Submission

Commerce Commission Input Methodologies Review

Options to maintain investment incentives in the context of declining demand

10 February 2023

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1. Introduction

1. The Commerce Commission (the **Commission**) has called for submissions on "Options to maintain investment incentives in the context of declining demand" (**Consultation Paper**) as part of the 2022/23 input methodologies (**IM**) review.

2. While the Consultation Paper focusses predominantly on the circumstances of gas pipeline businesses (**GPBs**), it is not impossible (although unlikely in the short-to-medium term) that other regulated suppliers might face similar issues in the future, at least in part.

3. The conundrum that the Commission is trying to address is how to ensure GPBs (in this instance) continue to invest in safe and reliable networks in the face of:

   3.1. declining demand, especially as larger industrials convert to electricity;

   3.2. a high probability that natural gas will become a sunset industry/service; and

   3.3. limited options for asset re-use and redeployment.

4. Aurora Energy Limited (**Aurora**) welcomes the opportunity to submit its views on the Consultation Paper. No part of our submission is confidential.

2. General Comments

5. The Government's first emission reduction plan (ERP) seeks, inter alia, to manage the phase-out of fossil fuels, including fossil gas. The ERP identifies that "*[p]hasing out fossil gas presents short-term and long-term challenges, including balancing capital investment with declining fossil gas use, fossil gas affordability and the risk of stranded network assets*.".[1]

6. To further explore and manage these challenges, the Government has committed to "*developing a gas transition plan by the end of 2023. This will set out a transition pathway for the fossil gas industry, explore opportunities for renewable gases, and ensure an equitable transition. The gas transition plan will be an input to the energy strategy.*".[2]

7. The Commission has identified that the gas transition is likely to lead to a situation where GPB assets become economically stranded, and that this may disincentivise GPBs from making necessary investments to maintain the safety and reliability of their networks, as GPBs are unlikely to recoup their investments within the remaining economic life of their assets.

8. The Commission has identified three options to address asset stranding risk:

   8.1. further changes to IMs to better align regulatory asset lives with economic asset lives;

   8.2. changes to IMs to support the use of alternative depreciation methods; and

   8.3. tools to support reallocation of asset stranding risk to suppliers

2.1. An options portfolio is warranted.

9. Aurora considers that the asset stranding risk faced by GPBs is material, and that the Commission requires an effective portfolio of tools to help support at least minimum required investment in GPB networks, and to help facilitate an orderly transition from fossil gas that protects consumers' interests to the extent possible.

10. While the ERP is clear in its goals, the gas transition plan is unlikely to be finalised in time for consideration within the IM review project timeframe. That creates a degree of uncertainty that needs to be managed, especially considering that, given a standard IM review cycle of seven years, the IMs that will be determined later this year are likely to remain in effect for two GPB regulatory periods, unless specific out-of-cycle IM changes are made.

11. Having regard to all of the circumstances, some element of flexibility appears to be desirable and Aurora considers that it would be appropriate for the Commission to have a portfolio of options available to it. We

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1 New Zealand Government. (2022). Towards a productive, sustainable and inclusive economy: Aotearoa New Zealand's first emmissions reduction plan. Action 11.3.1, p216.

2 Ibid.

note that none of the options outlined in paragraph 8, above, are mutually exclusive and therefore consider that the IMs should be amended to permit each option to be used singly or in concert.

12. We note the Commission's comment that:

> *"If demand drops quickly, or if current or future Governments were to enforce restrictions or an early phase-out of natural gas use, GPBs may be exposed to unmitigated stranding risk to the extent that the price increases required to recover their costs exceed consumers' willingness or ability to pay."*[3]

We agree, and note the importance of taking action while consumers' willingness (or ability) to pay is not yet affected by declining demand.

13. To that end, shortened asset lives should be considered in conjunction with front-ended depreciation to ensure GPBs have a higher certainty of recouping their investment before their businesses are no longer viable. Whilst IM changes cannot be applied until the next gas reset in 2026, shortened asset lives and, especially, front-ended depreciation is required sooner rather than later, while consumer numbers and gas volumes remain high, and the price impact is more easily absorbed.

14. While the ability to transfer stranding risk from consumers to GPBs, or set a hybrid risk allocation, should be part of the Commission's options portfolio moving forward, Aurora considers that preference should be given to shortened asset lives and front-ended depreciation because there is considerably more uncertainty as to:

14.1. how much risk should be transferred to GPBs; and

14.2. the scale of the necessary risk premium in compensation.

15. The beneficial features of risk transfer include stronger incentives to innovate and secure efficiencies and, ultimately, to repurpose assets where possible. It is a commercial convention that risks should be allocated to the party best placed to manage them; however, if risk transfer to GPBs is contemplated to incentivise the ultimate repurposing of assets, then there should be a reasonable prospect that repurposing is feasible and likely.

16. Aurora considers that the risk premium associated with any risk transfer should be applied within the DPP building blocks model, as occurs for fibre, rather than by a WACC uplift, since a WACC uplift would be likely to skew other mechanisms, including IRIS retention factors.

2.2. Extension to other regulated sectors

17. While it is Aurora's view that the portfolio of tools, described above, is necessary to promote incentives to continue investment by GPBs, we do not necessarily agree that those tools are required in the IMs for other sectors.

[3] Commerce Commission. (2022). Input Methodologies Review: Options to maintain investment incentives in the context of declining demand. Paragraph 2.12.3, p26.

18. The key issue for EDBs is incentivising investment in the electricity sector in the face of significantly increasing, but uncertain, electricity demand. While this is the subject of wider review, it is critical that the Part 4 framework builds in adequate investment flexibility.

2.3. Other options

2.3.1. Form of control for GDBs

19. During the 2015/15 IM review, the Commission retained the weighted average price cap (**WAPC**) for gas distribution businesses (**GDBs**). It was considered, at the time, that quantity forecasting was not a significant issue for GDBs.[4] It was further noted that:

> *"Stakeholders highlighted that we needed to consider the differences between the electricity and gas (distribution) sectors. The key difference is that gas is a somewhat more discretionary fuel for the majority of consumers which gives suppliers an incentive to drive volumes to increase their revenues. This incentive is best accommodated under a WAPC."*[5]

20. While these factors may have held true in 2016, it is unlikely that they will hold true in 2026 when the gas DPP is reset. It is highly likely that connection and volume incentives will be entirely inconsistent with the gas transition plan due for publication later this year. Therefore, and subject to the views of GDBs, it may be appropriate to consider changing the form of control for GDBs from a WAPC to a revenue cap.

2.3.2. Tailored reconsideration mechanism

21. Aurora considers that, under the gas transition plan, there could be sudden and significant changes to connection numbers and volumes. It may be necessary to schedule mid-period reviews of the gas DPP, and have available some form of volume adjustment reconsideration mechanism, especially if a WAPC is retained.

2.3.3. Maintaining the WACC percentile uplift

22. The Commission recently sought submission on aspects of the cost-of-capital IMs[6] and a published a companion report[7] by Cambridge Economic Policy Associates (**CEPA**).

23. One of the questions raised by the Commission was the desirability of maintaining a WACC uplift for GPBs. In our submission, we noted that "*the rationale for an uplift in the WACC percentile is to compensate for potential*

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[4] Commerce Commission. (2016). [Input methodologies review decisions: Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower](). Paragraph 213, p49.

[5] Ibid. Paragraph 212, p49.

[6] Commerce Commission. (2022). [Letter to stakeholders - CEPA report on aspects of the cost of capital Input Methodologies for the 2023 review]().

[7] Cambridge Economic Policy Associates. (2022). [Review of Cost of Capital 2022/2023]().

estimation error when setting the cost-of-capital which, if the estimate of WACC is below the actual WACC, may lead to an investment disincentive."[8]

24. Aurora considers, in the context of the likely decarbonisation impact on GPBs, that maintenance of the WACC uplift for GPBs is vitally important to ensure that a countervailing investment disincentive is not created.

2.4. Gas phase-out

25. In its consultation paper, the Commission notes that:

> *"…, while the delivered volume of natural gas will likely decline over time, it is not clear how quickly this will happen or when any phase out will be complete. In general, significant uncertainty remains around the pace of change, the rate at which demand for natural gas will decline, and potential impact on gas pipeline businesses."*[9]

26. What does seem clear, however, is that the fossil gas transport industry has a finite lifespan, and there appears to be only limited opportunity for repurposing of assets (Boston Consulting Group considers that "*hydrogen is unlikely to be an economic alternative to gas in pipelines*").[10] It is reasonably foreseeable that GPBs will reach a point where continued operation is no longer viable and will need to close their businesses. This will inevitably lead to a number of consumers being stranded without service, as can happen when closures occur within workably competitive markets.

27. What will be unique in the closure of GPBs is that, unlike in workably competitive markets where it is usual that stranded customers can readily migrate to an alternative service provider, it is possible that alternative service provision may not be able to be arranged at short notice (for example, conversion of homes and business to electricity may be delayed by congestion at various points in the supply chain).

28. We consider that there is likely to be a balance that needs to be struck between providing consumers with a degree of certainty over how the future of gas transmission and distribution is likely to unfold, and causing a degree of distress that might drive a transition away from fossil gas that is faster than economically justified or anticipated by climate policy-makers.

29. Nonetheless, and while it may not be an imperative for this IM review, Aurora considers that the Commission must start to give thought to how the Part 4 regime will address this potential sector closure. It will be important for both consumers and suppliers to understand how this may play out, even if the timing remains very uncertain.

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8 Aurora Energy Limited. (2022). Commerce Commission Input Methodologies Review - CEPA report: Review of Cost of Capital 2022/2023. Paragraph 38, p6.

9 Ibid. Paragraph 2.23, p28.

10 Boston Consulting Group. (2022). [The future is electric: A decarbonisation roadmap for New Zealand's electricity sector](). P13.