Commerce Commission
By email: im.review@comcom.govt.nz

10 February 2023

Dear Commerce Commission

Re: Input Methodologies Review – Options to maintain investment incentives in the context of declining demand ("paper")

1. This is Greymouth Gas New Zealand Limited's (and its related companies') (**Greymouth**) submission on the Commerce Commission's (**Commission**) paper, "Options to maintain investment incentives in the context of declining demand" (**paper**).

A. Not taking proper account of future uses of the pipelines risks benefits to future consumers to the detriment of current consumers

2. Characteristic of this paper and the wider IM Review is the constraint faced by the Commission in being unable to take into account the future use of gas pipelines[1] for conveyance of alternative gases other than in the abstract, as a 'possibility'.[2] On this point, Greymouth does not interpret the Commission to be redefining the natural and ordinary Gas Act meaning of natural (fossil) gas which would subvert proper legislative process and have many unintended consequences.[3] However, it would benefit actors if the Commission's natural gas position was unequivocal.

3. Given that both policy and commercial incentives for many actors are aligned in driving a transition that includes the repurposing of gas pipelines, the paper's premise that natural (fossil)[4] gas demand will decline (without materially considering alternative gases) artificially overstates the risk of asset stranding and the risk of overall declining demand.

4. Of concern to natural gas consumers is that this artificial context will mean that maintenance and investment in pipelines will be front-loaded against present consumers, to the benefit of future consumers of alternative gases.

[1] albeit the future is not far away – 2023 might see hydrogen and biogas conveyance.
[2] note that even if a blend is physically conveyed, that does not make all actors suppliers (or deliverers) of blended gas.
[3] E.g. greenwash risk, misalignment with normative understandings and those of international agencies, undermining the premise of the paper and the Commission's 'Environment Guideline Claims' guideline note, and wider asymmetric policy risk.
[4] ref. X21, 1.19.2, and 2.21 in the paper and X25.

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5. If future gases continue to be materially excluded from consideration, it is difficult to see why investment incentives would need to be maintained when natural gas demand will decline to an eventual point when that demand does not require the infrastructure.[5] Forcey and Sandiford (2015) make this exact point.[6] To ensure that current consumers are not subsidising future consumers, the Commission should focus on:

    a. maintaining investment incentives where those are required to manage declining demand (e.g. for short-run marginal opex plus essential capex);

    b. eliminating investment incentives where those are unwarranted in a declining demand context;[7] and

    c. allocating the impact of investment and incentives to the industry needing the investment where different industries share gas pipeline conveyancing services.

6. It is not in consumers' long-term benefit (nor is it economically rational) for them to bear unnecessary costs or risks when they may not be future consumers, may not want alternative gases for cost or safety reasons, and may not accept de facto equity risk (for example, if investments fail). The alternative is inconceivable – that investment needs to be incentivised forever even if there is no demand for that investment. Surely the Act cannot have contemplated, or permit, that.

B. The Commission is therefore right to reconsider economic principles, but not in a way that keeps ex-ante FCM the same notwithstanding declining demand

7. The case for reconsidering economic principles is strong:

    a. it is not in consumers' best interests to pay ever-increasing rental costs that do not reflect the underlying (i.e. reducing) first principles value of assets;

    b. it is not fair to assume that consumers have unlimited funds;

    c. it sends the wrong signal to regulated asset owners that they will be protected from changing markets and societal / planetary needs even if they do not innovate;

    d. regulated asset owners receive WACC which has some equity risk, suggesting that they should take material asset stranding risk; and

    e. the Commission itself notes that GPBs are much better placed to manage risk[8] which aligns with the case for moving most of the risk onto GPBs as also noted by the Commission.[9]

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[5] this is a thought exercise – Greymouth agrees with the Climate Change Commission's inference (ref. Chapter 6 of 'Ināia tonu nei: a low emissions future for Aotearoa') that natural gas will be required in 2050+ and is not necessarily incompatible with *net* zero carbon goals.

[6] https://australiainstitute.org.au/wp-content/uploads/2020/12/MEI-Report-Dash-From-Gas.pdf then search for 'infrastructure'.

[7] this (and point a.) will require a more detailed Commission or Gas Industry Company Limited process around infrastructure access.

[8] ref. X40, X48, 3.54, 3.99, and 3.100 of the paper.

[9] ref. page 49+ in the 'Part 4 Input Methodologies Review 2023 Framework paper ("framework paper") and 3.98 and X48 of the paper.

8. However, Greymouth is sceptical of any proposals that result in outcomes inconsistent with a declining demand context, when not coupled with how those benefits and costs will be allocated as between today's and tomorrow's consumers. For example, not re-weighting asset stranding risk to GPBs, complex depreciation, and *"ex-ante compensation to support incentives for investment".*[10] If demand declines over time to a point when that demand does not require the infrastructure, what benefit could there be for consumers to give GPBs upfront windfall gains that keep ex-ante FCM afoot? That would increase asset stranding risk for consumers, provide no risk management tools, and increase exit risk.

9. Similarly, updating the economic lives of assets will not improve legislative outcomes in the context of declining demand if those lives keep getting brought forward and GPBs can keep recovering maximum funds.

10. Likewise, shortening regulatory periods, price smoothing, and capping annual increases are all roundabout token ways of keeping ex-ante FCM similar as it always has been without properly having regard for a declining demand context or consumers' interests.

C. It is not clear why alternatives to ex-ante FCM have not been considered, particularly when there are two good options

11. The Commission has previously said it would reconsider ex-ante FCM where warranted.[11] Greymouth considers that the declining demand set out in the paper warrants alternatives. Classical application of the ex-ante FCM principle will create an unsustainable death spiral of price increases and demand destruction. This is further evidenced by the DPP3 decision to shorten asset lives (and the paper's discussion about ex-ante compensation) which suggests that there is little underlying expectation of receiving a full return of, and on, capital absent those interventions. Ex-ante FCM is not sustainable in the context of declining demand.

12. Two good alternatives exist to ex-ante FCM in the context of declining demand:

    (1) ex-ante (or ex-post) *payments* by GPBs to consumers. This is premised on two matters:

        a. a circuit breaker that stops the unsustainable death spiral in the context of declining demand. I.e. GPB revenue needs to be affordable for consumers, not destroy consumers, and uphold the (minimal) investment incentives that competitive markets would fund knowing they owned an asset whose future cash flow and asset value was materially at risk; and

        b. a one-off payment from GPBs *to* consumers for the risk that consumers have borne and will bear from DPP1 through to the end of DPP3.[12] GPBs (not consumers) have been compensated (via ex-ante FCM, full recovery of funds and increases in RAB) for historical material asset stranding risk that

[10] ref. X43.3 of the paper.
[11] ref. 4.33.1 of the framework paper.
[12] with regard for any CPP equivalents.

consumers have borne.[13] This is the opposite to what should happen as returns should compensate the bearing of risk.[14]

(2) RAB write-downs that mimic what would happen to asset values in competitive markets that faced reduced future cash flows and declining demand from those assets, i.e. impairment.[15] While a cash flow valuation would create circular reference issues, there are other methodologies (and valuation experts) that would be able to determine what the asset base would be worth if it was not regulated in the context of declining demand for that asset.[16] Such a solution would be in consumers' best interests and – even if coupled with shortened asset lives – would result in a fair outcome for consumers and asset owners.

D. If ex-ante FCM is a must-have for some reason, its meaning is presently misunderstood and changes further in the context of declining demand; resulting in outcomes similar to the above

13. Turning first to the Commission's ex-ante FCM principle. I.e. "*regulated suppliers should have the ex-ante expectation of earning their risk-adjusted cost of capital (i.e. a 'normal return'), and of maintaining their financial capital in real terms over timeframes longer than a single regulatory period"* (which itself refers to the 2016 IM review where there was no context of declining demand).[17] The main observation is that ex-ante FCM supplier expectation about earning risk-adjusted cost of capital, i.e. getting a return on capital, is separate from ex-ante FCM supplier expectation about maintaining financial capital in real terms over timeframes longer than a single regulatory period, i.e. getting a return of capital. In the context of declining demand, this means that:

    a. there must always be an ex-ante expectation about earning a return on capital;

    b. the expectation about getting a return of capital:

        i. only needs to last longer than a single regulatory period, i.e. the principle does not require capital maintenance after that (even if that is a separate hope by the supplier);

        ii. does not need to last until the end of the economic life of the asset or until all capital has been returned; and

        iii. has already been met ex-ante for each regulatory period if it has been met ex-post over at least two historical regulatory periods (which it has).[18]

14. This means that the ex-ante FCM principle has been met when suppliers expect to get *some* of their capital back, not all of it – in fact not most of it if declining demand is

[13] ref X28 and page 25 of the paper.
[14] ref. 3.7 in the paper.
[15] https://www.auditnz.parliament.nz/resources/working-with-your-auditor/csf/impairment-of-assets
[16] https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/fair_value_measureme/fair_value_measureme__9_US/chapter_4_concepts_u_US/44_valuation_approac_US.html
[17] ref. 4.7 of the framework paper.
[18] suppliers cannot expect to maintain their capital beyond the last regulatory period of an asset's economic life which can only mean that maintaining minimum supplier expectations must have regard for both historical and future regulatory periods.

extreme. The hope of suppliers to get all capital back over the economic life of the asset must not be conflated with, and is not the same as, the ex-ante FCM principle where they expect to be on track for a full return of capital for the first ten years or so of regulation. This means that in DPP4 and the IM review,[19] the Commission can apply and comply with ex-ante FCM principles *and* reduce the RAB and/or require GPBs to pay consumers. It also fits with outcomes that would be expected in the context of declining demand in a competitive market as discussed earlier. The ex-ante FCM principle does not require suppliers to expect full return of capital beyond a short initial period from the start date of regulation.

15. Alternatively, unpacking what 'expectation' means is a different way of getting to the same conclusion. 'Expectation' must mean 'reasonable expectation', i.e. with regard to the circumstances, e.g. of declining demand. The question to ask is can suppliers have unreasonable expectations? The answer can only be no because an express or implied unreasonable expectation is not an expectation but a wish. Therefore, *if* the ex-ante FCM principle is to remain, suppliers' expectations must be reasonable and have regard for the context. This is the only interpretation because how can suppliers expect normal returns when the Commission cannot guarantee that?[20] Therefore 'expectation' must mean 'reasonable expectation' if the ex-ante FCM principle is to stay fit for purpose in the context of declining demand. I.e. GPB should expect to get a full return of capital for a short initial period and/or when demand is flat or growing, but otherwise they should expect to have no guarantees of getting a full return of capital after the short initial period and/or when demand is declining.

16. As another alternative, the Commission could ask suppliers what their expectation is in the context of long-term declining demand based on the fundamentals (not based on the presence of ex-ante FCM which could be used as a circular argument). The answers will likely demonstrate that ex-ante FCM is not a warranted principle in the context of declining demand, that expectations lack substance or are not willing to be disclosed, or that expectations pertain to hope. First Gas would be a good supplier to ask given that one of its ultimate shareholders was considering a sale of it or its assets last year.[21]

17. Turning next to the Commission's application of its ex-ante FCM principle. I.e. *"recognising the asymmetric consequences to consumers over the long term of under-investment versus over-investment"* and *"providing appropriate compensation to suppliers for the risks they are required to manage [in this case] through an ex-ante allowance to suppliers for bearing the risk (through either the WACC and/or cashflows), the cost of which ultimately falls on consumers"*.[22]

18. Greymouth submits that:

    a. asymmetric investment risk should not result in outcomes that provide unwarranted investment incentives;

[19] and depending how the court case goes in a restating of DPP3
[20] ref. X18 of the paper.
[21] https://www.afr.com/street-talk/first-sentier-tests-interest-in-gas-network-first-gas-bankers-up-20220210-p59vf8
[22] ref. 4.9 of the framework paper.

b. the Commission's application of the principle has little regard for the second part of the principle pertaining to the return of some capital;[23]

c. suppliers are not required to manage risk and in any case it is not suppliers that are primarily exposed to risk but consumers; and

d. the allowance for suppliers bearing the risk should not introduce a new element into the ex-ante FCM principle but should give effect to the principle in the context of declining demand.

19. Interestingly, the Commission notes that asset stranding is consistent with the ex-ante FCM principle.[24] However, that can only be true if reasonable expectations are given effect to in the context of declining demand. I.e. shortened asset life should result in asset base revaluation and vice versa (without further ex-ante compensation that undermines the package of actions). Asset base revaluation may even be appropriate even if the economic life of the asset is not shortened.

20. The only word tying the application of the principle to the principle itself is the word 'appropriate'. This means that, regardless of supplier expectations, the ex-ante FCM principle is not that the Commission must take actions consistent with suppliers' expectations, just that suppliers have expectations. The Commission has discretion as to whether it acts in a manner that gives effect to suppliers' expectations.[25] Even if the Commission did not meet suppliers' expectations does not mean that suppliers did or will not have ex-ante expectations. Therefore, the only *appropriate* compensation is one that has regard for declining demand and counterfactual outcomes that would be expected in a competitive market.

E. In conclusion much more work is required

21. Once the context of declining demand is unpacked, it is obvious that appropriate investment incentives and cost impacts on consumers are required (not ongoing investments that will become sunk and contribute to a death spiral). While the case for reconsidering the ex-ante FCM principle is strong, it does not actually matter whether ex-ante FCM is retained or not because the outcome should be the same – because if it is applied in the context of declining demand then supplier expectations and Commission application of that must be reasonable and not subvert the consideration of declining demand.

22. The best solutions are GPB payments to consumers, or RAB revaluations that reflect the context of declining demand commensurate with changes to economic lives and first principles valuation of the assets. The former without the latter in DPP3 was not a sustainable outcome, but the Commission now has a chance to create new policy that will, in the future, stand up to the rigours of academic critique.

23. Progressing an IM Review process within existing regulatory constraints is clearly not delivering fairness or equity for current consumers. The Commission should be working actively with government and industry to ensure that today's consumers are not

[23] ref. 4.10 of the framework paper.
[24] footnote 118 of the framework paper.
[25] ref. 4.8 of the framework paper.

subsidising tomorrow's consumers (or, as poignantly, today's or tomorrow's pipeline owners).

Yours sincerely,

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