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Commerce Commission
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Methanex submission on Options to maintain investment incentives in the context of declining demand

Methanex welcomes the opportunity to provide its views on the Options Paper[1] published by the Commerce Commission on 20 December 2022 as part of its 2022/23 Input Methodologies Review ("IM Review").

Methanex's interest in the IM Review rests principally on issues affecting the regulation of gas pipeline businesses ("GPBs") and in particular the ramifications of the Commission's decision to incorporate measures to address increased asset stranding risks facing GPBs implemented in the 2022-26 regulatory period ("DPP3").

Methanex's use of gas pipeline services is restricted to use of the Maui Pipeline; consequently the focus of its interest is the regulatory settings that relate specifically to gas transmission businesses ("GTB").

GENERAL COMMENTS

1. In Methanex's previous submission on the Process and Issues and Draft Framework Papers (submitted on 11 July 2022), Methanex noted as a principal concern:

   "That the key economic principles used by the Commission are applied in a manner that balances the interests of pipeline owners and consumers, both current and future and also remains consistent in promoting Section 52A objectives when addressing network stranding risks."[2]

[1] *Input Methodologies Review - Options to maintain investment incentives in the context of declining demand*

[2] *MX 2022 submission para 1*

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From Methanex's perspective the method selected to address asset stranding risks is less important than addressing the fundamental approach to allocating risk and the depth of analysis it applies to ensure the settings promote Section 52A outcomes.

2. Our concern remains that the key economic principles in respect to asset stranding risk are applied in a manner that systematically favours the interests of suppliers at the expense of consumers.

3. While Methanex accepts that the asset stranding risk facing gas pipeline businesses has increased in recent years , we have concerns regarding:

   (i) the rigour and depth of the Commission's evaluation of the scale and timing of the risk; and

   (ii) the degree of assurance of ex-ante FCM being given to suppliers and conceptualisation of the allocation of risk between suppliers and consumers.

4. Our analysis of the choices presented in the Options Paper is based on an assessment of the extent to which each option can achieve a better balance between the interests of suppliers and the interests of consumers than status quo. Specifically, the selected approach should:

   (i) objectively benefit consumers (Section 52A requirement)
   (ii) be simple and definitive (Section 52R requirement);
   (iii) enable a sufficient level of Commission scrutiny and transparency for consumers to reasonably evaluate the justification for and impacts of regulatory settings; and
   (iv) be able to be revised (in an objective and transparent manner) to respond to changes in outlook or to address the impacts of over-recovery in prior periods.

5. We see the Options Paper as introducing high-level concepts rather than comprehensively developed proposals. The timing of the Options Paper means that there is little time remaining for the Commission to fully assess the implications of the Options, formulate comprehensive, stakeholder-supported, proposals before draft decisions need to be made. As a result, it is Methanex's view that:

   (i) the Options set out in the Options Paper are not sufficiently defined or evaluated to enable support of any of them.
   (ii) none of the Options present a clear pathway towards a higher level of scrutiny or more comprehensive and objective assessment of asset stranding risks.

6. We consider that a focus of the IM review should include consideration of the current methodology to assess if it is fit-for-purpose and sufficiently adaptable if the outlook for asset stranding risk changes in the future, including being able to make compensatory adjustments to address the results of over-recovery in prior periods.

7. Any endorsement of the status quo implied in this submission does not derogate from our view expressed in previous submissions that the settings applied by in the DPP3 reset have been exaggerated and not sufficiently supported by evidence or analysis.

OUR PREVIOUS SUBMISSION

In Methanex's previous submission on the Process and Issues and Draft Framework Papers (submitted on 11 July 2022) suggestions were made for additional work that in our view would be valuable additions to the Commission's work programme.

Comparison against the method used for accelerated depreciation available to EDBs

8. We recommended that the Commission *"thoroughly reviews its decision to adopt accelerated depreciation, including its decision in respect of gas pipeline businesses to diverge from the approach taken with regard to allowing EDBs to apply for accelerated depreciation, and re-evaluates the level of acceleration that was applied in the DPP3 reset."*[3]

9. In addition to a general review of the decision to adopt an asset life adjustment factor for GPBs we made the specific request that the Commission re-evaluates its decision to deviate from the asset life adjustment process applied to Electricity Distribution Businesses when it introduced an asset life adjustment factor for GPBs.

10. We accept that the asset life adjustment factor in the GPBs IM is inherently more flexible than the mechanism for asset life adjustment applied for the EDBs. We consider the capacity to be able to revise the adjustment factor as being particularly important to respond to changes in outlook. So it is important to Methanex that there is the facility to make revisions to the adjustment factor that can compensate for any over-recovery should it be validated during the DPP4 reset.

11. However, in our previous recommendation to consider a similar mechanism for gas pipeline business as was applied for EDBs it is worth noting our focus was placed on:

    (i) the greater emphasis placed on evidence and scrutiny explicit in the application process;

    (ii) the expectation of stakeholder consultation on proposed adjustments; and

    (iii) placing an upper limit on allowable shortening of asset lives.

    We request that the Commission considers how those features could be integrated into the IMs, or into its decision making framework.

Consideration of the AER 2022 determination

12. Methanex also requested that the Commission *"gives particular consideration to the Australian Energy Regulator's draft decision in respect to regulation of the APA Victorian Transmission System released in June 2022."*[4]

13. While it may not have any effect on the decisions made in the DPP3 reset, further examination by the Commission may better inform its views moving forward on ways of improving upon

[3] *MX 2022 submission para 6*
[4] *MX 2022 submission para 8-11*

the methodologies for addressing asset stranding risk and more importantly its decision making framework and judgement of risks.

Level of scrutiny applied by the Commission[5]

14. In our previous submissions we have highlighted our concern regarding what we believe to have been insufficient scrutiny and depth of analysis by the Commission in determining the DPP3 settings, including its assessment of asset stranding risks. We do not believe it has addressed its approach to scrutiny, analysis or evaluation in the Options Paper, to show it meets the objectives of Section 52A in an objective and transparent manner.

15. Having regard to this, all of the choices presented in the Options Paper have further implications on the appropriate level of scrutiny.

    (i) Options A and B in terms of the scrutiny of the suppliers nominations of asset lives. We found it surprising that in the case of Option A and B, the Commission identified its scrutiny as a pro, but did not set out how it would apply its scrutiny, while at the same time recognising the significant informational advantage that suppliers would have.

    (ii) Option C in terms of the inherent demands for increased analysis to determine alternative depreciation settings, and how or when they are applied.

    (iii) Option D and E in terms of establishing appropriate settings for ex ante allowances and in respect to Option E the scrutiny needed to police the process of identifying and evaluating stranded assets.

    The Commission has not elaborated upon how it would sufficiently and transparently address the increased demands for scrutiny and depth of analysis required if any of the Options are adopted.

ASSESSMENT OF OPTIONS

OPTIONS A AND B

Mechanisms enabling suppliers to nominate asset lives

16. We consider there is little practical distinction between Options A and B other than their respective asset classes and so we have considered the options together.

17. The Commission states that *"Suppliers are likely to be best placed to estimate the economic lifetime of individual assets at the time of commissioning and so the resulting asset lives should be closer to economic lives"*.[6] We disagree, instead suppliers are more likely to estimate economic asset lives in their own best interests.

[5] MX 2022 submission para 12-15
[6] Options Paper 3.65 and Table 1

18. The Commission cites the role of GAAP and its own scrutiny as the means to minimise risk of misestimating economic asset lives and offset the informational advantage that suppliers hold.

(i) Our chief concern is that suppliers will have a strong incentive to exaggerate risk and excessively shorten asset lives, and the Commission will be unable to sufficiently prevent or deter this behaviour. We believe that if Option A and or B were to be adopted there is an increased likelihood of excessive acceleration of capital recovery undermining Section 52A outcomes.

(ii) We are also concerned about the representation of GAAP rules as a benefit in respect of Options A and B. It doesn't appear to Methanex that GAAP places any particular constraint on suppliers exaggerating risks they can determine for themselves, only perhaps the opportunities for extreme or inconsistent positions.[7]

(iii) The Commission notes the information advantage held by suppliers and we believe this is critical when combined with the risk of insufficient scrutiny. We believe its role is to objectively, comprehensively and fairly assess the impacts of asset stranding risks, including the effect on economic asset lives. Any increased influence by suppliers in determining asset lives would be detrimental to achieving balanced outcomes.

(iv) In respect of disadvantages we believe that increased complexity is an additional disadvantage with Options A and B, just as is the case with the other Options presented in the Options Paper.

19. Given these concerns, Methanex does not support either of Options A or B. Instead Methanex recommends that the Commission investigates how it can strengthen existing IMs (and ID requirements) to increase the level of objective analysis it undertakes and the level of scrutiny it applies for making determinations to deviate economic asset lives from their underlying physical asset lives.

OPTIONS C AND D/E GENERALLY

20. The Options Paper has not been sufficiently specific on whether Option C, (addressing forms of depreciation), and Options D and E, in some combination, (providing for ex ante allowances with or without RAB write-downs) are competing alternatives to the status quo, or whether the Commission's considers the prospect of adopting some mix or all of the Options. It has also not sufficiently clarified how adopting any of these Options would affect the existing asset life adjustment mechanism.

21. In general terms, we believe the Options Paper contains insufficient guidance on how the options would be applied, interact with each other or interact with existing methodologies. We are also unclear as to whether the intention is to select one definitive method or set of methods, or instead have multiple discretional options in the IMs. If the latter is the case it would dramatically increase complexity and uncertainty, with no guarantee that increased flexibility would produce sufficient offsetting benefits to consumers. Methanex wants robust IMs but it also wants those IMs to, as far as practicable, be simple and definitive.

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[7] *3.60*

Setting aside the specific merits of any of the options Methanex does not support adopting a 'menu of options' approach in the IMs at least not without a substantial improvement in the definition of the Options and decision rules on the circumstances under which particular mechanisms might be selected.

OPTION C

Mechanism for use of alternative depreciation methods

22. There is logic to establishing depreciation methods that allow a better match between the shape of the depreciation profile and the shape of the underlying long-term demand profile for gas pipeline services. However, this relies entirely upon the ability to reasonably predict the demand profile at the outset.

    The Commission has also not elaborated upon how adopting Option C would influence the asset life adjustment settings. Methanex already holds the view that it has exaggerated the asset stranding risk and that this has had the effect of excessively accelerating capital recovery and the elevation of tariffs being paid by current consumers. So implementing any new depreciation method that further front-loads capital recovery will exacerbate the risk of over-compensation by current consumers.

23. It has also noted that in a situation of declining investment and a shrinking RAB, it may be that straight-line depreciation *"would result in an aggregate profile of depreciation that broadly reflects long-term total consumer demand expectations."* [8] On this basis, it doesn't appear that any alternative depreciation method systematically improves the expectation of a better match to the demand profile than straight-line depreciation.

24. Within this Option, several different approaches are presented without sufficient detail which complicates the evaluation of potential impacts[9], choosing between different types of depreciation method that could be selected:

    (i) Perhaps adopting one type for GDBs and a different type for the GTB;

    (ii) Applying different types at different times; and

    (iii) the Commission states – "*we could apply a different method for older existing assets compared to newer (or new) assets."* [10] This aspect in particular appears to be a significant complication, raising the prospect of creating an entirely new variable whereby asset treatment varies in some currently undefined way based on the particular age of a given asset. This would be a significant departure from the current simple way of distinguishing assets classes as either new assets entering the RAB, or existing assets already in the RAB. It has not supplied any detail as to how this discrimination between asset ages would be made in practice. Regardless, it would appear to greatly complicate the asset valuation process without any clear benefit for consumers.

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[8] *X46.2, (also in Table and 3.96)*
[9] *See Description section in Table 2*
[10] *Table 2*

25. We consider it unlikely that having alternative depreciation types will assure a better match to the long-term demand profile. This is compounded by the impacts on certainty and complexities in its application that these alternative depreciation methods would add. Consequently, Methanex does not support deviating from straight-line depreciation at this time.

OPTION D

Mechanism to enable use of ex ante allowance

26. In terms of improving incentives to innovate and invest efficiently we are uncertain as to whether ex ante allowances will yield real benefits to consumers over the status quo. An ex ante allowance might be more effective as an incentive to innovate and invest efficiently if there are conditionalities placed on it. If it is provided in respect of particular projects and initiatives, or conditional on certain objectives being achieved, then it might be more successful than accelerated depreciation in this respect. But if it is simply provided as an ex ante uplift in allowable revenue, without pre-conditions or a claw-back mechanism, it would appear to offer no advantage in practical terms over the status quo.

27. At this stage Methanex does not support adding an IM to enable an ex ante allowance. We believe the Commission has not presented sufficient information to support it as an alternative to the status quo.

    (i) We have concerns that the ex ante allowance might be more prone to creating an excessive uplift in allowable revenue than is already the case with shortening asset lives.

    (ii) While there does appear to be the ability to revise the asset life adjustment factor in the current IM, including the potential for it to provide compensatory adjustments to correct for over-recovery in prior regulatory periods, it is unclear what measures would protect consumers from over-compensation of suppliers that might occur from the provision of ex ante allowances.

28. In Option D ex ante allowances are presented as being a means of allocating some of the increased asset stranding risk to suppliers. But the Commission has not elaborated upon how it would determine the level of ex ante allowances, including how (or if) it would discount the ex ante allowance in order to effectively pass some risk to suppliers.[11] If an ex-ante allowance has the effect of excessively compensating suppliers for the increased risk of asset stranding as would seem to be the case if it adheres to its current approach of maintaining an expectation of ex ante FCM[12], and in Methanex's opinion, exaggerates the scale of asset stranding risks, then it does not appear to offer any tangible benefits to consumers compared with the status quo.

29. We disagree with the position taken by the Commission that *"suppliers should already have strong incentives not to over-invest"*[13] and we don't believe it has presented evidence that supports this statement. It is logical to conclude that the greater the assurance from the

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[11] *X31*
[12] *X51*
[13] *X49*

regulator that suppliers will fully recover their capital in any given situation the less incentive they have to invest efficiently and not over-capitalise.

30. We already hold the view that the use of the asset life adjustment factor mechanism and the settings established for DPP3 represent an exaggerated risk and over-recovery of capital from current consumers, but with the current IM we believe there is some capacity for revisions to the asset life adjustment factor including a compensatory adjustment to compensate consumers for over-recovery in DPP3. We don't see the same prospect for corrective adjustments if ex ante allowances are adopted as currently described in the Options Paper.

31. Methanex is also uncomfortable that Option D would be inserted in the IMs as some form of simplified enabling mechanism, light on specifics and with the prospect of later clarifying amendments being needed in the lead up to (or during) the DPP4 reset. While it is reasonable to exclude determination of the specific level of compensation from the IM, there is significant detail in terms of the mechanics of Options D (and E) that would still need to be specified in the IMs and which haven't been elaborated upon in the Options Paper.

    For instance, there would need to be sufficient detail in the proposed IM amendment to clarify the interaction between the provision of ex ante allowances and the existing asset valuation methods, and if it is inserted as a selective option what rules would be applied to determine the circumstances under which it would be applied.

OPTION E

Mechanism to enable RAB write-downs, in conjunction with ex ante allowances

32. The presentation of Option E has created the most uncertainty for Methanex of all the options. Methanex considers that risking the RAB to potential write-downs might be beneficial in reallocating risk to suppliers were it not for the prospect of excessively compensating suppliers for the risk by way of ex ante allowances. With uncertainty over the Commission's approach to setting ex ante allowances and its adherence to the principle of FCM assurance Methanex does not have confidence that Option E in conjunction with Option D would result in an outcome any better than status quo.

CONCLUDING REMARKS

33. Methanex believes the Options Paper is insufficient in presenting options with enough definition, or with a sufficiently comprehensive assessment of costs and benefits for it to be supportive of any of the Options at this time. There has also been insufficient evaluation as to whether the current IM mechanism is fit for purpose and how it might be improved upon going forward.

34. We are concerned that the Options Paper is ambiguous regarding which combination of Options that might be adopted, whether they are adopted as definitive replacements or complementary methods, or intended to provide a set of selective methods the Commission can choose between at each DPP reset. We don't believe this is consistent with the objective set out in Section 52R.

35. A deeper assessment of ex ante allowances might be warranted but given the insufficient definition in the Options Paper and the limited time remaining before draft decisions need to

be made we recommend the Commission instead focuses on ensuring the current IMs are fit for purpose. In particular we want assurance that the asset life adjustment factor can be readily revised and that it is able to incorporate adjustments to compensate for excessive capital recovery in prior periods.

36. Methanex would be receptive to (a) extending the IM Review, at least in respect of GPB IMs, to further develop the options and consult upon emerging views, and/or (b) undertaking a specific review of GPB IMs following determination of the Gas Transition Plan and Energy Strategy, provided that sufficient time is allowed to address IM amendments before embarking on the DPP4 reset process to avoid the same issues regarding time pressures and sufficiency of analysis and consultation experienced during the DPP3 reset.

37. Going forward, whether as part of the IM Review process or preliminary to determining specific settings at the next reset, Methanex requests that the Commission thoroughly reviews its general assessment of asset stranding risks[14] and approach to equitably allocating risk between suppliers and consumers (current and future), in light of concerns raised by Methanex and other consumer stakeholders. This would include the need for greater scrutiny and depth of analysis as the basis for capital recovery changes from a relatively objective basis (straight line depreciation over asset life) to more subjective assessments. We also consider the evolution in policy settings should warrant a recalibration of the Commission's assessment of asset stranding risks.[15]

Yours sincerely,

[redacted]

Stuart McCall
Managing Director

[14] *Including how it correlates declining volumetric gas demand and closure of major gas users with impacts on tariffs, sustainable pipeline revenues and asset stranding (see Para 2.36 to 2.43)*

[15] *We note the various objectives and proposals set out in the Emissions Reduction Plan including (i) the 2030 renewable electricity target as now being described as aspirational and (ii) a new target of 50% of final energy consumption from renewable sources by 2035 which appears to significantly shift the emphasis away from rapidly phasing out natural gas usage to meet emissions reduction targets.*

APPENDIX- EVALUATION OF OPTIONS

Options A and B

Pros	***Option Paper***	***Methanex view***
1	Requirement to apply GAAP should limit risk that asset lives are excessively shortened	Disagree GAAP will not necessarily limit supplier's ability to shorten economic asset lives by exaggerating risks.[16]
2	Commission scrutiny should limit exaggeration by suppliers	Disagree Increasing Commission scrutiny might be an advantage over status quo if the Commission significantly increases the level and specificity of its scrutiny and breadth of analysis in DPP settings. However, the Commission has not provided guidance in the Options Paper as to what its scrutiny would entail and how it might overcome the information advantage held by suppliers.
Cons		
1	Suppliers have an informational advantage	The likelihood is the supplier's information advantage combined with a history of the Commission's reliance on supplier information and relatively low level of independent scrutiny presents these Options as a significant risk.
2	Additional complexity	The Commission does not mention the additional complexity that would come from supplier nominated asset lives as a con, particularly so in respect of Option B which contemplates a comprehensive asset life reset process being triggered during each DPP reset.[17]

Option C

Pros	***Option Paper***	***Methanex view***
1	Greater control (by the Commission) over the aggregate depreciation profile	We agree with that if the Commission could more effectively match depreciation profiles with long –term demand profiles this would be an advantage. However, our concern is the greater control will not translate into a better matching, particularly if there continues to be, in Methanex view, a bias toward assuring capital recovery, exaggeration of stranding risks and an insufficient level of underlying analysis.
Cons		
1	Alternative methods are more complex than Straight-Line	Agree
2	Challenges in determining which method to use and when to apply an alternative method	Agree

[16] *3.60*
[17] *X40*

Option D

Pros	Option Paper	Methanex view
1	*"Inclusion of specific provisions that allow for ex-ante allowances in the IMs may provide more clarity and certainty to both suppliers and consumers about the tools available for use in DPP resets."*	Disagree The prospect of having an under-specified provision in the IMs where ex ante allowances exist only as a broadly defined option for the Commission to select (or not) seems inconsistent with promoting certainty. The manner in which Options D and E have been presented in the Option Paper, including having insufficient detail on how they would be applied and the interaction of the options with each other as well as their interaction with existing IMs adds to the uncertainty. Our view that the certainty factor presented in Option D is a Con rather than a Pro.
2	Ex ante allowance might allocate risks to suppliers more appropriately than the status quo	1. The ability to tailor the level of ex ante allowance to ensure that, in practical, terms some proportion of the well-assessed risk of asset stranding is reallocated from consumers to suppliers. 2. The ability to place conditions on suppliers receiving ex ante allowances and with claw-back provisions to ensure incentives to innovate and invest efficiently are demonstrated. Provided that ex ante allowances are sufficiently discounted and risked then there is an argument that the mechanism might better meet Section 52A outcomes in the face of asset stranding risks than shortening asset lives.
Cons		
1	Adds complexity	Agree In the absence of more substantive evidence that ex ante allowances achieve a systematically better outcome for consumers than status quo, the added complexity is a compelling case against ex ante allowances, at least at the level of detail discussed in the Options Paper.

Option E

Pros	Option Paper	Methanex view
1	*"may ensure that we have the tools available at a future price reset to best deal with the investment situation facing both GPBs and their consumers at that point in time."*	We disagree. The argument appears to rest on the prospect that if the Commission has more options then that is inherently a benefit to consumers (same issue applies to Options C and D). Our concern is that, without a fundamental change to the Commission's approach to allocating risk to suppliers or its approach to evaluating the risk of asset stranding, increasing the number of selective tools, will increase uncertainty, add

		complexity, and reduce transparency, without necessarily improving outcomes for consumers. In the light of this concern, Methanex prefers simple and definitive mechanisms that at least provide for greater transparency for consumers to evaluate the degree to which Section 52A objectives are being achieved.
Cons		
1	Uncertain bounds on the application of the tool prior to DPP4. Further revisions may be needed ahead of using these provisions.	Methanex seeks a robust IM Review that results in simple and definitive IM amendments. One of Methanex main concerns during the DPP3 reset was the inclusion of significant IM amendments being made during the reset timeframe. The manner in which Option E (and Option D) has been presented is strongly indicative that the same undesirable situation may repeat itself during the DPP4 reset if they are adopted in this IM Review. To some degree similar concerns hold for the other Options given the level of definition in the Options Paper.
3	Need a process to identify stranded assets – adds complexity to the DPP reset process.	Agree The asset life adjustment factor mechanism has an advantage in terms of simplicity and certainty, our issue remains not with the method selection as much as with application of Commission scrutiny and judgement in arriving at an appropriate level of adjustment that meets the objectives of Section 52A.
4	Commission would not be able rely on suppliers to remove assets from the RAB as they would be incentivised not to disclose when assets become stranded	Agree We believe it would be prohibitive for the Commission to effectively police supplier assessments of asset utilisation; it would need to employ a significant increase in its own analysis of the RAB and evaluation of risks. We also note that the Commission's concern regarding supplier incentives in regard to Option E should be matched by similar concern over supplier incentives in respect to Options A and B.