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Vector cross submission - gas pipeline business default price-quality paths from 2022

1. This is Vector's cross submission to the Commerce Commission's (Commission) consultation on gas pipeline business (GPB) default price-quality paths from 2022 (DPP3).

2. Submitters were largely focussed on the Commission's decision to accelerate deprecation of GPB assets to address the heightened risk of asset stranding faced by GPBs as New Zealand transitions to a net zero carbon economy by 2050.

3. The Commission's decision to accelerate depreciation is a critical first step to address the risk of asset stranding, thereby promoting the Part 4 purpose by supporting an expectation of ex ante Financial Capital Maintenance (FCM).

4. As discussed in our submission to the Draft Decision, we consider the Commission has taken a cautious and conservative approach. The Commission needs to introduce further mechanisms to speed up capital recovery to fully address stranding risk, including un-indexing the RAB from inflation.

5. In particular, the Gas Infrastructure Future Working Group's further analysis has found the DPP3 decision "*reduces longer-term cost recovery risk and improves longer term consumer price impacts, but does not remove it.*"[1]

6. We note accelerating depreciation in the face of heightened asset stranding risk is an orthodox move for an economic regulator to take. For example, Ofgem in the United Kingdom and the Australian Energy Regulator have both introduced variants in response to stranding risk for gas pipelines in the transition to a low carbon economy.[2] We do not consider the arguments raised by submitters opposed provide any compelling reasons for the Commission to reconsider its decision to accelerate depreciation.

7. Our submission has expanded below on what appeared to be the key arguments made by those submitters opposed to accelerated depreciation.

Should the Commission have waited until the IM review to accelerate depreciation?

8. A key theme from submitters opposed to accelerated depreciation appeared to be that the Commission should have waited until the IM review to consider accelerated depreciation.

9. This argument seemed to largely comprise the following elements:

[1] NZ Gas Infrastructure Future Working Group, *Further analysis paper* (26 March 2022), page 1
[2] See also Oxera, *Regulatory tools applied to gas networks to accommodate energy transition: Note prepared for Firstgas, Vector and Powerco* (26 August 2021) which describes approaches to address stranding risk taken by regulators in Europe.

a) The process did not allow stakeholders sufficient time to engage and, as a substantive change, was more appropriately left to the IM review;
b) The Commission should have waited until policy was more certain and that stranding risk remains uncertain; and
c) Questions around why the Commission needs to act in DPP3 not DPP4 (MGUG referred to this as the 'counterfactual').

Process

10. We disagree with stakeholders such as the Major Gas Users Group (MGUG) who argued the process did not provide sufficient time to consider accelerated depreciation, as a substantive IM change.

11. In our experience, the timeframe and volume of material was not out of the ordinary for a DPP or an individual IM consultation

12. The Commission's Process and Issues paper (published August 2021) stated the Commission was considering mechanisms to address stranding risk and discussed applying an adjustment factor to shorten asset lives as a potential option.

13. The Commission's Notice of Intention (published 4 February 2022) stated the Commission was considering amending the IMs to provide a mechanism to adjust asset lives for existing and new assets.[3] The Notice of Intention set out its timeframe for this decision, being that submissions would be invited until 10 March 2022, Cross-submissions until 25 March 2022; and a final decision by 12 May 2022.

14. The Commission ultimately extended this timeframe, allowing submissions until 10 March 2022 and cross-submissions until 28 March 2022.

15. We expect the Commission would follow a substantially similar process (and time frame) if it had been making this decision as part of the substantive IM review. In practice, stakeholders would likely have less time and resource to consider accelerated depreciation if it was part of a substantive IM review process given the breadth of significant issues (such as cost of capital) typically canvassed in an IM review cycle.

16. The IM amendment to adjust asset lives is narrow, targeted and consistent with the current EDB IMs which contain a mechanism for EDBs to adjust asset lives (with some differences). Accordingly, it is entirely appropriate for an out of cycle IM amendment in the current environment.

17. The context for this DPP reset and its impact on the net zero transition mean DPP3 is not a "business as usual" reset. GPBs are facing unprecedented circumstances and a material risk of asset stranding. This is clearly a compelling and urgent rationale for the Commission to amend the IM. Failure to do so would prevent the Commission from setting a DPP that is fit for purpose.

18. Given the uncertainty facing GPBs, the heightened risk of asset stranding and the legislative requirement to set the DPP by 31 May 2022, it would have been unreasonable for the Commission to take a different approach. Not taking action to address stranding risk in DPP3 would lead to significant uncertainty for suppliers and would breach the cornerstone principle of Part 4 regulation - maintaining an expectation of ex ante FCM.

19. In addition, Chapman Tripp's legal advice (jointly submitted by Vector, First Gas and Powerco) is clear that the Commission's followed an appropriate process.

[3] Commerce Commission, *Notice of Intention: Potential Amendments for Gas Pipeline Services* (4 February 2022)

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Policy certainty and the risk of asset stranding

20. Submitters such as MGUG suggested the Commission should have waited for more policy certainty before taking action to address stranding risk. A related argument raised by some submitters was that the risk of asset stranding was currently uncertain.

21. For example, MGUG submitted:

> "*There are no energy policies for gas on which it is necessary to act now. Specific new policies are yet to be announced and may become more apparent through the development of a national energy strategy in 2024. The Commission is acting ahead of policy. We think that it sets a poor precedent to base fundamental decisions on what policy decisions might be, rather than what has actually been decided.*"[4]

22. We consider this line of reasoning misstates the problem the Commission is addressing. We acknowledge the Government has not yet announced its policy on gas and it is not clear that GPB assets will be stranded.

23. It is clear, however, that GPBs face a heightened risk of asset stranding. The transition to net carbon zero and its impact on consumer behaviour means stranding risk exists regardless of the where the Government lands on policy over the DPP3 period.

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24. As the Commission's draft decision recognises:

> "*Regardless of how climate change policy evolves over DPP3, New Zealand is embarking on a period of marked change in the energy sector to address climate change. This transition will undoubtably have a profound impact on the role of GPBs and on their consumers in the long term.*"[5]

25. The Electricity Networks Association (ENA) similarly submitted:

> *New Zealand's push to decarbonise its economy will have a material consequence for the future of both gas and electricity distribution business. However, consequences for these two sectors will be very different.*"[6]

26. This means - without regulatory action to address this risk - investors may not be willing to invest in the GPB. Similarly, GPB directors may be unable to approve expenditure (barring expenditure unavoidable for health and safety) and also comply with their fiduciary duties (i.e. a director may be unable to approve expenditure where they did not have a reasonable expectation of a return on/of capital *and* act in the best interests of their company).

27. This would compromise the long-term benefit of consumers by limiting the ability of the GPB to invest to maintain an effective network and could cause the network to be retired prematurely (while consumers still demand the service). It also raises equity issues for future consumers who cannot leave the network if the stranding risk materialises.

28. As summarised by the ENA:

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[4] Major Gas Users Group, *Re: GPB IM Review and DPP3 Reset,* (14 March 2022), at X(8)(a)
[5] Commerce Commission, *Default price-quality paths for gas pipeline businesses from 1 October 2022: Draft reasons paper*, (10 February 2022), at 6.144-6.145
[6] Electricity Networks Association, *Submission to the Commerce Commission on gas networks draft default price path* (14 March 2022), page 1

"Maintaining the Commission's commitment to ex-ante FCM ensures suppliers in all regulated industries continue to have incentives to invest and promotes the long-term benefit of consumers in line, with the Part 4 purpose."[7]

29. It is clear action to address stranding risk is required from the Commission regardless of where the Government lands on policy for gas over the DPP3 period.

30. In addition, the Commission cannot reasonably defer action to address stranding risk until Government policy is more certain (for example, after the CCC recommendations are delivered). This is because:

- If action is not taken this DPP, the earliest possible opportunity to address stranding risk would be DPP4 beginning in 2026. This would leave four years of significant uncertainty for GPBs compromising the principle of FCM.
- If the Government implements the CCC proposals, GPB's may be unable to recover their capital by 2050 if action is not taken in DPP3. This means the FCM principle will be breached.
- Even if the Government does not implement the CCC recommendations or expressly limit the role of gas, GPBs still face significant potential asset stranding risk in the context of the transition to net carbon zero and its impact on consumer behaviour. Accordingly, maintaining an expectation of ex ante FCM requires action to address asset stranding risk regardless of Government policy.

31. As CEG's report found:

"*The modelling in this report, even though only illustrative at a high level, suggests that, if the Commerce Commission does not take significant action now, there is a significant risk that networks will face the real prospect of stranding risk increasing in the medium to longer term.*

Network businesses will be compromised with their asset management strategies. Long term planning and investment are put on hold because and management perceive that the firm will not make it in the long term.

The disastrous nature of the potential transaction costs associated with managing stranding risk is precisely why management does everything in their power to prevent this occurring within their control.

If regulatory inaction does lead to financial stress it is important to recognise that it will cause costs associated with managing this risk for the firm and suboptimal investment decisions. This may take the form of hoarding cash by foregoing what would otherwise be sensible investments or running down existing assets."[8]

Counterfactual - what would occur if action on asset stranding was delayed until the IM review

32. We note MGUG's submission that,

"*The counterfactual (applying IM settings from DPP4) hasn't been adequately addressed in the reasoning. The stranding risk model used by the Commission offers no answer as to why making IM amendments in DPP3 versus in DPP4 is in the long term interest of consumers. It only offers an answer to the value of acting now, versus never acting at all."*[9]

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[7] Ibid, page 3
[8] CEG (on behalf of Vector), *Stranding risk depreciation vs uplift* (August 2021), at 104 - 107
[9] Major Gas Users Group, *Re: GPB IM Review and DPP3 Reset,* (14 March 2022), X9

33. We disagree with this assertion. While the asset stranding model does not expressly consider the impact of action in DPP4, the Commission's draft decision does explain its reasoning that taking some action now rather than waiting to future regulatory periods best promotes the Part 4 purpose:

"it might be possible to only begin addressing stranding risk in future regulatory periods beyond DPP3. However, we consider addressing the issue to some degree for DPP3 is consistent with outcomes likely to be produced in competitive markets in similar circumstances and therefore likely to be in the long-term interests of consumers. This is because it:

- *Increases the credibility of the regime by continuing to provide a reasonable expectation of FCM for the GPBs, which in turn provides incentives for investment to maintain safe and reliable networks; and*
- *Provides some headroom if other building block model cost components increase in future regulatory periods to better manage consumer price shocks."*[10]

34. We agree with the Commission's reasoning. The principle of ex ante FCM would be compromised if the Commission deferred action to the IM review.

35. There is also clear evidence that taking action in DPP3 will ensure future price increases for consumers are lower than they would otherwise have been. For example, the need to bring cash-flows forward to mitigate the burden on future consumers was addressed in reports by Frontier Economics and Houston Kemp submitted during the Process and Issues Paper consultation.[11]

36. The report by Frontier Economics that Vector, First Gas and Powerco are submitting as part of the cross-submission process also demonstrates this point.

37. Frontier used the Commission's asset stranding model to assess the outcomes of delaying the decision to accelerate depreciation below. Frontier found:

"*if the Commission were to wait until DPP4 to accelerate depreciation, the future gas price increases that would, in expectation, be required in order to the GPBs' to recoup their full RABs by 2050 would be materially and persistently higher from approximately 2031 onwards than if the Commission were to begin accelerating depreciation in DPP3.*"[12]

38. Accordingly, it is clear the long-term benefit of consumers is best promoted by accelerating depreciation in DPP3 rather than delaying until DPP4. Deferring to DPP4 would compromise the principle of ex ante FCM and therefore inhibit efficient investment. In addition, action in DPP3 is needed to support the equity of future consumers by avoiding higher price increases in the future.

Outcomes consistent with a competitive market

39. Some submitters criticised accelerated depreciation on the basis it was inconsistent with outcomes in a competitive market. For example, Greymouth Gas submitted:

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[10] Commerce Commission, *Default price-quality paths for gas pipeline businesses from 1 October 2022: Draft reasons paper*, (10 February 2022), at 6.67

[11] See Frontier Economics *The case for a nominal returns framework for regulated gas networks in New Zealand: a report prepared for Vector, Powerco and First Gas* (27 August 2021), page 24 and Houston Kemp, *Consequences of Declining Gas Pipeline Utilisation: A Report for Powerco, Vector and First Gas* (August 2021), page 16

[12] Frontier Economics, *Memo: Response to key submissions made by stakeholders on the Commerce Commission's approach to addressing stranding risks in the Gas Draft DPP3 Decision* (28 March 2022), at 19

"*The Commission's draft decision does not consider that consumers (particularly large consumers) and producers are facing asset-stranding risks because of the phasing out of natural gas, and in many cases do not have the same opportunities to repurpose those assets. Those consumers and producers do not have the luxury of a regulated price-setting process allowing them to recover their asset costs in full ahead of 2050."*[13]

40. Stranding risk in a regulated business is not directly comparable with stranding risk in a competitive business. This is because, while competitive businesses bear stranding risk, they are free to factor this into their prices. In a regulated business stranding risk is not factored in to prices.

41. Furthermore, Frontier Economics memorandum explains that the Commission's approach is not incompatible with the outcomes of a competitive market:

"it is true that in a competitive market no individual firm facing a growing stranding risk would be able to raise its prices to recoup its costs more quickly – because doing so would make it uncompetitive compared to its rivals. However, if the stranding risk affected all firms in the industry similarly, then all firms could raise their prices to accelerate cost recovery without facing any competitive disadvantage. This is precisely the circumstance that the Commission is seeking to address in the draft decision. All (not some) GPBs face a common emerging stranding risk. Nothing about the Commission's approach to accelerating the cost recovery of all the GPBs in response to this common stranding risk is incompatible with the outcomes of a competitive market."[14]

42. Frontier Economics memorandum provides further detail on these points.

Are there alternatives to accelerated depreciation?

43. Submitters such as MEUG and Fonterra suggested other actions that could be taken to address stranding risk rather than accelerating depreciation. The following approaches were raised:
    a) GPB's applying for a customised price path (CPP);
    b) GPB's changing their capital contributions policy; and
    c) Applying accelerated depreciation to new assets only

44. None of these approaches offer a feasible alternative to deal with the magnitude of stranding risk facing GPBs.

Customised price-paths (CPP)

45. Fonterra and MEUG suggested GPBs could instead apply for a CPP to manage stranding risk.

46. If the Commission took this advice, we expect it would receive CPP applications from every GPB which would present practical difficulties and lead to significant uncertainty for GPBs throughout the application process.

47. We do not consider relying on a CPP is a feasible solution for sector wide uncertainty. Applying an adjustment factor through the IMs is a lower cost and practicable approach.

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[13] Greymouth Gas, *RE: Default price-quality paths for gas pipeline businesses from 1 October 2022* (14 March 2022), at 9

[14] Frontier Economics, Memo: Response to key submissions made by stakeholders on the Commerce Commission's approach to addressing stranding risks in the Gas Draft DPP3 Decision (28 March 2022), at 60 (c)

48. We note MEUG also suggested introducing a new reopener for to allow a "*GPB that may have a specific concern about continuing investment and maintenance to meet standards because of factors such as stranding risk in the current DPP.*"[15] Again, this is not a feasible approach to deal with the magnitude of the stranding risk, particularly given it is a is sector wide risk.

Capital contributions policy

49. MEUG also suggested GPB's could change their approach to capital contributions to address stranding risk.[16]

50. The Commission's idealised MAR profile (to deliver capital recovery) already reflects this approach, as it assumes all GPBs have either 100% contributions for relocations, connections and system growth (or that these investments cease entirely).[17]

51. We also note Vector has already changed its approach to recover 100% customer connection capex and system growth capex through capital contributions.

52. However, changing capital contributions policy is in no way sufficient to mitigate stranding risk. It does not have any impact on capital already invested or new capital expenditure that is not driven by customer connections.

Application of depreciation solely to new assets

53. Nova and Munroe Duignan suggested that accelerated depreciation be applied to new assets only.

54. This approach would clearly breach the principle of ex ante FCM. As Frontier Economic's memorandum explains:

    "The approach adopted by the Commission in all of its decisions to date is to set regulatory allowances using the building block approach within the NPV=0 framework. The regulated business is provided with an ex ante allowance that is sufficient in expectation to cover its operating costs, to recover the capital that was invested, and to provide a fair return on capital while the investment is in place. The NPV=0 framework—which the Commission also refers to as the Financial Capital Maintenance (FCM) principle— requires the regulatory allowance to be just sufficient, in expectation, to make the investor whole over the life of the asset…

    What is proposed in the above submissions [that accelerated depreciation applies only to new assets] would be a clear breach of the ex ante FCM principle. The suggestion is that the regulatory allowance on existing assets should be set such that asset owners do not in expectation recover the cost of existing assets – because there is nothing the asset owner can do about that, given that the existing assets are already sunk."[18]

55. If the Commission were to abandon its long-standing commitment to providing an expectation of ex ante FCM, the long-term benefit of consumers would be severely undermined as investors would not have confidence in recovering their capital invested.

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[15] Major Electricity Users Group, *GPB IM amendments* (14 March 2022), page 3
[16] Ibid, page 2
[17] Commerce Commission, *Default price-quality paths for gas pipeline businesses from 1 October 2022: Draft reasons paper*, (10 February 2022), at 6.124
[18] Frontier Economics, Memo: Response to key submissions made by stakeholders on the Commerce Commission's approach to addressing stranding risks in the Gas Draft DPP3 Decision (28 March 2022), at 43-47

56. This negative outcome would affect not only GPB's and their consumers, but investors and consumers in all regulated industries.

Prices

57. We note MGUG's submission that:

"*the Commission has accepted the GDB's own connection and volume growth forecasts to 2028. So our argument is that any possible price shocks in 2026 from the normal IM review would be applied to a larger base of customers than in 2022. This deals directly to the Commission's statement that it is better to provide a price shock now in order to manage "unmanageable consumer price shocks in future regulatory periods*"[19]

58. Vector does not expect its consumer base to grow through DPP3. As explained in Vector's submission to the Draft Decision, our 2021 AMP was never intended to provide a forecast for DPP3.

59. Vector took the decision to take a "business as usual" approach to the 2021 AMP (in an environment that was, of course, anything but business as usual) in lieu of any trends that could reasonably be projected forwards. At the time, we hoped uncertainty would be alleviated by the end of the year when the Government responded to CCC and, we expected, impacts from Covid (and other drivers of uncertainty) were clearer. Ultimately, this was not the case as the Government response to CCC was delayed and the other drivers remained unclear.

60. We consider it highly unlikely for our network to experience growth over the DPP3 period based on current trends. Accordingly, the widest customer base to recover capital recovery from is the existing customer base in DPP3.

61. We also note that, if the Government implements the CCC recommendations, the CCC pathway would result in significantly different growth projections than those made by GPBs, as recognised by the Commission's expert report by Concept Consulting.[20]

62. However, regardless of connection growth over the DPP3 period, the long-term benefit of consumers is better served by addressing stranding risk now rather than delaying to DPP4.

63. Beginning accelerated recovery in DPP3 will mitigate the impact of price increases in future regulatory periods. Accordingly, taking action in DPP3 will ensure consumers (current and future) face the lowest possible prices over time. Houston Kemp's report explained

> "*if no change is made to depreciation during the 2022 to 2027 regulatory control period, the smoothed price path applying from 2027 would be 8.8 per cent higher than the smooth price path that would have applied from 2022, ie, prices will permanently be 8.8 per cent higher due to this decision.*"[21]

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[19] Major Gas Users Group, *Re: GPB IM Review and DPP3 Reset,* (14 March 2022), at 24

[20] Concept Consulting, *Basis and methodology for producing gas demand projections to feed into the default price-quality path (DPP) regulation of gas distribution businesses: prepared for the Commerce Commission* (15 November 2021), page 9

[21] Houston Kemp, *Consequences of Declining Gas Pipeline Utilisation: A Report for Powerco, Vector and First Gas* (August 2021), page 15

64. As described at Paragraph 37, Frontier Economics found - if the Commission implemented accelerated depreciation at DPP4 rather than DPP3 - prices would be "*materially and persistently higher from approximately 2031 onwards.*"[22]

65. It is also worth noting accelerating depreciation is an orthodox approach for an economic regulator to take in an industry facing asset stranding risk (regardless of growth in the short term). For example, the Commission amended the IMs to allow EDBs to apply for accelerated depreciation due to the risk of stranding from new technology. This approach was taken on the understanding it would promote the long-term benefit consumers by providing an expectation of ex ante FCM and avoiding unmanageable impacts on future consumers. This reasoning holds despite short term growth for EDBs.

66. We certainly agree price increases to consumers should not be taken lightly. However, it is important to bear in mind the context of the proposed DPP3 price increases is coming off low prices from the previous regulatory periods. As Vector raised in our submission to the Draft Decision, Vector's prices have reduced by about one-third in real terms since DPP1. While prices will increase in DPP3, they will still remain lower than what customers had historically paid for the network (prior to the current regulatory regime).

67. We also note the Commission has taken action to manage consumer price shocks, in particular a 10% limit on real annual price increases over DPP3 and smoothing mechanisms to ensure real average annual price increases remain constant over DPP3.

Repurposing scenario

68. Submitters opposed to accelerated depreciation also expressed concern that the Commission had not factored in the residual value of the network that could be repurposed.

69. For example, MGUG submitted:

    "*The Commission interpretation of "gas pipeline services" as being restricted to "natural gas" conflicts with the overall intent of part 4 to regulate markets with little or no competition. s52G provides an opener to consider goods and services that fit this definition. The restrictive interpretation of what constitutes gas pipeline services has also led to unreasonable assumptions that RAB of GDBs would be left economically stranded despite RAB having a residual value for repurposing. The Commission's interpretation also discounts the long term interest consumers have in gas pipeline services continuing to offer consumer energy choices.*"[23]

70. As explained in the Draft Decision, the Commission is limited in the extent it can consider repurposing as its statutory remit is limited to 'natural gas' pipelines. However, contrary to MGUG's argument, the potential repurposing of the gas network provides support for the decision to accelerate depreciation.

71. As MGUG noted, the Commission must consider "*the long-term interest consumers have in gas pipelines continuing to offer consumer energy choices.*"[24] This interest can only be promoted by maintaining the expectation of ex ante FCM in the face of asset stranding risk to ensure suppliers can continue to invest. Otherwise, there is a risk of the network ceasing to operate while consumers still have demand for the service (and ahead of any repurposing scenario becoming feasible).

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[22] Frontier Economics, *Memo: Response to key submissions made by stakeholders on the Commerce Commission's approach to addressing stranding risks in the Gas Draft DPP3 Decision* (28 March 2022), at 19

[23] Major Gas Users Group, *Re: GPB IM Review and DPP3 Reset,* (14 March 2022), at X4a

[24] Ibid

72. Furthermore, as Houston Kemp explained, accelerating depreciation of existing assets could support the transition of the network to clean gases. If the costs of the existing network are not recovered from current consumers and the repurposing becomes feasible, the costs of the network would be recovered by potential future clean gas consumers. This could act as a disincentive to the uptake of clean gas.[25]

Yours sincerely

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[25] Houston Kemp, *Consequences of Declining Gas Pipeline Utilisation: A Report for Powerco, Vector and First Gas* (August 2021), page 16