

19 July 2023
Commerce Commission
Level 9, 44 The Terrace
Wellington 6011
By email to im.review@comcom.govt.nz

To whom it may concern,

GasNet Limited's submission on the Commerce Commission's draft decision on the Input Methodologies review dated 14 June 2023, as it relates to gas distribution businesses

Purpose

1. This is GasNet Limited's (**GasNet** or **we**) submission on the New Zealand Commerce Commission's (**NZCC**) draft decision on the Input Methodologies (**IMs**) review relating to electricity distribution businesses (**EDB's**), gas distribution businesses (**GDB's**), gas transmission business (**GTB**), Transpower and regulated airport services, dated 14 June 2023.
2. We support the review of the IMs to ensure that incentive-based economic regulation remains effective across all regulated sectors, including the suitability of rules and predictability of the overall regime. We welcome the NZCC's draft decision reports informing changes to the IMs in these unprecedented times of uncertainty and volatility. The changes are driven by decarbonisation related policy changes which have a material impact on investments on long term assets.
3. At this stage of the process, we are responding to the matters of concern below as they relate to GasNet, and we look forward to further engagements with the NZCC as it refines its approach to provide certainty to both consumers and suppliers alike in these uncertain times.

Overview

4. We note changes to the IMs focused on the following, with limited changes related to GDBs. The table below illustrates NZCC's draft IM decisions which are new, amended or remain unchanged:

#	IM decision	New IM provisions	Amended IM provisions	Unchanged IM provisions
Chapter 3: Financing and incentivising efficient investment				
3a	Maintain RAB indexation to inflation for EDBs and GPBs			
3a	Introduce RAB indexation to inflation for Transpower			
3a	Enable Transpower to apply for an alternative depreciation profile			
3b	Not to introduce any tools to alter cashflow timings specifically for IRIS			
3c	Introduce a new connections volume wash-up mechanism for EDBs on a CPP			
3d	Maintain approach to address asset stranding risk in the context of expected declines in gas demand			
3e	Maintain the form of control for GDBs			
3f	Not to adopt a financeability test in the IMs			
Chapter 4: Our approach to incentivising efficient expenditure for EDBs and Transpower				
4a	Not adopt a totex regime. Maintain current expenditure incentive schemes as tools to mitigate capex bias			
4b	Maintain current incentive mechanisms as they best balance effectiveness and understandability			
4c	Adjust IRIS allowances for inflation			
4d	Maintain our approach to setting incentive rates			
4e	Not to exclude specific expenditure categories from IRIS			
4f	Use the midpoint discount rate in the opex IRIS calculation			
4g	Maintain our current treatment of operating leases			
4h	Make no change to IRIS for undercharging			
4i	Remove the Transpower baseline adjustment term			
Chapter 5: Inflation Risk				
5a	Maintain our current method for forecasting inflation			
5b	Introduce inflation wash-up on revenue for the first year of a regulatory period			
5b	Adjust annual revenue wash-up to reflect debt servicing costs being fixed in nominal terms			
Chapter 6: Innovation incentives for EDBs and Transpower				
6a	IMs generally enable the desired outcomes of regulatory sandboxes - no IM changes for this purpose.			
6b	Amend the innovation project allowance mechanism			

Table 1: NZCC Draft IM Decisions 'at a glance'.¹

5. Whilst we understand the merit of wanting to keep the IM changes to a minimum as it would promote least uncertainty to both suppliers and consumers in relation to the rules, requirements, and processes applied under Part 4 of the draft IM; we strongly encourage the NZCC to ensure that the IMs remain relevant and provide assurance that the methodologies are fit-for-purpose as New Zealand navigates an uncertain changing economic landscape.
6. Changes to the IMs should therefore provide GDBs with confidence that they are reasonably able to manage the economic risks allocated to them.

Changing circumstances and uncertainty

7. Gas Pipeline Business (**GPBs**) face significant uncertainty and demand risk. Three key related Government policy decisions underpin this uncertainty:
 - 7.1 The Government has committed to achieving net zero emissions by 2050, which require all greenhouse gases, other than biogenic methane, to reach zero on a net accounting emissions basis by 2050.
 - 7.2 The Emission Reduction Plan (**ERP**) was published on 16 May 2022, setting a pathway to reduce the reliance on fossil gas and a key step in developing a hydrogen roadmap. The ERP acknowledged phasing out fossil gas presents short-term and long-term challenges, including balancing capital investment

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.

with declining fossil gas use, fossil gas affordability and the risk of stranded network assets. The Climate Change Commission ERP advice also assumed zero gas ICPs by 2050.

- 7.3 The Government published the terms of reference for the Gas Transition Plan (**GTP**) on 16 May 2022 to help guide the fossil gas sector in reducing emissions, in line with emission targets and budgets. The plan is expected to be completed by the end of 2023, following mid-year stakeholder consultation.
8. Based on the Government’s terms of references in the GTP, there appears to be a great deal of uncertainty surrounding the expected decline in gas demand. We expect residential customers (which constitute the majority of GasNet’s customers) to be able to transition away from the use of gas relatively easily when compared to commercial and industrial customers.
 9. Despite the expected decline in demand, continuous investment and maintenance is required to ensure that the gas network continues to provide a safe and reliable supply of natural gas until its phased out as part of the GTP. In our view, this would require regulated supplier to be sufficiently compensated for the uncertainties involved. Therefore, the IM in its current state is misguided, as it promotes investments on a “just in time basis” with limited ways to address the greater risk of asset stranding, incentives and options to address demand risks.
 10. The draft IM appears to be silent on how it intends to address net zero emissions targets by 2050, whilst appropriately incentivising regulated suppliers to achieve outcomes consistent to a competitive market. We encourage the NZCC to test possible amendments in the IMs relating to net zero emissions with regulated businesses. Given climate change is an issue impacting numerous sectors, it will also be useful to understand how competitive markets navigate climate related risks and their ability to service shifts in demand going forward, from gas to electricity.
 11. Furthermore, GasNet notes that the NZCC are encouraging suppliers to move away from deterministic planning and engage in a probabilistic and scenario-based planning to better plan for uncertainty and risk where relevant. GasNet requests the NZCC to provide more clarity on this requirement and explain how it would discourage compliance costs.

Declining demand for natural gas will increase the risk of stranding

12. The NZCC rightly acknowledged that GPBs will face a stranding risk driven by policy decisions to curb and potentially halt the consumption of natural gas in New Zealand. Further, changes in consumer preferences will also add to the stranding risk issue, as the cost of alternative fuel is expected to decline², capping the willingness of

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.

consumers to pay for natural gas, which may steer consumers away from assets using gas to ensure that their own investments do not become stranded.

13. Over and above asset stranding, GasNet would also like to emphasise to the NZCC that there is a potential decommissioning liability that could arise in the event where no viable alternative use of the gas network is identified. GasNet encourages the NZCC to consider this and provide a response in the treatment of this decommissioning liability in the IMs.
14. On stranding, a stranded network is where assets continue to remain in the regulatory asset base (**RAB**), as the assets are not stranded in an economic sense unless the firm is unable to achieve full capital recovery on its RAB. However, retaining assets in the RAB does not provide the ability to recover the costs where there are insufficient end-users to generate the revenue required to achieve financial capital maintenance (**FCM**). In this context, the NZCC provides the following example: *'if demand were to drop quickly, or if the Government were to enforce restrictions or an early phase-out of natural gas use, GPBs may be exposed to unmitigated economic network stranding risk for the RAB as a whole'*.³
15. Managing asset stranding risk could be achieved through:
 - 15.1 Shortening asset lifetimes,
 - 15.2 Use of alternative depreciation profiles,
 - 15.3 Use of other alternatives, such as changing the NZCC's stance on RAB indexation or an uplift to the allowed rate of return.
16. We provide further commentary on the shortening of asset lifetimes and changing depreciation profiles in sections '**Shortening of asset lifetimes**' and '**Use of alternative depreciation methods**' below; and the discussion on WACC in section '**Cost of capital: WACC parameters**' below.

Shortening of asset lifetimes

17. We support the draft IMs decision to maintain the current approach to address stranding risk by retaining the stranding assets in the RAB and applying accelerated depreciation to ensure ex-ante FCM is maintained over the regulatory period.
18. We do, however, note that the NZCC considered two options as outlined in NZCC's publication on 20 December 2022 titled *Input Methodologies Review: Options to maintain investment incentives in the context of declining demand*, to further address stranding risk.⁴

³ Commerce Commission: Input Methodologies Review: Options to maintain investment incentives in the context of declining demand, 20 December 2022.

⁴ Commerce Commission: Input Methodologies Review: Options to maintain investment incentives in the context of declining demand, 20 December 2022.

- 18.1 Amend the current approach to give suppliers discretion to set economic asset lives for **new assets** consistent with the Generally Accepted Accounting Principles (**GAAP**).
 - 18.2 Allow suppliers to propose updated economic asset lives (consistent with GAAP) for **all existing assets** as part of the DPP reset. Introducing a requirement to apply GAAP when establishing economic asset lives should limit the risk of asset lives being shortened below its useful economic life.
19. In the draft IM, the NZCC appears to disregard the changes mentioned in paragraph 18 above, as the NZCC believes changing the current approach now will create more uncertainty.
 20. We encourage the NZCC to consider the above to address asset stranding, so as to ensure investment incentives are maintained at the time of the DDP4 reset, when demand is expected to decline. GasNet strongly believes making these changes in the IMs will provide more certainty and predictability of cost recovery. If these changes were adopted in the final IMs, we would expect the NZCC to retain the ability to manage price fluctuations for consumers by smoothing price adjustments.

Use of alternative depreciation methods

21. GasNet's view is that changes to depreciation profiles, other than Straight Line Depreciation (**SLD**), should be considered, given expectations of declining consumer demand. Changes to the depreciation method that applied to some, or all assets, are more likely to result in an aggregate profile that better reflects total demand expectations.
22. We note that the NZCC's view in the draft IMs is that allowing alternative depreciation methods would add complexity and compliance cost (and alternative methods may be possible in a Customised Price-quality Path (**CPP**)).
23. An example of an alternative is a tilted annuity approach which has been used by the NZCC before and regulators overseas. The tilted annuity approach is a measure of economic depreciation, which front-loads or accelerates the allowed return of capital and the cashflow profile. Using a tilt in the annuity formulation allows one to replicate the cost recovery conditions that would be faced by a firm in a competitive market. The tilt achieves this as it is set with reference to the expected price trends of assets that are being valued.
24. This alternative depreciation method allows cash flow allowances to be brought forward; i.e., the resulting front-loaded depreciation profile would spread the depreciation charges (and allowance) over the entire life of the asset while anticipating the majority of them in the earlier years. This profile could be matched to the expected changes in retailer customer bases (i.e., higher tariff recovery from a larger base of users in the earlier years and lower recovery from a small base of users in the later

years) for a more equal allocation of total charges among current and future customers.

25. In NZCC's publication on 20 December 2022 titled *Input Methodologies Review: Options to maintain investment incentives in the context of declining demand*, the NZCC noted benefits of such an approach to include more control over the aggregate depreciation profile and the ability to manage risks of consumer price shocks.⁵ The key challenges noted were determining the degree of the tilt and choosing the year from when to apply the alternative method. GasNet emphasises the NZCC has until 2026 to address these challenges for the next reset, and complexity is not a sufficient reason to disregard an alternative depreciation method, particularly in the face of expectations of declining consumer demand.

Cost of capital: WACC parameters

26. NZCC's position to adopt the 50th percentile for GDBs as outlined in the draft IM is based on the reduced probability of reticulated gas outages with lower costs to consumers resulting from those outages. Gas is significantly more reliable than electricity. GasNet respectfully disagrees with NZCC's view to move to a 50th percentile but agrees with NZCC that gas is more reliable than electricity.
27. NZCC's view in the draft IMs is to maintain the current approach to estimate the risk-free rate used in the NZCC's cost of debt and cost of equity calculations. Currently, the NZCC estimates the risk-free rate using a three-month average of prevailing wholesale New Zealand dollar denominated NZ government bonds with a maturity period equal to regulatory period.
28. GasNet supports the approach of using the prevailing market rates to establish the risk-free rate, however, believes that the NZCC should consider a longer observable period rather than a three-month window for setting the risk-free rate. Given the volatility of capital markets, the short-term observable period can result in the risk-free rate set either too low or too high over the full DPP control period. The volatility is likely to produce outcomes which are unfavourable for consumers and suppliers alike during the DPP period. Therefore, we believe that the NZCC should consider a longer observable period to estimate the risk-free rate.
29. NZCC's view in the draft IMs is to maintain its six-step approach of estimating the equity beta used in the cost of equity calculations with the sample size of 54 companies of which 50 are based in the US. The equity beta coefficient measures the sensitivity of the particular investment relative to the market and hence only considers the systematic risk which affects the broader market.
30. GDBs in New Zealand face a much higher industry specific risk when compared to gas networks in the US, which is especially valid as New Zealand looks towards extensive

⁵ Commerce Commission: *Input Methodologies Review: Options to maintain investment incentives in the context of declining demand*, 20 December 2022.

decarbonisation over the coming years. GasNet believes that the transition risk is quite real, and we are of the view that there is a real risk of underinvestment during the gas transition under the forthcoming GTP. Further, the aging workforce in the gas industry coupled with industry uncertainty means attracting new entrants will make it undoubtedly difficult for the industry to continue to maintain, retain and operate the network reliably. GasNet is of the strong view that the NZCC should consider capturing industry specific risks through the application of an alpha (additional risk premium) via cost of equity.

31. NZCC's view in the draft IMs is to maintain its historical evidence and judgment-based approaches to estimate the tax adjusted market risk premium (**TAMRP**). The NZCC correctly points out that "TAMRP is a forward-looking concept which cannot be directly observed". GasNet agrees with the NZCC's view that the TAMRP is not directly observable, and generally supports the theoretical approaches followed. However, we do not agree with the NZCC's view on frequency of measuring the TAMRP and we believe that TAMRP should be estimated as part of the DPP cost of capital determination process. This approach should more closely align with the market required return for the given level of risk.
32. With gas being phased out, coupled with limited economic asset life, GDBs would most likely have to raise additional equity or hybrid facilities to fund replacement capital expenditure. The draft IM's currently do not have an explicit allowance for potential equity raising related cost.
33. NZCC note that risks relating to climate change policies which affect the natural gas industry are likely to be non-systematic. These risks are not compensated through the parameters that determine the WACC (equity beta) in the Gas IMs. We note this could be partially alleviated through a capacity risk premium which could act to neutralise the risk associated with underutilisation of the gas networks.

Protection against inflation forecast errors

34. GasNet agrees with the NZCC that inflation risk is a problem considering that inflation volatility and suppliers and consumers should be protected against forecast errors in inflation to achieve real FCM. The NZCC's inflation forecasts plays an important role in determining the allowed return on capital over a regulatory period, including revaluations.
35. We welcome the decision of the adjustment for a wash-up for year 1 of a regulatory period and replacing the existing maximum allowable revenue (**MAR**) wash-up with one that calculates a wash-up amount by re-running the building blocks model for the regulatory period in question, using actual consumer price index (**CPI**) in place of the forecasts used originally. However, the proposed modifications only relate to EDBs and GTBs revenue path wash-up mechanisms. GasNet requests the NZCC to consider whether changes can be made to GDBs capital expenditure wash-up mechanism to address inflation risk, as WACC incorporates inflation expectations.

36. GasNet notes that inflation cycles will continue to coincide with future WACCs. We are currently in an environment with interest rates sitting significantly above the medium-term average with high inflation. Inflation is expected to remain elevated as global and domestic pressures persist. Inflation is forecasted to fall within the RBNZ's target range in late 2024. This implies a significant lower inflationary environment (and a lower interest rate environment) with the next reset to be in October 2026, and the approach around inflation risk would need to take this into account.
37. GasNet further notes the risk of a higher long term neutral rate. For example, in the most recent Monetary Policy Statement (**MPS**) (May 2023), RBNZ's mean estimate of the long-term neutral rate increased to 2.2%, confirming expectations of a continued increase into the future; while the current approach is a linear transition to the RBNZs mid-point target of 2%. This supports an argument for the NZCC to revise how it deals with inflation, similar to recent approaches adopted by the Australian Energy Regulator (**AER**) and the Queensland Competition Authority. Regulation needs to be predictable and provide certainty, which may require the NZCC to be more flexible to ensure long term outcomes for consumers.

Form of control

38. The draft IM proposes to maintain the Weighted Average Price Cap (**WAPC**) as the form of control for GDBs as it best promotes the purposes of Part 4. Whilst a WAPC exposes suppliers to demand risk, the NZCC does not believe maintaining this form of control will result in additional risk of GDBs not investing in the network.
39. GasNet notes WAPC provides incentives for GDBs to pursue new gas connections (consistent with s 52A(1)(a) and (b)). However, GasNet is of the view that incentives to grow connections under WAPC is no longer relevant, given climate change policies to phase out natural gas. A move to a revenue cap may therefore be more appropriate. However, GasNet is also of the view that irrespective of the form of control, given expectations of declining consumer demand, there is likely to be an inability to recover costs where there are insufficient end-users to generate required revenue.
40. A question the NZCC may want to explore is the need for regulation of natural gas networks in the future, similar to the approach adopted around the need for deregulation of the copper network facing declining demand.

Price stability

41. There is an issue of price stability as GasNet transitions as a response to the new climate environment. As noted by the NZCC in the draft IM review⁶, declining long-term demand for natural gas is likely to increase the extent of underutilised or redundant assets, thereby increasing the impact of asset stranding risk on consumers that remain

⁶ Commerce Commission: Financing and incentivising efficient expenditure during the energy transition topic paper – Part 4 Input Methodologies Review 2023 – Draft decision, 14 June 2023.

connected to gas pipeline networks. For the remaining consumers this would mean that prices are likely to increase as gas volumes decline, leading to an increased risk of disconnections. Therefore, there is a very real risk of falling into a 'death spiral', where investments need to be maintained for a smaller number of residential, commercial and industrial customers.

42. GasNet welcomes the NZCC's view that it can manage risk of consumer price shocks independent of how they address stranding risk, by smoothing price increases over multiple years, and setting an 'alternative rate of change' for a particular supplier if deemed desirable to minimise price shocks. However, GasNet notes the NZCC's current threshold to tolerate a price shock may need to be reconsidered in DPP4.
43. Ultimately, retailers are responsible for how services are marketed to end-consumers, including the price and service offering trade off and the pass through of higher wholesale prices. Achieving price stability over both the short-term and long-term, will best promote the long-term benefit of end users. Price stability for consumers can be maintained in the short and long term by having depreciation that has been accelerated or front loaded to deal with stranding risks.

Closing comments

GasNet thanks the NZCC for considering the points made above and is happy to respond to any questions raised by this submission.

Regards

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