Letter to the Commerce Commission

19 July 2023

To: Vhari McWha, Commissioner, [redacted]

Cc: IM.Review@comcom.govt.nz

From: Ben Gerritsen, General Manager Customer & Regulatory, Firstgas; Stuart Dickson, General Manager Customer, Powerco; Mark Toner, Chief Public Policy & Regulatory Officer, Vector

Kia Ora Vhari

Joint gas network submission on the draft input methodologies

This is a joint submission made by the major gas pipeline businesses (GPBs): Firstgas, Powerco and Vector on the *Part 4 Input Methodologies Review 2023 – Draft decision* published on 14 June 2023.

We welcome the opportunity to comment on certain key issues of common interest that have emerged from recent work of the Gas Infrastructure Future Working Group (Working Group). This is not a comprehensive submission and supplements submissions each business has made or will provide separately.

The submission draws on the following recent Working Group projects that provides more detailed insight on the future of gas infrastructure in Aotearoa New Zealand:

- **Gas Transition Analysis Paper** | This paper reports on modelling work commenced in November 2022 to assess four gas transition scenarios advised by the Gas Industry Company (GIC). It uses a conceptual financial model previously developed by the Working Group with updated inputs to analyse potential impacts on gas consumers, gas pipeline businesses and Government of alternative gas futures. The model and inputs to it were updated to incorporate more recent information and to consider the gas transition scenarios over the period out to 2050.

- **Gas network rightsizing study** | This study is looking at how future decisions could be made to decommission parts of the gas infrastructure where it is sensible to do so. It has also considered how consumer demand could be transferred from reticulated gas to other energy systems – such as LPG supply or electricity network supply – in the short to medium term. The study has been pursued as a desktop exercise focused on research and discussion with collaboration to this point among the gas distribution networks.

Commission staff along with other stakeholders have been involved in both work streams via the Working Group. The Gas Transition Analysis Paper is attached to this submission. We will share the Gas Network Rightsizing Study Interim Report with the Commission once it is finalised.

The remainder of this submission focuses on three key issues.

Issue 1: How to maintain financial capital maintenance under alternative gas transition pathways

The Commission's paper 'Financing and incentivising efficient expenditure during the energy transition topic paper' notes that: [1]

> *The key economic principles most relevant to this topic paper are ex-ante real FCM and FCM's practical application in the form of net present value = 0 (NPV = 0), and allocation of risk.*

And that: [2]

> *The pace of this transition and the impact on GPBs remains uncertain, and presents a transition risk, given the many possible pathways for the sector to decarbonise. This will be considered by the Government in the Gas Transition Plan, which is due for release at the end of 2023.*

Both statements are consistent with the analysis and discussion undertaken by the Working Group, which has explored how alternative transition pathways may affect GPBs and gas consumers over the medium to long-term. Underpinning that work is a concern that the financial capital maintenance principle could be frustrated by the policy and demand uncertainty facing the energy sector at present, which could have significant adverse consequences for gas consumers that is not in their long-term interests.

Early analysis has suggested that in some cases GPBs may not be able to recover their efficient costs of providing gas transportation services, especially where demand declines rapidly. This reinforces the importance of the Commission continuing to focus on the financial capital maintenance principle in its future decision making.

The Working Group is extending its recent modelling to take a closer look at how acute potential cash flow and profitability concerns are for GPBs. We will share this with the Commission once available.

Issue 2: How to address asset stranding risk

The Commission's paper also recognises that asset stranding risk is a concern for GPBs: [3]

> *Natural gas use is expected to decline in the long-term but there is significant uncertainty about the pace of change and extent of decline, and the potential impact on GPBs. This has potential implications for how best to address asset stranding risk in order to promote the Part 4 purpose.*

To address that concern, the Commission proposes to retain its accelerated depreciation mechanism for GPBs that was first adopted in its default price path decisions for GPBs made last year. This is consistent with recent decisions by the Australian Energy Regulator to adopt

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1 Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, para.2.8.

2 Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, para.2.13.

3 Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, para.3.168.

accelerated depreciation when determining allowed prices and revenue for the Victorian gas distribution networks,[4] which the Working Group has discussed.

The Working Group's analysis suggests that adopting accelerated depreciation consistent with that used in the DPP decisions does help to reduce asset stranding risk. Although it does not remove that risk entirely, that analysis suggests that the tool can go some way to promoting the financial capital maintenance principle.

However, the Commission's paper goes on to conclude that: [5]

> *Our draft decision is that our current approach to addressing asset stranding risk appropriately incentivises continued investment in gas pipelines for the long-term benefit of consumers.*

This conclusion does not appear obvious to us based on the information available. The Working Group's analysis highlights that *even with* accelerated depreciation being applied, GPBs could face a significant cost recovery risk if there is a full winddown of their infrastructure.

The recently finalised 'Gas Transition Analysis Paper' observes that:[6]

> *A winddown of regulated gas pipelines exposes gas pipeline businesses to material cost recovery risk – both in terms of unrecovered allowed revenue while the pipeline is operating and unrecovered capital when it ceases operating (i.e., as reflected in the regulated asset base, or RAB, at that time).*
>
> *Initial analysis indicates that a winddown of regulated gas pipelines exposes gas pipeline businesses to material cost recovery risk:*
>
> - *$973 million if full winddown occurs by 2050, and*
> - *$568 million if conversion to LPG occurs by 2040,*
>
> *both in present value terms ($2022) and assuming no further regulatory or policy levers (or mitigations) are applied beyond those reflected in the recent DPP decisions.*
>
> *Given this, initial analysis suggests that the financial viability of GPBs is at risk under the full winddown and LPG conversion scenarios, assuming no change to current regulatory settings or Government intervention.*

Although there are clearly limitations with this type of analysis, it at least raises the question as to whether GPBs can expect to recover their efficient investment costs. As the Working Group's paper notes, such a concern can undermine efficient investment in gas pipelines. A plausible expectation of future losses from asset stranding risk would likely lead to deferral of otherwise efficient investment or in underinvestment. This could likely have adverse consequences for consumers over time – for example, it could lead to declining service quality or coverage.

Consistent with this focus on expectations, the Commission's paper notes that:[7]

> *The risk of 'asset stranding' is a problem if it results in deferral of otherwise efficient investment or in underinvestment. This can happen where there is <u>an expectation of losses</u>*

[4] AER, *Final decision, Australian Gas Networks (Victoria & Albury), Gas distribution access arrangement, 1 July 2023 to 30 June 2028*, May 2023.

[5] Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, para. 3.170.

[6] Gas Infrastructure Structure Future Working Group, *Gas Transition Analysis Paper*, 16 June 2023, p.4.

[7] Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, para. 3.177.

> *<u>from investment due to asset stranding risk despite there being sufficient willingness to pay from consumers (before the investment is made) to support normal returns</u>. The magnitude of risk for GPBs depends on the longterm outlook for gas pipelines, but also depends on how we regulate GPBs and specifically how we address stranding risk through the IMs. 'Asset stranding' occurs when the returns a firm makes on an investment are less than necessary to compensate for the initial investment cost. For example, this could occur if an asset is permanently underutilised or shut down early. (emphasis added)*

By extension, without being clear as to whether losses can be expected or not, it seems premature to conclude – as the draft decision does – that the Commission's current approach to addressing asset stranding risk appropriately incentivises continued investment in gas pipelines for the long-term benefit of consumers. As a minimum, the Working Group's analysis suggests that more needs to be done before such a conclusion can be reached.

Nevertheless, even if it retains its current approach in its 2023 input methodology (IM) decisions, it will be important for the Commission to continually refine its approach to accelerated depreciation in *future* IM and DPP decisions as new information comes to light. We would also strongly encourage the Commission to explore the profile of future cost recovery over the longer term – similar to what the Working Group has attempted – to better understand whether future losses could be expected or not.

Issue 3: How to treat unutilised assets

The Commission proposes to continue leaving unrecovered capital costs in the regulatory asset base (RAB) until fully depreciated, even if the underlying assets are permanently underutilised, redundant, or decommissioned.[8] The rationale is that this treatment helps maintain incentives to invest and innovate in line with paragraph 52A(1)(a) of the Commerce Act 1986.[9]

The Working Group's network rightsizing study provides support for this approach. That *desktop* study is exploring how GPBs could decommission parts of their networks where it is sensible to do so. Of relevance here, the study also looks at what barriers there may be to GPBs pursuing such a strategy – with one being the regulatory treatment of decommissioned or unused assets. If there is a real prospect that the unrecovered capital value of those assets will be removed from the RAB, then this could defer otherwise sensible decisions to rightsize networks – potentially resulting in continued inefficient ongoing expenditure that could otherwise be avoided.

Consistent with that work, the Commission's proposal would help encourage GPBs to pursue a rightsizing strategy. But a question remains as to what might happen in future years. To that end, the Commission goes on to note that there is no guarantee that the value of those assets will remain in the RAB in future.[10] It notes that there could be situations where demand drops or Government action means that GPBs cannot recover their investments.[11]

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8 Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, paras. 3.171 and 3.200.1.

9 Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, para. 3.202.

10 Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, para. 3.213.

11 Commerce Commission, *Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Draft decision*, 14 June 2023, footnote 153.

Faced with that uncertainty, GPBs may be concerned that pursuing a rightsizing strategy could leave them worse off than not. We encourage the Commission to further consider how its IM and future DPP decisions can affect incentives for efficient network rightsizing.

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Once again, we welcome the opportunity to engage with the Commission on its draft IMs for GPBs. We also appreciate the continued involvement of Commission staff with the Working Group as we look to foster a constructive dialogue on what are undoubtedly tricky questions facing the gas sector at present.

Please let us know if you have any questions about the points raised above or in the attached Gas Transition Analysis Paper.

Ngā mihi nui,

[redacted]

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Attach.

Attachment: Gas Transition Analysis Paper