

# Memorandum

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## The relationship between Section 52A of the Commerce Act 1986, FCM and the government's climate change response

- 1 In its Process and Issues Paper for resetting default price-quality paths for gas pipeline business from 1 October 2022<sup>1</sup> (**Issues Paper**) the Commerce Commission (**Commission**) has explained how it intends to approach the gas DPP3 reset, including the interaction of climate change policy and s 52A of the Commerce Act 1986 (the **Act**).
- 2 The Commission has acknowledged that s 5ZN of the Climate Change Response Act 2002 (**CCRA**) allows it to take into account the 2050 net zero emissions target (the **2050 target**).<sup>2</sup> However, the Commission has provisionally determined that its ability to consider the 2050 target is "limited" given: (i) the relationship between s 5ZN and s 52A of the Commerce Act, and (ii) uncertainty regarding the Government's response to the report of the Climate Change Commission.<sup>3</sup>
- 3 In our view, the Commission has incorrectly interpreted the relationship between s 5ZN and s 52A and, as a result, has understated the relevance of the 2050 target to its decisions for the gas DPP3 reset. Section 5ZN is relevant to the Commission's decision-making for DPP3 in two ways:
  - 3.1 the 2050 target is a relevant consideration when applying the s 52A purpose statement, particularly in the context of ensuring the price path provides an *ex ante* expectation of maintaining financial capital. The Commission has erred by failing to properly take account of the Government's legislative

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<sup>1</sup> 4 August 2021.

<sup>2</sup> CCRA, s 5Q.

<sup>3</sup> Climate Change Commission "Ināia tonu nei: a low emissions future for Aotearoa" available at <https://www.climatecommission.govt.nz/our-work/advice-to-government-topic/inaia-tonu-nei-a-lowemissions-future-for-aotearoa/>. The Climate Change Commission's final report recommends setting a date, of no later than 2025, when no new natural gas connections are permitted and where feasible, all new or replacement heating systems installed are electric or bio-energy. It also encouraged a phasing out of current gas appliances.



commitment to the 2050 target and the implications of that commitment for the gas sector; and

- 3.2 section 5ZN is an enabling provision that empowers the Commission to make decisions that are consistent with, or contribute to the achievement of, the 2050 target, emissions budgets or emissions reduction plans, alongside the outcomes set out in s 52A(1)(a)-(d).

### **Section 5ZN of the CCRA**

- 4 Section 5ZN of the CCRA provides that a body exercising or performing a public function, power or duty conferred by or under law may:

if they think fit ... take into account –

- (a) the 2050 target; or
- (b) an emissions budget; or
- (c) an emissions reduction plan.

- 5 The 2050 target is a legislative commitment to achieve net zero emissions (excluding biogenic methane) by 1 January 2050, and specified reductions in biogenic methane.<sup>4</sup> Emissions budgets are set by the Minister, on advice from the Climate Change Commission, and define the quantity of emissions that will be permitted in each emissions budget period as a net amount of carbon dioxide equivalent. The Government is required to set emissions budgets with a view to meeting the 2050 target.<sup>5</sup> An emissions reduction plan is a plan determined by the Minister that sets out the policies and strategies for achieving an emissions budget. The Minister is required to determine an emissions reduction plan for achieving each emissions reduction budget.<sup>6</sup> Collectively, these mechanisms ensure accountability for achieving the Government’s objective of net zero emissions.
- 6 The purpose of section 5ZN is to allow the 2050 target and emissions budgets to “influence broader Government decision making where they are relevant”.<sup>7</sup> If consistent with other legal requirements applying to a decision, the decision maker may take the 2050 target, an emissions budget or a reduction plan into account. However, the section also makes it clear that there is no legal requirement to do so,<sup>8</sup> although a decision-maker would need to show a proper basis for disregarding s 5ZN.
- 7 As initially drafted, s 5ZN included a subsection (2) providing that a failure by any person to take the 2050 target or an emissions budget into account would not

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<sup>4</sup> Section 5Q.

<sup>5</sup> Section 5X.

<sup>6</sup> Section 5ZG.

<sup>7</sup> Climate Change Response (Zero Carbon) Amendment Bill (136–1) (explanatory note) at 11.

<sup>8</sup> Ibid.



invalidate anything done by that person. The Select Committee deleted subsection (2), saying that it preferred to leave the common law to develop unrestricted.<sup>9</sup>

- 8 This view was echoed in a Cabinet paper from February 2019 (prior to the Select Committee report). Minister Shaw noted that the Bill, as initially drafted to ensure a failure to take the emissions target and budget into account would not invalidate government decisions, was contrary to the purpose of providing a framework by which NZ could implement clear and stable climate policies. Accordingly, he recommended that the Bill be amended to remove subsection (2) to allow the common law to develop over time.<sup>10</sup>
- 9 The Commission, in setting default price-quality paths under Part 4 of the Commerce Act 1986, exercises a public function and power conferred by law. Accordingly, in determining DPP3, the Commission is entitled to take into account the matters set out in s 52N of the CCRA. The nature and extent of that entitlement is the subject of this advice.

#### **Section 52A of the Commerce Act**

- 10 The Commission's decision-making in exercising its Part 4 functions is guided by the purpose statement in s 52A, which provides as follows:
- (1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
    - (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
    - (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
    - (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
    - (d) are limited in their ability to extract excessive profits.

- 11 Section 52A seeks to promote outcomes that are consistent with outcomes produced in workably competitive markets, i.e. markets exhibiting workable or effective competition.<sup>11</sup> The relevant outcomes include those listed in s 52A(1)(a) to (d) – including suppliers having incentives to innovate and invest<sup>12</sup> “consistent with the

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<sup>9</sup> Climate Change Response (Zero Carbon) Amendment Bill) (136–1) (select committee report) at 15.

<sup>10</sup> Ministry for the Environment “Cabinet paper policy decisions for Climate Change Response (Zero Carbon) Amendment Bill departmental report” (October 2019) at 7. Available at: <https://environment.govt.nz/publications/cabinet-paper-policy-decisions-for-climate-change-response-zero-carbon-amendment-bill-departmental-report/>.

<sup>11</sup> Commerce Act 1986, s 3(1).

<sup>12</sup> Section 52A(1)(a).



manner in which suppliers in workably competitive markets have incentives to innovate and invest”.<sup>13</sup>

- 12 Section 52A is forward looking, and focused on the long-term benefit of consumers. The explanatory note to the amendment bill that introduced the current Part 4 records that the role of the s 52A purpose statement, *inter alia*, was to “improve clarity, certainty, timeliness, and predictability for businesses” and to “provide specifically for incentives to invest in infrastructure”.<sup>14</sup> At the time the new Part 4 was introduced, the Minister noted in the Committee of the Whole House that the inclusion of incentives to innovate and invest “is really sending a signal about how important it is not to forget that future needs are just as important when we are looking at a non-competitive market”.<sup>15</sup> Finally, the structure of s 52A, with the primary consideration to promote the long-term benefit of consumers, “makes it clear that in terms of incentives to invest, it is the interests of consumers in suppliers having appropriate incentives to invest that matter, not the interests of the suppliers themselves”.<sup>16</sup>
- 13 Over the course of a number of regulatory decisions, the Commission has elaborated on the s 52A purpose statement by adopting three key economic principles that guide its decision making:
- 13.1 financial capital maintenance (**FCM**);
  - 13.2 appropriate allocation of risk; and
  - 13.3 addressing asymmetric consequences of over- and under-investment.<sup>17</sup>
- 14 These principles help to promote regulatory predictability by signalling to stakeholders how the Commission is likely to approach relevant decisions.
- 15 The FCM principle provides that a regulated supplier should have an *ex ante* expectation of maintaining its financial capital or, in other words, to earn a normal return of and on the capital invested in providing the regulated service. Decisions to allocate and compensate for apprehended risks to capital recovery are made at the outset of the regulatory period and then gains and losses in the period largely lie where they fall. Applying FCM, the Commission:<sup>18</sup>

provides regulated suppliers the ex-ante expectation of earning their risk-adjusted cost of capital (a ‘normal return’). This provides suppliers with the opportunity to maintain

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<sup>13</sup> *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289 (**WIAL v Commerce Commission**) at [27]. See also (20 March 2008) 646 NZPD 15157; and (2 September 2008) 649 NZPD 18313-4.

<sup>14</sup> Commerce Amendment Bill 2008 (201–1) (explanatory note).

<sup>15</sup> Hon Lianne Dalziel (Commerce Minister). (2 September 2008) 649 NZPD 18541.

<sup>16</sup> *WIAL v Commerce Commission* at [761].

<sup>17</sup> Issues Paper at [2.21]; referring to Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016) pages 38-49.

<sup>18</sup> Issues Paper at [2.21.1].



their financial capital in real terms over timeframes longer than a single regulatory period.

- 16 Over the lifetime of an asset, returns for efficient firms (discounted by an appropriate weighted average cost of capital) would be expected to be approximately equal to the initial investment amount. This gives the related net present value (**NPV**) equals zero principle. The expected NPV of an efficient investment and its subsequent returns should be zero.
- 17 In *Wellington International Airport Ltd v Commerce Commission*, the High Court explained that:<sup>19</sup>

FCM is seen as an outcome consistent with the making of normal but not excessive profits and is therefore an outcome that will also efficiently promote the purpose of, and outcomes sought by, s 52A(1).

**The Commission's view on the relationship between s 5ZN and 52A and the consequences for DPP3**

- 18 The Commission's view of the relationship between s 5ZN and 52A is that:<sup>20</sup>
- 18.1 section 52A of the Commerce Act does not reference decarbonisation or mitigating climate change as outcomes to be promoted to achieve the purpose of Part 4;
- 18.2 the Part 4 purpose remains paramount and the s 5ZN factors may only be considered to the extent they do not conflict with s 52A. The outcomes in s 52A(1)(a) to (d) are the Commission's primary considerations; and
- 18.3 the Commission's scope to consider the 2050 target when making decisions under Part 4 is therefore limited.
- 19 The Commission's assessment of the relationship between s 5ZN and s 52A in the Issues Paper feeds into the Commission's preliminary proposals for DPP3, including its approach to addressing the risk of economic network stranding. The Commission recognises that:<sup>21</sup>
- [d]ue to the transition to a net zero emissions economy, there is an increased risk of the gas pipeline networks becoming economically stranded. This means there is a risk that GPBs may be unable to, at some point in the future, fully recover their historic capital investment as customers disconnect from GPB networks.
- 20 The Commission notes that there may accordingly be a need to shorten asset lives or adopt other measures such as *ex ante* compensation to ensure suppliers have an

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<sup>19</sup> *WIAL v Commerce Commission* at [263].

<sup>20</sup> Issues Paper at [2.14]–[2.16].

<sup>21</sup> Issues Paper at [D2].



expectation of FCM or other NPV-neutral mitigation measures,<sup>22</sup> and invites stakeholder views on whether changes would be appropriate for DPP3.

- 21 However, the Commission's view is that the immediate future for the energy transition, particularly in the gas sector, is highly uncertain, in part because the Government's response to the Climate Change Commission report is not yet available and no policies have yet been established to achieve the energy transition set out in the Climate Change Commission's report.<sup>23</sup> The Commission concludes that, "given the timing of the Government's response to the CCC's report...we consider it infeasible to implement any changes to the IMs following the Government's decisions in time for DPP3".<sup>24</sup> On that basis, the Commission appears to be ruling out making material changes to the IMs to address the consequences of climate policy for recovery of investment in gas assets in time for DPP3.

#### **Our view on the relationship between s 5ZN and 52A**

- 22 The Commission has understated the relevance of s 5ZN to its decision-making framework. Section 5ZN is relevant to the Commission's decision-making for DPP3 in two ways:

22.1 the 2050 target is a relevant consideration when applying the s 52A purpose statement, particularly in the context of ensuring the price path provides an *ex ante* expectation of maintaining financial capital. The Commission has erred by failing to properly take account of the Government's legislative commitment to the 2050 target and the implications of that commitment for the gas sector; and

22.2 section 5ZN is an enabling provision that empowers the Commission to make decisions that are consistent with, or contribute to the achievement of, the 2050 target, emissions budgets or emissions reduction plans, alongside the outcomes set out in s 52A(1)(a)-(d).

#### **1. Section 5ZN is a relevant consideration when applying the s 52A purpose statement**

- 23 The factors set out in s 5ZN are relevant when the Commission is applying its s 52A purpose statement as they form part of the factual matrix for the Commission's decision-making. In applying s 52A, the Commission should take into account the 2050 target, and particularly the significance of the Government's legislative commitment to the 2050 target, to quantify the risk of economic stranding of network assets as a result of climate change policies affecting the gas sector. The legislative commitment to the 2050 target is clear, and so the gas DPP3 reset as well as the IMs should appropriately take into account this factual consideration.
- 24 In its Issues Paper, the Commission emphasises the uncertainty associated with climate change policies and the energy sector, in part due to the timing of the Government's response to the Climate Change Commission's report. On that basis,

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<sup>22</sup> Issues Paper at [D30] and [D31].

<sup>23</sup> Issues Paper at [3.14].

<sup>24</sup> Issues Paper at [3.16].



the Commission appears to be ruling out making significant changes to the IMs or the DPP settings to address the impact of climate change policies on the gas sector.

- 25 This perspective fails to account for the fact that, while the process and specific policies may be uncertain, the Government has already committed to achieving its 2050 targets. These are enshrined in law and can only be amended by an Act of Parliament.<sup>25</sup> The Government has also committed to developing climate change mitigation and adaptation policies with reference to the Climate Change Commission's recommendations. In particular:
- 25.1 The scheme of the Climate Change Response Act is intended to ensure accountability for the achievement of the 2050 target. The 2050 target is enshrined in law and can only be changed by Act of Parliament. Ministers are required to develop emissions budgets and emissions reductions plans aimed at achieving the 2050 target. The Government is therefore obliged to take action consistent with meeting the 2050 target.
- 25.2 The Climate Change Commission report demonstrates persuasively that any emissions reduction budget and plan would have to include policies for a wind-down or transition of natural gas supply in order to meet the requirements of the CCRA.
- 25.3 While the Government has not yet formally responded to the Climate Change Commission report, it has already signalled its commitment to implementing the Climate Change Commission's recommendations, and to developing a detailed Emissions Reduction Plan in time for COP26 in November 2021.<sup>26</sup>
- 25.4 In his speech at the release of the report, Minister Shaw noted that "building a low emissions future will require urgent action across a range of areas, including energy, transport, waste, agriculture, construction and financial services". He also noted that he has "been clear since the Commission published its draft advice in January that every part of the Government will need to come to the table and commit to urgent action to bring down emissions in their sector".<sup>27</sup>
- 25.5 Most recently, following the release of the IPCC's Sixth Assessment report, Minister Shaw noted that "a collective effort involving every sector of the economy, every community, and almost every government agency and their Minister will be needed to avert a climate crisis". He said "we must use this chance to review progress and make sure the actions we are committing to will cut emissions in line with what the latest science requires".<sup>28</sup>
- 26 Under either a 'wind-down' scenario (where gas consumption is phased out and gas infrastructure decommissioned) or a 'repurpose' scenario (where gas consumption

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<sup>25</sup> CCRA, s 5Q.

<sup>26</sup> <https://www.beehive.govt.nz/speech/minister-shaw-addresses-global-ministerial-climate-action>.

<sup>27</sup> <https://www.beehive.govt.nz/speech/speech-release-climate-change-commissions-final-advice>.

<sup>28</sup> <https://www.beehive.govt.nz/release/govt-will-be-equal-latest-climate-science>.



transitions from natural gas to an alternative such as hydrogen or biogas, sometimes termed 'clean gas') for gas consumption, the Climate Change Commission report demonstrates that gas networks in 2050 will be materially different to GPB networks today.

- 27 Given the legislative commitment, for the purposes of the Commission's decision-making the 2050 target is not uncertain, and nor is the development of an emissions reduction plan to achieve it. The Climate Change Commission's report provides convincing evidence that any compliant emissions reduction plan would entail significant disruption to gas pipeline businesses. Moreover, having determined that the Government's climate objectives are relevant to its decisions, the Commission is not entitled to then disregard the 2050 target. One of the consequences of s 5ZN is to require decision-makers, where they have decided climate policy is relevant to their decision, to take the 2050 target, emissions budgets and reduction plans seriously.
- 28 By emphasising the uncertainty in the Government's response, the Commission is implicitly adopting a position on climate policy that is at odds with the legislative commitments in the CCRA. The 2050 target will have a material impact on the natural gas sector and role of GPBs. If the reset of DPP3 does not consider this legislative outcome, then it would likely negatively impact consumers in future. For example, as the Commission recognises:<sup>29</sup>
- As customers leave, prices for remaining customers may need to rise beyond their willingness to pay given their economic alternatives as GPBs recover their costs across a smaller base. Setting higher prices that result in further customers leaving the network would not be in the long-term interest of consumers, or an efficient outcome.
- 29 To the extent that s 5ZN creates a discretion about whether to take into account the listed matters, the courts will require that this is exercised reasonably,<sup>30</sup> having regard to the statutory context of the power or function being exercised and its relationship to the s 5ZN matters. When assessing the risk to capital recovery for suppliers, the CCRA and s 5ZN direct the Commission to proceed on the basis that the Government is serious about responding to climate change.
- 30 In any event, there is sufficient information available for the Commission to conclude that policies are forthcoming that will affect suppliers' ability to recover capital. To take one example, the IMs currently provide for asset lives in excess of 50 to 70 years for certain assets.<sup>31</sup> For assets commissioned in 2021, the regulatory settings therefore anticipate recovery of invested capital out as far as 2071-2091, well beyond the point at which the Climate Change Commission anticipates natural gas will no longer comprise a significant part of New Zealand's energy supply. A number of existing commissioned assets will presumably have remaining asset lives

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<sup>29</sup> Issues Paper at [D3].

<sup>30</sup> *Waitakere City Council v Lovelock* [1997] 2 NZLR 385 (CA) at 402.

<sup>31</sup> Gas Distribution Services Input Methodologies Determination 2012 (consolidation all amendments as of 3 April 2018 at Schedule A, available at: [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0029/59717/Gas-distribution-services-input-methodologies-determination-2012-consolidated-April-2018-3-April-2018.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0029/59717/Gas-distribution-services-input-methodologies-determination-2012-consolidated-April-2018-3-April-2018.pdf) .



that extend beyond the horizon indicated by the Climate Change Commission. Applying the FCM principle, it would be appropriate to have regard to the risk of asset stranding to bring forward the recovery of that invested capital.

- 31 Certainty regarding the nature and timing of those policies is not a necessary precondition to adjusting the regulatory settings to address that risk. To the contrary, in a workably competitive market suppliers would apprehend a risk that achievement of the 2050 target would entail disruption to the gas sector that would likely truncate asset lives. Accordingly, it would not be consistent in this regulated market to defer addressing climate change action in DPP3.<sup>32</sup> Under s 52A(1)(a) in particular, the Commission should be considering the 2050 target in the context of suppliers' incentives to invest – which should be appropriately scoped towards the 2050 target.

## **2. Section 5ZN is an enabling provision**

- 32 The Commission's position is that the s 52A purpose statement is "paramount" and that the s 5ZN factors are subordinate to the outcomes set out in s 52A(1)(a) to (d).
- 33 This understates the role of s 5ZN in the context of Part 4. As outlined in the explanatory note to the introduction of the Bill, the purpose of this provision was to allow the 2050 target and emissions budgets to "influence broader Government decision making where they are relevant".<sup>33</sup> Section 5ZN recognises that meeting the challenge of climate change requires a whole of Government response, and empowers decision-makers such as the Commission to have regard to the legislatively codified objectives to the extent relevant to the Commission's role.
- 34 We find no support in the scheme of the Climate Change Response Act or the Commerce Act for the Commission's assertion that the s 52A purpose statement is "paramount". The Commission's reasoning rests on the proposition that "section 52A of the Act does not reference decarbonisation or mitigating climate change". That ignores the very purpose of s 5ZN, which is to enable decision-makers to have regard to those matters where they are not already part of those decision-makers' existing legislative frameworks. The intent of s 5ZN was to introduce additional considerations into the decision-making of all any body exercising public functions and powers.
- 35 The better reading of s 5ZN is that it elevates the factors in paragraphs (a) to (c) of s 5ZN as considerations of equal weight to the factors in paragraphs (a) to (d) of s 52A where relevant.
- 36 An analogy can be drawn to sections 162 and 166 of the Telecommunications Act 2001. Section 162 of the Telecommunications Act is a purpose statement drawn in almost identical terms to s 52A of the Commerce Act. Section 166 is entitled "matters to be considered by Commission and Minister" and provides that the Commission must make the decision that the Commission considers best gives effect to:

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<sup>32</sup> See *Commerce Commission v Vector Limited* [2012] NZCA 220 (**Vector CA decision**) at [34](b).

<sup>33</sup> Climate Change Response (Zero Carbon) Amendment Bill (136-1) (explanatory note) at 11.



- 36.1 the purpose statement in s 162; *and*
- 36.2 “to the extent that the Commission...considers it relevant, to the promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services” (s 166(2)(b)).
- 37 Section 166 is couched in mandatory rather than permissive terms but, similar to s 5ZN and s 52A, it establishes both a purpose statement and, separately, an additional relevant consideration that the Commission must take into account, but only to the extent the Commission considers it relevant.
- 38 In the course of developing the Fibre Input Methodologies, the Commission considered the interaction of the s 162 purpose statement and the additional relevant consideration in s 166(2)(b). The Commission observed that:<sup>34</sup>
- 38.1 section 166(2) does not establish a hierarchy between the promotion of the two outcomes; and
- 38.2 there is a complementary relationship between the s 162 purpose statement and the additional relevant consideration in s 166(2)(b). This requires the Commission to make the decision that best gives effect to both, recognising that in certain circumstances the “best blend” would be achieved by prioritising s 166(2)(b) over s 162.
- 39 The Commission expressly rejected a stakeholder’s submission that the s 162 purpose statement has primacy over s 166(2)(b) and reiterated its view that neither has primacy over the other.<sup>35</sup>
- 40 That reasoning is equally applicable in the present context. Neither the fact that s 5ZN appears in separate legislation nor the fact that s 5ZN is permissive rather than mandatory supports the view that s 52A is paramount. Section 166(2)(b) is also permissive in nature in that it empowers the Commission to make its own assessment of whether that consideration is relevant.
- 41 Overall, the Commission appears to have been influenced by an assumption that addressing climate change is outside its core role and therefore of only limited significance to its decision-making. To the contrary, the purpose of s 5ZN – as set out in the legislative background – is to recognise that all public decision-makers have a role in achieving the climate objectives and to enable them to do that.
- 42 Accordingly, the better interpretation of s 5ZN is that it establishes considerations that rank equally with the outcomes set out in paragraphs (a) to (d) of s 52A and therefore enables the Commission to make decisions that are consistent with, or contribute to the achievement of, the 2050 target, emissions budgets or emissions reduction plans. While the Commerce Commission is not principally responsible for achieving the 2050 target (that responsibility lies principally with the Minister), s

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<sup>34</sup> Commerce Commission, *Fibre Input Methodologies: Main Final Decisions – Reasons Paper* (13 October 2020) at [2.231.4], [2.233].

<sup>35</sup> *Ibid* at [2.239].



5ZN permits the Commission to take the 2050 target into account, alongside the other outcomes in s 52A, and set a price path that is consistent with achieving the 2050 target and facilitates the measures necessary to achieve the target. In the present context, that would include setting a price path that enables a capital recovery profile consistent with a wind-down of the regulated service, or transition of the assets to alternative gases, within the horizon the Climate Change Commission has indicated is necessary to achieve the 2050 target.

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