomes in the policy space relating to the energy strategy.

We look forward to engaging with the Commission on this topic in the draft IM decision, or potentially beforehand. If you have any questions regarding this submission or would like to talk further on the points we have raised above, please contact Jeremy.Smith@powerco.co.nz.

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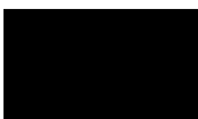

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