GasNet
Connecting communities

2 June 2021

New Zealand Commerce Commission
Level 9
44 The Terrace
PO Box 2351
Wellington 6140

Andy Burgess,
Head of Energy, Airports, and Dairy Regulation
Regulation Branch

c/o regulation.branch@comcom.govt.nz;

Re: Feedback on Fit for Purpose regulation

Thank you for the opportunity to consider the New Zealand Commerce Commission's (NZCC) 'Open letter—ensuring our energy and airports regulation is fit for purpose' of 29 April 2021 (Open Letter). Following discussion with my Board, I provide some commentary below, while apologising for the late submission as feedback was welcomed by 5 pm, 28 May 2021.

GasNet Limited (GasNet) welcomes stakeholder engagement around NZCC's 'current main prioritised processes' listed in the Open Letter (and covering email of 29 April 2021). GasNet recognises that all three planned processes affect our regulated gas distribution business (GDB) activities.

<u>Emerging Issues relating to NZ's decarbonisation</u>
GasNet agrees with the NZCC that our business exists during a period of change and uncertainty underpinned by New Zealand's emerging legal and moral commitment to Government's leadership embodied by the Climate Change Response (Zero Carbon) Amendment Act 2019. This triggered amongst other key things, establishment of the new, independent Climate Change Commission and hence, the very recently released Climate Change Commission 2021 Draft Advice for Consultation report (and final report to be released on or about 9 June 2021).

At GasNet we are committed to contribute to community wellbeing through competent provision of business services and infrastructure management to ensure safe conveyance of energy today and in to the future as we have yesterday and through the past. As an essential service provider GasNet understands its responsibilities to the communities in which our assets are located and equally the benefits therein provided to our consumers whether residential, commercial, industrial enterprise or public facilities.

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The underlying issue is an investment signal disconnect between:

- the current NZCC regulatory business-as-usual framework, and
- recommended Climate Change Commission (CCC) business-not-as-usual framework,

There are two important causes of this disconnect. In the case of the energy sector as a whole, the current input methodology is delivering allowable rates of return that are substantially too low to incentivise a level of investment needed to transition to a low carbon energy mix. We explain this in more detail below.

Second, in the case of the gas sector specifically, the time horizon (or payback period) in the regulatory framework is materially inconsistent with the time horizon implied by the CCC recommendations. This will stymie research and investment into cleaner gas solutions such as biogas and hydrogen.

New energy sector technologies

GasNet supports mobilisation within our industry towards hydrogen and biogas studies that are occurring because the industry is focussed on providing a climate friendly fuel into the foreseeable future.

The emerging issues are:

- research and development funding in relation of mentioned new energy sector technologies
- negative impacts on throughput and connection numbers during the energy transition phase (and beyond)
- a regulatory framework that provides insufficient incentive to invest in transition technologies

which are offset to some degree by:

- short term energy type switching tends to have high transaction costs
- longer term energy type switching tends to have disaggregated timing (portfolio effect)

Impacts of COVID-19

GasNet views any material economic impacts from COVID-19 are yet to be felt as:

- consumer pricing signals are muted
- significant government funding has been in place until recently to support the economy
- New Zealand, by international benchmark, has to date been very successful in containing COVID-19 as evidenced by a new norm of COVID-19 Alert Level 1

But, New Zealand trades internationally and we are now seeing:

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- Raw material shortages
- Imported goods delays
- Increased cost for items and their delivery
- Reduction in breadth and depth of labour market for core skills/competences

The emerging issues are:

- increased management of the logistic channels
- higher local inventory holdings
- increased pressure on labour resourcing across competing sectors of the economy
- greater risk and uncertainty associated with a 'stop-start' economy

Planning our upcoming regulatory processes
GasNet notes the NZCC's narrative here and supports review under Part 4 of all four dot points listed at the bottom of page 3.

GasNet is grappling with the enduring relevance of current regulatory settings in light of known CCC recommendations unless there is a role for GasNet as a GDB, now, during and post the 'energy transition' period as a GDB.

It is GasNet's view that the CCC report and the Government's response to that report may also sensibly require the opportunity to provide comment on any changes that might be made to existing regulations. It is entirely possible that the future delivery of energy from a variety of sources will become a more competitive market that may justify a lower level of regulation than is currently the case.

Framework recommendations to mitigate the highlighted issues
As noted above, an underlying problem is that the allowable rate of return on new investments is too low. This is because the framework is built on a risk free rate assumption that is fit for purpose in a 'normal' economic environment, but is not fit for purpose in an environment where global central banks are consciously targeting long-term bond rates. Long-term bond rates are no longer a good proxy for market expectations of interest rates or of a fair return on business risk. We recommend that the base return be based on a blend of current market rates and a realistic assumption about a long-term sustainable rate of return.

The disconnect between the time horizon implicit in the regulatory framework, and the time horizon implicit in emerging climate policy, could be dealt with in several ways but the simplest would be through accelerated depreciation allowances that better reflect the economic life of assets. This is especially critical to incentivise investments in biogas and hydrogen.

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There is a deeper issue that a framework based on the weighted average price of capital (WAPC), which provides incentives for GDBs to pursue new connections consistent with s52 of the Act, is no longer an appropriate or fit for purpose framework when such incentives do not exist due to CCC policy. In simpler terms, a return-driven regulatory model does not accord with a climate policy working in the opposite direction.

We also note an important but more technical point that COVID-19 is creating greater inflation uncertainty, which puts profitability at risk for GDBs. We recommend that the Commission reconsiders how it deals with any mismatch between actual inflation and what is assumed in regulation process. Australia's glide-path mechanism seems like a pragmatic solution.

Lastly, with increased financial uncertainty and hardship associated with the COVID-19 environment, there is a good case for reconsidering the X in the CPI-X framework. We note that undue financial hardship is now a mandatory consideration of the Commission.

Please contact me, should there be a need for clarification/expansion of commentary – thank you.

Regards

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