

Proposed amendments to input methodologies for gas pipeline businesses related to the 2022 default price-quality paths

Draft reasons paper

Date of publication: 10 February 2022



Associated documents

Publication date	Reference	Title
4 August 2021	ISBN 978-1-869459-15-4	Resetting default price-quality paths for gas pipeline businesses from 1 October 2022 - process and issues paper
10 February 2022	ISBN 978-1-869459-78-9	Default price-quality paths for gas pipeline businesses from 1 October 2022 – Draft reasons paper (10 February 2022)
10 February 2022	ISBN 978-1-869459-74-1	[DRAFT] Gas Distribution Services Default Price-Quality Path Determination 2022 – 10 February 2022
10 February 2022	ISBN 978-1-869459-75-8	[DRAFT] Gas Transmission Services Default Price-Quality Path Determination 2022 – 10 February 2022
10 February 2022	ISBN 978-1-869459-84-0	[DRAFT] Gas Distribution Services Input Methodologies Amendment Determination 2022 – 10 February 2022
10 February 2022	ISBN 978-1-869459-85-7	[DRAFT] Gas Transmission Services Input Methodologies Amendment Determination 2022 – 10 February 2022
10 February 2022	ISBN 978-1-869459-82-6	[DRAFT] Gas Distribution Information Disclosure Amendment Determination 2022 – 10 February 2022
10 February 2022	ISBN 978-1-869459-83-3	[DRAFT] Gas Transmission Information Disclosure Amendment Determination 2022 – 10 February 2022

Commerce Commission
Wellington, NEW ZEALAND

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Glossary

Acronym	
DPP	Default price-quality path
DPP3	Default price-quality path for the third regulatory period (1 October 2022 – 30 September 2026)
DPP4	Default price-quality path for the fourth regulatory period (1 October 2026 – 30 September 2031)
the Act	Commerce Act 1986
CPP	Customised Price-quality Path
EDB	Electricity Distribution Businesses
FCM	Financial Capital Maintenance
FLA	Financial Loss Asset
Gas IMs	Input Methodologies for gas pipeline services
GDB	Gas Distribution Business
GPB	Gas Pipeline Business
GTB	Gas Transmission Business
ID	Information Disclosure
IMs	Input Methodologies
NPV	Net Present Value
Part 4	Part 4 of the Commerce Act 1986
RAB	Regulated Asset Base
TAMRP	Tax Adjusted Market Risk Premium
WACC	Weighted Average Cost of Capital

Executive summary

- X1 The amendments apply to the Input Methodologies (**IMs**) for default price-quality paths (**DPPs**) and, where appropriate, also to the IMs for customised price-quality paths (**CPPs**) and information disclosure (**ID**).
- X2 These are the only IM changes we think are appropriate to change ahead of the DPP3 reset. The full statutory IM review (**IM review**), which we will start this year, will provide an opportunity to consider all gas-related IMs, including those we are proposing to amend now.
- X3 We seek the views of interested parties on most of the proposed amendments by Thursday, 10 March 2022, except for our proposed amendments to the cost of capital IMs for which we are seeking views by Thursday 24 February 2022.

Input methodologies amendments we are proposing

- X4 Table 1 sets out a summary of the IM amendments we are proposing.

Table 1: Summary of proposed input methodologies amendments for gas pipeline businesses

IM amendment	Description
Economic network stranding – adjusting depreciation	Introducing a mechanism to allow us to adjust asset lives when calculating depreciation for a DPP if we are satisfied that doing so would better promote the purpose of Part 4. For DPP3, this will allow us to reduce asset lives and accelerate depreciation for GPBs, thereby bringing forward the expected recovery of capital to mitigate GPBs' stranding risk from declining use of gas networks. There are flow-on amendments for how depreciation is calculated for ID.
Treatment of operating leases	Better align the ID and price-quality treatment of capitalised 'right of use' assets with new accounting standard NZ IFRS 16.
Capital expenditure capacity and risk event reopener	Proposing reopeners to address capacity events and risk events that apply to individual projects or programmes relating to large connections, system growth, asset relocations and to asset replacement and renewals capex for the following types of situations: <ul style="list-style-type: none"> • projects and programmes that were unforeseen at the time of publishing supplier expenditure forecasts that the Commission based its allowances on; or • projects and programmes that were foreseen for later regulatory periods, but changes in circumstances mean that the project or programme is brought forward into the current regulatory period.
Tax adjusted market risk premium	Increasing the tax adjusted market risk premium (TAMRP) parameter value in the weighted average cost of capital estimation for price-quality paths and ID from 7.0% to 7.5%, in line with the recent analysis completed for the fibre input methodologies.

IM amendment	Description
WACC amendments to align with the length of the relevant regulatory period for DPP3	Enabling us to set a weighted average cost of capital (WACC) estimate for the length of the regulatory period of the DPP for both price-quality and ID which may be a four-year or five-year regulatory period.

Chapter 1 Introduction

Purpose of paper

- 1.1 This paper outlines our draft decisions, and invites submissions on how we propose to amend the input methodologies for gas pipeline services (**Gas IMs**):
 - 1.1.1 for Gas Distribution Businesses (**GDBs**) contained in the Gas Distribution Services Input Methodologies Determination 2012 (**GDB IM Determination**)¹; and
 - 1.1.2 for the Gas Transmission Business (**GTB**) contained in the Gas Transmission Services Input Methodologies Determination 2012 (**GTB IM Determination**).²
- 1.2 The proposed amendments to the GDB and GTB IM determinations relate to our draft decisions for DPP3 and have been assessed in accordance with the decision-making framework outlined in Chapter 2.
- 1.3 In our August 2021 Process and Issues Paper for resetting the GPB DPP we indicated that amendments to the Gas IMs may be required for the reset.³
- 1.4 In accordance with section 52V of the Commerce Act 1986 (**Act**), we published a notice of intention relating to the proposed Gas IM amendments set out in this paper on 4 February 2022.⁴
- 1.5 This Chapter sets out:
 - 1.5.1 the structure of this paper;
 - 1.5.2 when the proposed Gas IM amendments are intended to take effect;
 - 1.5.3 what materials have been released alongside this paper; and

¹ Prior to the amendments outlined in this paper, the principal determination was most recently amended in 21 December 2017 by Gas Distribution Services Input Methodologies Amendments Determination 2017 [2017] NZCC 31. [An unofficial consolidated version of the principal determination and all subsequent amendments was published by us on 3 April 2018.](#)

² Prior to the amendments outlined in this paper, the principal determination was most recently amended in 21 December 2017 by Gas Transmission Services Input Methodologies Amendments Determination 2017 [2017] NZCC 32. [An unofficial consolidated version of the principal determination and all subsequent amendments was published by us on 3 April 2018.](#)

³ [Commerce Commission Resetting default price-quality paths for gas pipeline businesses from 1 October 2022 – Process and Issues paper” \(4 August 2021\).](#)

⁴ [Commerce Commission “Notice of Intention for potential amendments to IMs for Gas in 2022” \(4 February 2022\).](#)

- 1.5.4 how you can provide your views.

Structure of paper

- 1.6 Chapter 2 of this paper outlines our framework for considering the scope of potential Gas IM amendments and the decision-making framework we have applied in proposing the Gas IM amendments.
- 1.7 Chapter 3 of this paper describes our proposed changes to the GDB and GTB IM Determinations. It sets out:
- 1.7.1 the current Gas IM requirements;
 - 1.7.2 the proposed Gas IM amendments and why we are proposing these changes; and
 - 1.7.3 how the proposed Gas IM amendments meet the decision-making framework.
- 1.8 Chapter 4 of this paper outlines our draft decision to not amend the existing change event reopeners or introduce new reopeners in the GDB and GTB IM Determinations to address climate change policy uncertainty. Chapter 4 explains our reasoning using the decision-making framework outlined in Chapter 2.

Effective dates for proposed amendments

- 1.9 Section 52W of the Act requires us to publish, by way of notice in the *Gazette*, a brief description of any IM amendment and the goods and services to which it applies, the reasons for determining that IM amendment and how we are making it publicly available.⁵
- 1.10 We propose that the amendments discussed in this paper take effect on the day following publication in the *Gazette* in accordance with s 52W.
- 1.11 This means that the amendments will apply to any relevant price-quality determinations made after the date on which the amendment takes effect. This includes the Gas DPP3 determination scheduled to be made by 31 May 2021. We have separately proposed amendments to the definitions of “IM determination” in the gas distribution and gas transmission ID determinations, so that any amendments we make to the IMs for information disclosure will also apply to the ID determinations.

⁵ Section 52W(1)(b) states that IM amendments are secondary legislation which means that the publication requirements for secondary legislation in the Legislation Act 2019 apply.

Materials released alongside this paper

- 1.12 Alongside this paper, we have published a:
- 1.12.1 draft Gas Distribution Services Input Methodologies Amendments Determination (**draft GDB IM amendments Determination**);⁶ and
 - 1.12.2 draft Gas Transmission Services Input Methodologies Amendments Determination (**draft GTB IM amendments Determination**).⁷

How you can provide your views

Submissions on this paper

- 1.13 We welcome your views on the matters raised in this paper and how we are proposing to give effect to our draft decisions within our draft GDB IM amendments determination and draft GTB IM amendments determination within the timeframes below.
- 1.13.1 For our proposed amendments to the cost of capital IMs:
 - 1.13.1.1 submissions by 5pm on **Thursday, 24 February 2022**; and
 - 1.13.1.2 cross-submissions by 5pm on **Friday, 4 March 2022**.
 - 1.13.2 For all other proposed amendments:
 - 1.13.2.1 submissions by 5pm on **Thursday, 10 March 2022**; and
 - 1.13.2.2 cross-submissions by 5pm on **Friday, 25 March 2022**.
- 1.14 The shorter consultation timeframe for our proposed cost of capital IM amendments is because the WACC estimate used for the DPP final decision must be determined by 31 March 2022. The shorter consultation timeframe will give us sufficient time to consider stakeholder views and finalise our decisions on the cost of capital IM amendments before determining the WACC.

Address for submissions

- 1.15 Please email submissions to regulation.branch@comcom.govt.nz with “GPB IM amendments” in the subject line of the email.

⁶ [DRAFT] Gas Distribution Input Methodologies Amendments Determination 2022 (10 February 2022).

⁷ [DRAFT] Gas Transmission Input Methodologies Amendments Determination 2022 (10 February 2022).

- 1.16 We prefer submissions in both a format suitable for word processing (such as a Microsoft Word document), as well as a 'locked' format (such as a PDF) for publication on our website.

Confidential submissions

- 1.17 While we encourage public submissions so that all information can be tested in an open and transparent manner, we recognise that there may be cases where parties that make submissions wish to provide information in confidence. We offer the following guidance:
- 1.17.1 If it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is confidential.
 - 1.17.2 Where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice their commercial position or that of another person who is the subject of the information.
 - 1.17.3 Both confidential and public versions of the submission should be provided.
 - 1.17.4 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
- 1.18 Parties can also request that we make orders under s 100 of the Act prohibiting the publication or communication of any confidential information. If we receive a request we will exercise our judgement in deciding whether or not an order is appropriate and any order we make will apply for a limited time as specified in the order. We will provide further information on these orders if requested by parties.
- 1.19 We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

Chapter 2 Decision-making framework

Purpose of this chapter

- 2.1 This chapter describes:
- 2.1.1 our framework for considering the scope of potential Gas IM amendments, which is relevant in considering what IMs it may be appropriate to amend outside of the statutory IM review cycle in s 52Y of the Act; and
 - 2.1.2 the decision-making framework we have applied in proposing the Gas IM amendments.

Framework for considering the scope of potential Gas Input Methodologies amendments

- 2.2 Our framework considers:
- 2.2.1 the statutory context
 - 2.2.2 our specific powers to amend Gas IMs; and
 - 2.2.3 what we must take account of when amending Gas IMs outside of the statutory IM review cycle under s 52Y.

Statutory context

- 2.3 When considering amendments to IMs, we must consider the purpose of IMs and the purpose of Part 4. This section discusses the tensions between making changes to improve the regime and the certainty intended by the IMs.
- 2.4 The purpose of IMs, set out in s 52R of the Act, is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to the regulation, or proposed regulation, of goods or services under Part 4. To that end, s 52T(2)(a) requires all IMs, as far as is reasonably practicable, to set out relevant matters in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier. In that way, the IMs constrain our evaluative judgements in subsequent regulatory decisions and increase predictability.⁸

⁸ *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para [213].

- 2.5 However, some uncertainty remains inevitable.⁹ As the Court of Appeal observed (in relation to a judicial review against decisions made in the IMs under Part 4) “certainty is a relative rather than an absolute value”,¹⁰ and “there is a continuum between complete certainty at one end and complete flexibility at the other”.¹¹
- 2.6 The s 52R purpose is primarily promoted by having the rules, processes and requirements set upfront prior to being applied by regulated suppliers or ourselves.
- 2.7 However, as recognised in ss 52X and 52Y, these rules, processes and requirements may change over time.
- 2.8 The power to amend an IM must be used to promote the policy and objectives of Part 4 of the Act as ascertained by reading it as a whole. It is clear that Parliament saw the promotion of certainty as being important to the achievement of the purposes of price-quality (PQ) regulation. While this is to an extent implicitly inherent in s 52A (for example, providing suppliers with incentives to invest in accordance with s 52A(1)(a)), it is also expressed in s 52R in relation to the purpose of IMs, but also in other aspects of the regime, such as the restrictions on reopening DPPs during their regulatory periods.¹²
- 2.9 When considering IM amendments, we must therefore be mindful that this may have a detrimental effect on:
- 2.9.1 the role that predictability plays in providing suppliers with incentives to invest in accordance with s 52A(1)(a); and
 - 2.9.2 the role that the IMs play in promoting certainty for suppliers and consumers in relation to the rules, requirements, and processes in advance of being applied by us and suppliers in setting the DPP.
- 2.10 At times there will be a tension between making changes to improve the regime and better promote the s 52A purpose on the one hand, and certainty on the other.
- 2.11 While we will have regard to the s 52R purpose (and the other indications of the importance of promoting certainty), ultimately, we must nevertheless make decisions that we consider promote the s 52A purpose.

⁹ *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para [214].

¹⁰ *Commerce Commission v Vector Ltd* [2012] NZCA 220, para [34].

¹¹ *Commerce Commission v Vector Ltd* [2012] NZCA 220, para [60].

¹² For further discussion see *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para [213]-[221].

- 2.12 Section 52A governs all our decision-making processes under Part 4, including our IM decisions. The other purpose statements within Part 4 are relevant matters but they should be applied consistently with s 52A.¹³
- 2.13 When making our decisions we must only give effect to these other purposes to the extent that doing so does not detract from our overriding obligation to promote the purpose set out in s 52A.
- 2.14 Therefore, where the promotion of s 52A requires amendment to an IM, s 52R does not prevent us from making a change that is consistent with s 52A.

Amendments inside and outside the Input Methodologies statutory review cycle

- 2.15 This section considers the circumstances in which IMs may be amended and what must be taken into account when making amendments to IMs outside of the statutory review cycle.
- 2.16 All IMs must be reviewed at least once every seven years, as mandated by s 52Y. This process is key to delivering on the s 52R certainty purpose of IMs, while at the same time allowing the regime to mature and evolve in response to changing circumstances.
- 2.17 Given the certainty purpose of the IMs and the scheme set out in the Act to promote this purpose, we must carefully assess what amendments are appropriate to consider outside the statutory IM review cycle. Additionally, as noted previously, the predictability the IMs provide is key to promoting the s 52A purpose and, in particular, incentives to invest as required under s 52A(1)(a).
- 2.18 On the other hand, it is important that the IMs are fit-for-purpose going into a DPP reset, particularly as under s 53ZB(1) IM amendments made after a PQ path is determined (other than in limited circumstances) will not affect the PQ path until the next reset.¹⁴
- 2.19 Leading up to a DPP reset, we may therefore need to consider which topics are appropriate to consult on as potential s 52X amendments in order to identify changes to the IMs that are necessary to ensure that the DPPs are able to be

¹³ We note that the High Court, in *Wellington International Airport Ltd & Ors v Commerce Commission* considered that the purpose of IMs, set out in s 52R, is “conceptually subordinate” to the purpose of Part 4 as set out in s 52A when applying the “materially better” test. See *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, para [165].

¹⁴ Under s 53ZB(2) a PQ path must be reset by us with a new PQ path made by amending the PQ determination if: an IM changes as a result of an appeal under s 52Z; and that changed IM would have resulted in a materially different PQ path being set had the changed IM applied at the time the PQ path was set.

workable and effective in promoting the outcomes in s 52A, as we have done in this case.

- 2.20 The next statutory IM review is due for completion by December 2023. It should be noted that the IMs that we are proposing to amend could be further amended at that stage. However, as noted above, given s 53ZB(1), we may not reopen the DPP3 PQ path to implement any IM amendments made as part of the statutory IM review after DPP3 takes effect.

Amendments outside of the statutory IM review cycle

- 2.21 We generally focus on two types of amendments outside the statutory IM review cycle:

2.21.1 those that support incremental improvements to PQ paths; and

2.21.2 those that enhance certainty about – or correct technical errors in – the existing IMs.

- 2.22 We do not generally consider it to be appropriate to consider 'fundamental' changes outside the statutory IM review cycle. Fundamental IMs are generally those that define the fundamental building blocks used to set PQ paths (listed in s 52T(1)(a)), and that are central to defining the balance of risk and benefits between suppliers and consumers.

- 2.23 However, we can and will reconsider fundamental building blocks where there is a compelling and urgent rationale for doing so.¹⁵

The decision-making framework we have applied

- 2.24 In deciding whether to propose IM amendments as part of the DPP3 setting process, we are using a decision-making framework that we have developed over time to support our decision-making under Part 4 of the Act.¹⁶ This has been consulted on and used as part of prior processes, and helps provide consistency and transparency in our decision-making.

- 2.25 Specifically, in respect of each potential IM amendment we will consider whether they would:

¹⁵ An example of this was the re-consideration of the Part 4 WACC percentile decision in 2014. The compelling reason for this was criticism by the High Court of this decision in the IM merits appeal process, and the urgency was due to the upcoming default price-quality path and individual price-quality resets for EDBs and Transpower New Zealand Limited.

¹⁶ See, for example, [Commerce Commission "Input methodologies review decisions: Framework for the IM review" \(20 December 2016\)](#), para 59 and [Commerce Commission "Amendments to Electricity Distribution Services Input Methodologies Determination – Reasons paper" \(26 November 2019\)](#), para 2.17-2.20.

- 2.25.1 promote the Part 4 purpose in s 52A of the Act more effectively;
 - 2.25.2 promote the IMs purpose in s 52R of the Act more effectively; or
 - 2.25.3 reduce compliance costs, other regulatory costs or complexity (consistent with the purpose of DPP regulation in s 53K).
- 2.26 As part of these considerations, we will also consider whether the potential IM amendment would detrimentally affect any of the matters in paragraph 2.25. As discussed in paragraphs 2.12 to 2.14 above, while the other purpose statements in Part 4 of the Act (including s 52R and s 53K) are relevant matters, s 52A governs our decision-making process under Part 4. We may, therefore, make an IM amendment that does not promote the IM purpose in s 52R more effectively than the current IM where we consider that would promote the s 52A purpose more effectively. We further consider that we must generally only make IM amendments to promote the IMs purpose in s 52R, or to reduce costs or complexity, where this does not detract from our obligation to promote the purpose in s 52A.
- 2.27 We refer to the outcomes specified in paragraph 2.25 as the 'IM amendments framework outcomes' in this paper.

Chapter 3 Proposed amendments to the GDB and GTB Input Methodologies Determinations

Purpose of this chapter

- 3.1 This chapter describes our proposed changes to the GDB and GTB IM Determinations. Most of the proposed amendments are the same for the GTB and the GDBs. The exception is the proposal to amend the taxation IMs for GDBs only as part of the treatment of operating leases.
- 3.2 For each of these proposed changes, we explain:
- 3.2.1 our current requirements;
 - 3.2.2 our proposed amendment; and
 - 3.2.3 how the proposed amendment is likely to promote an IM amendments framework outcome, as defined in Chapter 2, para 2.25-2.26.

Summary of proposed amendments

- 3.3 We propose amending the GDB and GTB IM Determinations as follows.

Economic network stranding – adjusting depreciation

- 3.4 We are proposing to accelerate depreciation for GPBs when setting DPP3 by shortening asset lives, bringing forward the expected recovery of capital in the Regulated Asset Base (**RAB**). As explained in our Gas DPP3 Draft Decisions Reasons Paper, accelerating depreciation advances cash flows for GPBs and mitigates the risk of economic network stranding from long-term declining use of gas networks.¹⁷
- 3.5 The mechanism we propose to introduce in the Gas IMs allows us to adjust asset lives when calculating depreciation for a DPP if we are satisfied that doing so would better promote the purpose of Part 4. There are flow-on amendments for depreciation calculations in ID. We are seeking feedback on whether any rules are required about which particular assets can have their lives adjusted by GPBs in the ID asset register to align with the DPP.

Treatment of operating leases

- 3.6 We are proposing to better align the ID and PQ treatment of capitalised ‘right of use’ assets with new accounting standard NZ IFRS 16. We propose that a GAAP-based life can be assigned to depreciate right of use assets by GDBs and the GTB,

¹⁷ Commerce Commission “Default price-quality paths for gas pipeline businesses from 1 October 2022 – Draft reasons paper” (10 February 2022), chapter 6.

and that GDBs adopt opening GAAP deferred tax balances when calculating tax allowances for ID, DPP and CPP purposes.

Capital expenditure reopeners

- 3.7 We are proposing to introduce two reopeners for capital expenditure.
- 3.8 The first is a capacity event reopener that will allow us to reconsider the price path in the DPP if the supplier can demonstrate it needs additional capacity on its network.
- 3.9 The second is a risk event reopener that will allow us to reconsider the DPP if the supplier establishes that part of its network will deteriorate to the extent that failing to invest during the DPP period, beyond the allowance already provided, would:
- 3.9.1 materially adversely affect its ability to meet its quality standards; or
 - 3.9.2 compromise the safety of any person or the integrity of assets.

Tax adjusted market risk premium

- 3.10 We are proposing to increase the TAMRP parameter in the WACC calculation from 7.0% to 7.5% to reflect our most recent decisions on this parameter when we set the cost of capital IMs for fibre regulation in October 2020.

Weighted Average Cost of Capital (four-year regulatory period)

- 3.11 We are proposing a four-year regulatory period for DPP3 which will require a WACC estimate for a four-year regulatory period. This requires IM amendments to two parameters used to calculate WACC. The changes to the parameters are:
- 3.11.1 an estimate of the risk-free rate that is based on the length of the regulatory period; and
 - 3.11.2 debt issuance costs that align with the length of the regulatory period .
- 3.12 We expand on each of these proposed IM amendments below.

Economic network stranding IM amendments – adjusting depreciation

Current requirements

- 3.13 The straight-line method for calculating total regulatory depreciation allowances must be applied when setting a DPP for a GPB. Under a straight-line method, the amount of forecast depreciation calculated for each year of the DPP period is effectively determined by remaining asset lives.

- 3.13.1 An average life for all assets that are forecast to exist at the start of the DPP period is derived from a calculation of the weighted average of remaining asset lives from data in past ID disclosures for each GPB. The asset life data obtained from past ID disclosures draw on the physical asset lives specified in Schedule A of the GDB and GTB IMs.
- 3.13.2 Assets forecasts to be commissioned during the DPP period for each GPB are assumed to have a 45-year remaining life in their year of commissioning for DPP modelling purposes. The depreciation lives of the individual assets actually commissioned during the DPP period, however, are subsequently recorded by GPBs for ID purposes generally in accordance with Schedule A of the GDB and GTB IMs.
- 3.14 There is some ability for GPBs under the current IMs to adjust asset lives prescribed in Schedule A for individual assets for ID purposes, generally based on the physical use or characteristics of assets. These adjustments affect depreciation calculations for ID purposes and the rolled-forward ID RAB, which is then used to inform future DPP resets. However, there is currently no ability for either us or GPBs under either ID or DPP provisions to adjust asset lives or otherwise adjust the profile of depreciation for assets to reflect the risk of economic asset stranding.
- 3.15 Lastly, the RAB of each GPB is indexed for inflation which affects the amount of depreciation calculated each period but preserves the real value of the RAB over time and is ex-ante NPV-neutral.

Proposed amendments

- 3.16 As discussed in our Gas DPP3 Draft Decision Reasons Paper, we propose maintaining straight-line depreciation and RAB indexation, but propose reducing asset lives for both GDBs and the GTB when setting DPP3.¹⁸ This would have the effect of accelerating forecast depreciation for DPP3 for GPBs, bringing forward the expected recovery of capital in the RAB to mitigate the risk of economic network stranding from long-term declining use of gas networks. The changes to the IMs for GPBs described below would allow us to implement this draft decision for DPP3.
- 3.17 The proposed IM mechanism operates in two parts.
- 3.17.1 First, as part of setting the DPP, we may specify an adjustment factor to apply to the asset lives for each GDB and the GTB to alter the calculation of forecast depreciation. For assets that are forecast to exist at the start of the DPP period the adjustment factor is applied to the weighted average remaining asset lives derived from past ID disclosures for each GPB. For

¹⁸ Commerce Commission “Default price-quality paths for gas pipeline businesses from 1 October 2022 – Draft reasons paper” (10 February 2022), chapter 6.

assets forecast to be commissioned during the DPP period (**additional assets**) the 45-year life modelling assumption is adjusted. We must be satisfied that “applying the adjustment factor better promotes the purpose of Part 4”. The adjustment factor is the same across existing assets and additional assets.

- 3.17.2 Secondly, following the DPP reset, GPBs will be required to adjust some or all of the remaining asset lives for individual depreciable assets recorded for ID purposes. The adjustments must be done in a way that ensures that in the first ID reporting year of the new DPP regulatory period the weighted average remaining asset life of all assets under ID is consistent with the DPP weighted average remaining asset life for existing assets applied in the DPP modelling. The asset lives recorded in the ID registry for new assets commissioned must be adjusted commensurately in line with the reduction for existing assets of that same class. This ensures the extent of adjustment for individual new assets is consistent with existing assets of a similar type.
- 3.18 We are not proposing to explicitly change the 45-year assumption for additional assets required by the IMs to be applied in the DPP3 financial model forecasting, nor the asset lives specified in Schedule A that are required to be used in ID for assets that are commissioned during the period. Rather, as described above, for the purposes of the DPP we use a simple adjustment factor which has the effect of reducing the 45-year DPP modelling assumption, and we avoid specifying adjusted asset lives for new assets for ID purposes.
- 3.19 If no further adjustments are made to asset lives as part of future DPP resets then the levels of accelerated depreciation we propose for DPP3 will continue for future regulatory periods unless, and until, assets become fully depreciated or are disposed of. As discussed above, this is because the asset life adjustments required for ID purposes to align with DPP3 modelling will affect ID depreciation calculations and the rolled-forward ID RAB, which is then used to inform future DPP resets.
- 3.20 Other key aspects of the proposed mechanism for GPBs are set out below. We note that the IM mechanism we propose for GPBs is similar to that implemented for electricity distribution businesses (**EDBs**) as part of the 2016 statutory IM review to address increased economic stranding risk (which in that case was expected to arise from technological change) although there are some differences.¹⁹
- 3.20.1 We will not require an application from regulated gas suppliers before implementing the adjustment for DPP purposes. The EDB mechanism

¹⁹ [Commerce Commission “Amendments to electricity distribution services input methodologies determination in relation to accelerated depreciation – Reasons paper” \(8 November 2018\).](#)

requires EDBs to formally request an adjustment prior to the commencement of the next DPP period and provide supporting evidence.

- 3.20.2 There is no cap on the extent of the adjustment across existing and additional assets for each GPB for DPP purposes. The mechanism can be used to shorten asset lives (by applying an adjustment factor of less than 1) or extend asset lives (by applying an adjustment factor greater than 1), although for DPP3 we propose shortening lives thereby accelerating depreciation. For EDBs the adjustment was capped at a 15% reduction (equivalent to a factor of 0.85) to average remaining asset lives, and for existing assets only.
- 3.20.3 The mechanism is not limited to a one-time adjustment in DPP3. In our IM reasons paper for the EDB mechanism, we stated that “because of the added complications that would occur if we allowed EDBs to make multiple adjustment, EDBs will only ever be allowed to make one adjustment’.²⁰ In contrast, it is possible that further adjustments in future regulatory periods and/or changes to how network stranding risk is mitigated and/or compensated for will occur for GPBs. Where further adjustments to asset lives are made then, as noted above, it is possible for the mechanism to be used to extend lives, as well as shorten them, to account for new information and changing levels of risk if necessary.
- 3.21 While there are other ways to bring forward cash flows for DPP purposes (such as using a tilted annuity or other front-loaded depreciation method), we think it is preferable in the context of a DPP to base the mechanism for GPBs on the established EDB mechanism which applies an adjustment factor to asset lives. The EDB mechanism is transparent, easy to understand, and we expect it to be relatively straight forward for GPBs to implement in practice.. Additionally, as noted above, it allows for GPB’s depreciation to be further adjusted as part of future DPP resets – even to the point of offsetting prior acceleration measures if required. While the EDB solution was introduced in response to technological change we consider a similar mechanism is appropriate to deal with economic network stranding risk for GPBs under the current circumstances.
- 3.22 We are not proposing to specify how GPBs should adjust remaining asset lives across individual depreciable assets in the RAB for ID purposes, except:
- 3.22.1 the resulting weighted average adjusted asset lives of all individual assets for ID for the first year of the DPP period must equal the weighted average

²⁰ [Commerce Commission “Input methodologies review decisions: Topic paper 3 The future impact of emerging technologies in the energy sector” \(20 December 2016\)](#), p. 26.

asset life calculated and applied for existing assets for the DPP for that year; and

3.22.2 assets commissioned in the first and subsequent disclosure years of a DPP period must have the asset lives which would otherwise apply under ID requirements adjusted by the same adjustment factor as that applied under ID to existing assets of a similar type.

3.23 We are interested in submitters' views about whether any further rules are required in the Gas IMs about which assets or asset classes can have lives adjusted in the ID asset register. For example, whether assets that are shared between gas and other regulated or unregulated services (and therefore subject to cost allocation in the Gas IMs) should be ineligible for adjustment for ID purposes.

How the proposed amendments are likely to promote an Input Methodologies amendments framework outcome

3.24 We acknowledge that the IM amendments proposed for the draft decision affect elements of a foundational building block of the regime. Under normal circumstances, we would be hesitant to make changes to fundamental IMs outside of the statutory IM review cycle. However, as explained below, the changes are necessary for us to continue to apply our regulatory framework consistently and will enable us to set a fit-for-purpose DPP3 that promotes the Part 4 purpose more effectively.

3.25 We consider that there are compelling reasons to make this amendment outside of the normal statutory IM review cycle.

3.25.1 We were open to and had raised the prospect of amending the asset valuation IMs for GPBs as part of the 2016 statutory IM review to address the risk of economic network stranding and consider that current circumstances warrant taking such action now.²¹

3.25.2 At the time of the 2016 statutory IM review, we decided not to make changes to the Gas IMs to address increased economic stranding risk from technological change given the evidence available at the time.²² While there were some potential drivers of stranding risk, GDBs had the ability and incentive to grow connections in any given regulatory period, making the risk faced by GDBs less asymmetric than for EDBs.²³ However, we

²¹ [Commerce Commission "Input methodologies review decisions: Topic paper 3 The future impact of emerging technologies in the energy sector \(20 December 2016\)](#), paras 96-104.

²² [Commerce Commission "Input methodologies review decisions: Topic paper 3 The future impact of emerging technologies in the energy sector \(20 December 2016\)](#), para 104.

²³ [Commerce Commission "Input methodologies review decisions: Topic paper 3 The future impact of emerging technologies in the energy sector \(20 December 2016\)](#), paras 98-99.

noted that we could revisit the Gas IMs if future developments were to impact on gas networks.

- 3.25.3 For the reasons we explain in detail in chapter 6 of our draft DPP3 reasons, there is now a material risk of an accelerated decline in the use of gas pipelines for conveying natural gas, exposing GPBs to economic network stranding. We note that while GDBs can influence natural gas demand in the short term through growing connections, or trying to maintain existing ones, our expectations are that natural gas demand will still fall in the medium to long-term. We consider this to be an exceptional situation facing the gas sector and there is a strong case for making targeted changes to the IMs now to allow us to start addressing these circumstances.²⁴
- 3.25.4 The proposed mechanism is NPV-neutral (with respect to the WACC). It does not alter the value upon which assets enter the RAB, nor the total present value that is available to be recovered by suppliers through revenues over time. While it does alter the expected time profile of capital recovery, there are less serious implications for errors in estimation than other potential solutions, and subsequent adjustments to average asset lives can align with new estimates if needed. We consider this is an appropriate solution for addressing economic stranding risk in a way that preserves flexibility in the context of current uncertainty, and avoids the need to introduce a novel mechanism into the IMs.
- 3.25.5 If we were to wait until the upcoming IM review then the proposed solution would not be available to be implemented until DPP4. We consider being able to address the current risk of economic network stranding in DPP3 is important to support the expectation of real ex-ante Financial Capital Maintenance (**FCM**) over the long-term and consistently apply our regulatory framework going forward. Early action lessens the chances of network stranding becoming unavoidable and helps preserve optionality for managing future uncertainty. As a consequence, we expect GPBs to be incentivised to continue to invest to maintain safe and reliable service for consumers while being limited in their ability to extract excessive profits.
- 3.26 The proposed mechanism will place some additional requirements on us in terms of consulting on and ultimately setting DPPs when it comes to applying appropriate asset adjustment factors for each GPB. It will also place some additional compliance obligations on GPBs when calculating new remaining asset lives for existing and

²⁴ As explained in our Gas DPP3 Draft Decisions Reasons Paper, we consider that economic network stranding is a risk that can be reasonably anticipated now and is best addressed for DPP3 through adjusting depreciation to promote the long-term benefit of consumers.

new assets for ID reporting. However, we consider that the likely long-term benefits to consumers sufficiently outweigh any increase in compliance costs, other regulatory costs or complexity.

Treatment of operating leases

Current requirement

- 3.27 A new accounting standard NZ IFRS 16 was issued in 2016 applying to financial reporting periods beginning on or after 1 January 2019 (although early adoption was permitted). The standard constitutes generally accepted accounting practice (**GAAP**) in New Zealand and is recognised as such by the current Gas IMs.
- 3.28 NZ IFRS 16 fundamentally changes the accounting treatment of operating leases for lessees, by requiring operating lease payments, previously classified as operating expenditure, to be reported as capital expenditure. The resulting capital assets are shown on businesses' balance sheets as 'right of use' assets, with a value based on the present value of the lease payments and depreciated over the lease term.
- 3.29 We considered the regulatory implications of NZ IFRS 16 for EDBs and Transpower New Zealand Limited (**Transpower**) prior to their recent price-quality path resets.²⁵ The IMs for those suppliers were amended to achieve better alignment with NZ IFRS 16 and minimise compliance costs.
- 3.30 At the time of the IM amendments for EDBs and Transpower we noted that:²⁶
- [t]he change in GAAP by the implementation of NZ IFRS 16 will have effects for other regulated businesses that have operating leases, and we will address these through our formal processes for each sector in due course.
- 3.31 Right of use assets have been capitalised by all GPBs in accordance with NZ IFRS 16 and have been included in the 'base year' RAB values rolled forward to the start of DPP3 in our draft DPP3 financial model.²⁷ In addition, values for additional assets forecast to be added to the RAB during DPP3 include right of use assets. As such, these assets give a return of, and on, capital during DPP3, as well as potentially affecting other elements of the DPP path (eg, calculation of tax allowances).
- 3.32 Currently, the Gas IMs permit right of use assets to be capitalised and included in the RAB. This is consistent with the financial modelling that has been adopted for the DPP3 draft decision. However, other associated implications of the new NZ IFRS 16 standard have not been considered for GPBs ahead of the DPP3 gas reset.

²⁵ [Commerce Commission "Treatment of operating leases: Final decisions paper" \(13 November 2019\).](#)

²⁶ [Commerce Commission "Treatment of operating leases: Final decisions paper" \(13 November 2019\)](#), para X7.

²⁷ The 'base year' for DPP3 for all GPBs is the disclosure year 2020.

Proposed amendments

- 3.33 Consistent with the IM amendments made for EDBs and Transpower, we are proposing to generally accept alignment with NZ IFRS 16 for gas PQ and gas ID purposes. This means that DPP and CPP price paths, and returns on investment under ID, will be calculated using capitalised right of use asset values.
- 3.34 We propose two types of amendments to better align the existing IM treatment:
- 3.34.1 amend the asset valuation IMs applying to ID for both GDBs and the GTB to allow a GAAP-based life to be assigned to right of use assets. The treatment will flow through automatically for DPP and CPP purposes, as ID values are used as the basis for forecast DPP and CPP asset values – including for DPP3; and
- 3.34.2 amend the taxation IMs for GDBs (who are required to use the modified deferred tax method to calculate tax allowances) to allow the opening GAAP deferred tax balance to be applied to right of use assets and other assets that do not have a corresponding regulatory tax asset value.²⁸ This amendment requires changes to the IMs applying to ID, DPPs and CPPs.
- 3.35 Further changes were considered and implemented for EDBs and Transpower, but are not proposed for GPBs for the following reasons:
- 3.35.1 Pass-through or recoverable costs – a specific treatment is not required to be prescribed for GPBs because none of these types of costs specified in the Gas IMs would include the costs of right of use assets; and
- 3.35.2 Incremental rolling incentive scheme (**IRIS**) – an IRIS does not currently apply for GPBs, and we do not propose washing-up for the difference between the 45-year standard life assumption used for DPPs and the GAAP lives for additional right-of use assets commissioned during the DPP period. No other gas assets have this wash-up and we do not expect the amounts involved for right of use assets to warrant such an adjustment.²⁹
- 3.36 We propose implementing the IM changes such that they can be applied for setting DPP3 PQ paths and to any upcoming ID disclosures.

²⁸ Similar to Transpower, the GTB uses the taxes payable method which automatically applies the correct treatment to right of use assets, so no changes to taxation IM are proposed for the GTB.

²⁹ Consistent with other types of gas assets however, a wash-up applies for the actual values of assets commissioned compared to those values forecast for the period from the base year to the start of the DPP period – see clause 3.1.3(1), (5) and (6) of the GDB and GTB IMs.

How the proposed amendment is likely to promote an Input Methodologies amendments framework outcome

- 3.37 We have arrived at the proposed changes with a view to best promoting the purpose of Part 4, promoting the IM purpose in s 52R of the Act, and addressing unnecessary compliance costs, other regulatory costs or complexity.³⁰
- 3.38 With respect to the specific changes proposed:
- 3.38.1 The asset valuation IMs applying to ID generally require a ‘physical asset life’ to be used for depreciation purposes, which, for a non-network asset, is the asset’s life as determined under GAAP. Where right of use assets are network assets however, there is no equivalent provision in the Gas IMs, and the remaining physical life provisions do not make sense for this type of asset. We consider the proposed changes maintain the workability and effectiveness of the IMs in a way that is consistent with their original policy intent and Part 4 purpose, and promotes certainty; and
- 3.38.2 Allowing the opening GAAP deferred tax balance to be applied in respect of right of use assets and any other assets that do not have a corresponding regulatory tax asset value removes the overcompensation arising from applying a nil opening balance with no reversal of temporary depreciation differences consistent with the Part 4 purpose. The proposed treatment also avoids the need to retain a separate regulatory notional tax asset record, and so avoids unnecessary compliance costs or complexity.
- 3.39 We acknowledge that the proposed amendments affect elements of the asset valuation and taxation IMs for GPBs which we consider to be fundamental. We propose to make these IM changes, outside of our statutory IM review cycle, because the change to GAAP was not an issue we considered as part of our 2016 IM review, and we consider the changes will result in more effective decisions for DPP3 which will commence on 1 October 2022. If consideration of these changes were to be deferred until the upcoming statutory IM review then the potential for material detriment to either regulated suppliers or consumers would be greater.

³⁰ Note that the changes are not designed to leave GPBs perfectly neutral in a regulatory sense to the introduction of new accounting standard NZ IFRS 16. For instance, all GPBs will continue to receive the benefit from the return on capital (calculated using the WACC) on the new right of use assets over the incremental cost of debt used to establish their value. The benefit will be greater for right of use assets with longer lives. As for EDBs and Transpower, we intend to monitor the durations of new leases through ID to identify whether excessive benefits are accruing as a result of lease terms being extended.

Capital expenditure reopeners

Current requirement

- 3.40 Currently, the Gas IMs allow us to re-open the price paths we set for a DPP regulatory period. However, our ability to do so is limited to the following events:³¹
- 3.40.1 catastrophic events;
 - 3.40.2 change events;
 - 3.40.3 error events;
 - 3.40.4 major transactions; or
 - 3.40.5 false or misleading information has been provided.

Proposed amendments

- 3.41 We are proposing reopeners to address capacity events and risk events that apply to individual projects or programmes relating to large connections, system growth, asset relocations and to asset replacement and renewals capex. The reopeners have been introduced for the following types of situations:
- 3.41.1 projects and programmes that were unforeseen at the time of publishing supplier expenditure forecasts that the Commission based its allowances on; or
 - 3.41.2 projects and programmes that were foreseen for later regulatory periods, but changes in circumstances mean that the project or programme is brought forward into the current regulatory period.
- 3.42 We consider it appropriate that a greater level of scrutiny is applied to these reopeners than the approach we have taken in setting DPP capex allowances. We will require that the additional expenditure needs to be prudent and efficient to be approved.
- 3.43 We propose that the reopeners only apply to the portion of the additional expenditure that is not covered through the distributor's capital contributions policy and not already allowed for in the DPP allowances we set.
- 3.44 Our proposed reopeners that we have classed as capacity event and risk event reopeners are described in the following sections.

³¹ [Commerce Commission "Gas Distribution Services Input Methodologies Determination 2012](#) and [Gas Transmission Services Input Methodologies Determination 2012 \(3 April 2018\)](#).

Capacity and risk event reopeners

3.45 The capacity event reopener will allow us to reconsider the price path in the DPP if the supplier can demonstrate it needs additional capacity on its network. It allows us to provide additional funding where investment is required to support:

3.45.1 large connections (including alteration to existing connections);

3.45.2 large system growth;

3.45.3 a combination of large connections and system growth; and

3.45.4 large asset relocation.

3.46 The risk event reopener will allow us to reconsider the DPP if the supplier establishes that part of its network will deteriorate to the extent that failing to invest during the DPP period, beyond the allowance already provided, would:

3.46.1 materially adversely affect its ability to meet its quality standards; or

3.46.2 compromise the safety of any person or the integrity of assets.

3.47 Our view is that a risk event is an event where additional investment cannot be delayed until a future regulatory period. GPBs will need to demonstrate that the remediation investment needs to be prudent and efficient supported by a probabilistic risk assessment, where appropriate.

3.48 In investing in their networks for growth purposes, suppliers should understand that these investments risk being stranded in future. This risk may mitigate supplier over-investment in growth and incentivise suppliers to seek greater contributions from new connecting parties including for wider network reinforcement. We also expect that for large new connection and asset relocations capex not covered by capital contributions, in its reopener application a supplier will need to provide us with an undertaking from the third party driving the expenditure that it is committed to the project.

Expenditure thresholds for reconsidering the default price-quality path

3.49 We have considered what appropriate reopener expenditure thresholds may be for GPBs. These are aggregate thresholds for projects and programmes that can be applied for under these reopeners in any one disclosure year.

3.50 We need to set a maximum expenditure threshold, which if exceeded would necessitate the supplier applying for a CPP, and a lower threshold, which would balance the cost of processing a reopener application with the ability of suppliers to re-prioritise expenditure to meet the need, while maintaining their safety and quality obligations.

- 3.51 In EDB DPP3 we set the reopener maximum expenditure threshold that applied to all EDB businesses, stating that “The limited level of scrutiny applied under these reopeners, in line with the relatively low-cost nature of DPPs, is not appropriate for larger projects and programmes that are out of step with original forecasts or historic expenditure.”³² We considered that for EDBs a \$30 million maximum expenditure threshold was an appropriate level of expenditure to achieve this.
- 3.52 We considered setting the reopener maximum expenditure threshold at \$30 million for the GDBs and the GTB, in line with the EDB DPP IM settings. However, \$30 million is not reflective of the historical network capex for gas suppliers nor does it reflect the range of gas supplier business sizes. We reviewed the average historical levels of network capex used in our DPP top-down capex allowance setting approach, for both the GDBs and the GTB, to ascertain what a reasonable reopener maximum expenditure threshold may be for each supplier. We concluded that:
- 3.52.1 GasNet Distribution spent, on average, \$0.7 million (\$2021) on network capex per annum from DY17;
 - 3.52.2 Powerco Distribution, Vector Distribution and First Gas Distribution and Vector Distribution spent, on average, \$18.7 million (\$2021) on network capex from DY17; and
 - 3.52.3 First Gas Transmission spent, on average, \$30.7 million (\$2021) on network capex from DY18.
- 3.53 We propose to set maximum expenditure thresholds that are reflective of what gas suppliers have been spending in their networks balanced against the cost of a CPP and the fact that we will be requiring expenditure applications to be both prudent and efficient.
- 3.54 We consider that setting the maximum expenditure threshold at approximately 50% of what each supplier has been historically spending on its network over the DPP2 period balances these considerations. We invite submitter views on this decision. This means that we will set reopener maximum expenditure thresholds of:
- 3.54.1 \$350,000 for GasNet Distribution;
 - 3.54.2 \$10 million for Powerco Distribution, Vector Distribution and First Gas Distribution; and
 - 3.54.3 \$15 million for First Gas Transmission.

³² [Commerce Commission “Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision - Reasons Paper” \(27 November 2019\)](#), para G23.

3.55 In reconsidering the DPP, we will also be setting a reopener minimum expenditure threshold for suppliers. In setting a minimum expenditure threshold we believe that suppliers should be able to manage changes in expenditure requirements within the DPPs set for them. A minimum expenditure threshold is also required to avoid situations where the cost of administering the reopener is greater than the benefits to consumers. We are proposing to set the minimum expenditure thresholds that are consistent with those we set in the EDB DPP IMs and that are reflective of the supplier business size:

3.55.1 \$2 million for First Gas Transmission, Powerco Distribution, First Gas Distribution and Vector Distribution; and

3.55.2 \$100,000 for GasNet Distribution.

3.56 We invite submitter views on this decision.

How the proposed amendments are likely to promote an Input Methodologies amendments framework outcome

3.57 The approach we have taken to set capex allowances in this DPP reflects the fact that the DPP is intended to be a relatively low-cost form of regulation catering for a wide group of businesses using a generic approach. A DPP is not intended to deal with circumstances that require significant scrutiny of costs of an individual business.

3.58 In this DPP we have taken a top-down approach to setting the capex allowance for the majority of GPB capex. To do this we calculate GPB historical average capex and use this to cap allowances based on supplier capex forecasts. We discuss our capex allowance setting approach more fully in our Gas DPP3 draft decision reasons paper.³³

3.59 In past DPP capex analyses, where we have taken this top-down capex allowance setting approach, we have added margins to historical average capex projections to account for typical year-on-year fluctuations that tend to occur in capex.

3.60 In this DPP we propose not adding margins the historical average capex projections. We have done this to mitigate the risk that we might set capex allowances that are too generous considering downside demand risk and to address gas sector uncertainty.

3.61 To mitigate the risk that the capex allowances we set in this DPP are insufficient to deal with network asset risk or projects that are unknown or uncertain at the time

³³ Commerce Commission “Default price-quality paths for gas pipeline businesses from 1 October 2022 – Draft reasons paper” (10 February 2022), Attachments A and B.

the DPP was set, we propose introducing capex reopeners. These are similar to the reopeners introduced in the EDB IMs during the EDB DPP3 process.

- 3.62 We consider that there are good reasons for introducing these reopeners now and outside the statutory IM review cycle:
- 3.62.1 the reopeners will increase the flexibility available to suppliers and reduce the potential for unintended consequences from the high-level capex setting approach we have taken; and
 - 3.62.2 there is considerable uncertainty in the gas sector and the role of gas as a transition fuel away from more carbon intensive fuels.
- 3.63 We consider the introduction of these reopeners promotes the long-term benefit of consumers. They do so as they would allow for necessary additional investment during the period where the GPB can demonstrate the upfront allowance is insufficient (consistent with s52A(1)(a)). The reopeners are the most appropriate DPP mechanism to accommodate both the low-cost design of DPPs and the risk of unforeseen or uncertain investment. Reopeners reduce the risk that consumers pay more than necessary upfront if a more generous allowance had been provided (consistent with s52A(1)(b) and s52A(1)(c)).
- 3.64 In seeking additional capex funds, GPBs will also need to demonstrate that the need for the additional capacity or investment for the purpose of risk mitigation was for the following types of situations:
- 3.64.1 projects and programmes that were unforeseen at the time of publishing supplier expenditure forecasts that the Commission based its allowances on; or
 - 3.64.2 projects and programmes that were foreseen for later regulatory periods, but changes in circumstances mean that the project or programme is brought forward into the current regulatory period.
- 3.65 Our view is that for us to approve the additional expenditure, suppliers will need to provide us with justification for any projects and programmes that meet the test of prudence and efficiency. In applying the tests of prudence and efficiency we believe that the reopeners strike the right balance between ensuring GPBs can invest to maintain a safe and reliable network, while ensuring that additional expenditure is in the best interest of consumers.
- 3.66 GPBs can also apply for an alternative PQ path using a CPP to better meet their circumstances. A CPP can be tailored to meet the specific needs of the GPB and their consumers and provides the flexibility to generally deal with uncertainties that GPBs may encounter.

Tax Adjusted Market Risk Premium

Current requirement

3.67 The TAMRP represents the additional return, over and above the risk-free rate, that investors look for to compensate them for the risk of holding a portfolio of average risk (more precisely the market portfolio which is the average risk portfolio). It is one of the parameters in the Part 4 cost of capital IMs that is used when we determine the WACC for regulated suppliers. The current parameter estimate for the TAMRP in the cost of capital IMs for GPBs is 7.0%.

Proposed amendment

3.68 We are proposing to:

3.68.1 update the parameter estimate for the TAMRP in the Gas IMs to 7.5% which would align it with the TAMRP used in the Fibre IMs; and

3.68.2 remove the reference to the five-year period.

How the proposed amendment is likely to promote an Input Methodologies amendments framework outcome

3.69 The TAMRP is an economy wide parameter that is not specific to a particular sector. We are proposing to amend the parameter estimate for the TAMRP, which was last updated in 2015, to align with the updated estimate made when determining the Fibre IMs in October 2020. We published our analysis and consulted extensively on that decision as part of that process.³⁴ Our conclusion from that work was to increase the estimate of the TAMRP from 7.0% to 7.5%. We also considered determining TAMRP estimates for three, four and five-year regulatory periods. We found that the TAMRP estimate does not vary between these three potential terms, concluding that a single rate for TAMRP is appropriate for all regulatory periods.³⁵

3.70 To be consistent with the FCM principle, we consider that we should use our best estimate of the TAMRP as it is a component of our estimate of a normal return. All submissions received on our process and issues paper regarding TAMRP supported updating the estimate. We agree with Methanex's submission that the change provides consistency (as TAMRP is an economy wide parameter) and aligns with the Section 52A purpose, and therefore it is reasonable to update the parameter to the most recent estimate.

³⁴ [Commerce Commission "Fibre input methodologies – Main final decisions – reasons paper \(13 October 2020\).](#)

³⁵ [Commerce Commission "Fibre input methodologies – Main final decisions – reasons paper \(13 October 2020\), para 6.535.](#)

- 3.71 The more recent evidence we have supports a higher estimate of TAMRP than the current Gas IMs use. We therefore consider that amending the Gas IMs to increase the TAMRP from 7.0% to 7.5% will promote the Part 4 purpose in s 52A of the Act more effectively than the current IMs, as using the latest estimate of this parameter better supports the provision of ex-ante real FCM.
- 3.72 A full review of all the cost of capital IMs (including the TAMRP) will occur as part of the next statutory IM review cycle, beginning in 2022.

Weighted Average Cost of Capital (four-year regulatory period)

Current requirement

- 3.73 A key component of the Gas IMs is how we determine the cost of capital for PQ regulation and for ID. The cost of capital is the financial return investors require from an investment given its risk. WACC is an estimate of that rate of return. The WACC estimate impacts regulated providers and consumer outcomes for both quality and price.
- 3.74 Currently, the Gas IMs require us to determine a WACC estimate for DPP3 no later than six months prior to the start of the regulatory period.³⁶ Furthermore, the IMs currently only provide for a five-year regulatory period when calculating some of the parameters used to estimate the WACC. These parameters are:
- 3.74.1 the risk-free rate;³⁷
 - 3.74.2 the debt premium; and
 - 3.74.3 the debt issuance costs.
- 3.75 If we determine a four-year regulatory period for DPP3, we will need to amend these IMs to enable the estimation of a WACC that reflects a regulatory period of four years.³⁸

Proposed amendments

- 3.76 While the Act allows for a regulatory period shorter than five-years (but not less than four-years), the current cost of capital IMs for GPBs only provide for a WACC estimate that reflects a five-year regulatory period. In our original IM decisions, we

³⁶ [Commerce Commission "Gas Distribution Services Input Methodologies Determination 2012](#) and [Gas Transmission Services Input Methodologies Determination 2012 \(3 April 2018\)](#), clause 4.4.1(1)(c).

³⁷ [Commerce Commission "Gas Distribution Services Input Methodologies Determination 2012](#) and [Gas Transmission Services Input Methodologies Determination 2012 \(3 April 2018\)](#), clause 4.4.3.

³⁸ We may need to estimate both a four-year and five-year WACC given the IM requirement that we must determine the WACC estimate to be used in DPP3 two months before our DPP3 final decision, ie, by 31 March 2022.

discussed that the WACC should align with the term of the regulatory period. However, the IMs as drafted only provided for a WACC estimate that reflected the usual five-year regulatory period.³⁹

- 3.77 We propose correcting for this error by amending the IMs to provide for the setting of a WACC estimate for DPPs that reflects the term of the relevant DPP regulatory period. A WACC estimate that is consistent with the length of the DPP regulatory period requires amendments to the IMs, specifically changes to some parameters used to estimate the WACC.
- 3.78 We also propose amending the WACC IMs for ID to allow for the determination of an ID WACC estimate that reflects the term of the DPP regulatory period. At this stage we do not propose changing the IMs for the WACC estimate for CPPs. The WACC for CPPs would operate as currently designed. In the last IM review, we aligned the CPP WACC with DPP so that suppliers were not incentivised to apply to get a different rate of return.⁴⁰ We do not propose changing this decision.
- 3.79 Despite these potential changes relating to the cost of capital IM (one of the foundational building blocks IMs listed in s 52T(1)(a)), we consider it to be within the scope of this s 52X amendments process because the nature of the change is to correct a technical error and does not involve a policy change.

We propose amending the methodology for estimating the risk-free rate

- 3.80 The risk-free rate is the rate of interest expected when there is no risk of default. Debt issued by the Government and denominated in New Zealand dollars is considered to be free of default risk. The rate of interest on government issued debt can generally be readily observed from trading on the debt market.
- 3.81 The term of the risk-free rate is tied to the period of time that the supplier is exposed to interest rate risk. The supplier will be exposed to this for the length of the period. Suppliers can hedge this risk so we set the risk-free rate term equal to the length of the period.
- 3.82 We estimate the risk-free rate using bid yields on New Zealand government bonds, for a term to maturity equal to the length of the regulatory period for the businesses subject to PQ regulation and equal to the regulatory period term for each sector for ID regulation.
- 3.83 For GPBs, the risk-free rate is currently estimated for a five-year regulatory period only. We propose amending the Gas IMs to enable us to calculate an estimate of the risk-free rate that aligns with a four and five-year regulatory period. With prior

³⁹ [Commerce Commission "Input Methodologies Reasons Paper" \(December 2010\), p. 138-139](#)

⁴⁰ [Commerce Commission "Input Methodologies Review Decisions: Cost of Capital" \(20 December 2016\), p. 160-161](#)

knowledge of the term of the regulatory period suppliers can hedge their interest rate risk for the length of the period.

We propose not amending the methodology for estimating the average debt premium

- 3.84 We are not proposing to change our approach to estimating the debt premium. The debt premium is tied to the 'efficient' term of debt that a supplier holds for financing. From previous decisions and analysis the efficient term was found to be five years.⁴¹ The five year term used for the debt premium relates to the term of debt that is typically issued by the GPBs and not the length of the regulatory term.
- 3.85 To calculate the five-year debt premium, we use a five-year risk-free rate to match the five-year corporate bond yields. We do that for each day of the period we are calculating the debt premium for.

We propose amending the estimate for debt issuance costs

- 3.86 We propose amending the estimate for debt issuance costs by specifying the estimate for the length of the regulatory period. This is consistent with the approach we have taken in the Fibre IMs.⁴²
- 3.87 The debt issuance costs are 0.2% p.a. for a five-year regulatory period. For a four-year period, we propose an allowance of 0.25% p.a.. For a shorter regulatory period, we consider the debt issuance costs would be relatively higher as a proportion of total annual debt costs.⁴³

How the proposed amendment is likely to promote an Input Methodologies amendments framework outcome

- 3.88 Our proposed amendments resolve a technical error in the Gas IMs. In our view the proposed amendments promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it ensures the long-term workability of this IM.
- 3.89 We consider that the proposed amendments improve certainty for consumers and suppliers about how the cost of capital will be calculated when we come to set PQ paths and enables suppliers to employ the necessary strategies to mitigate the effects of prevailing external market conditions; for example, when putting in place financing arrangements.

⁴¹ [Commerce Commission "Fibre Input Methodologies Reasons Paper" \(13 October 2020\).](#)

⁴² [Commerce Commission "Fibre Input Methodologies Determination 2020" \(Consolidated 21 December 2021\)](#), see clause 3.5.2(6).

⁴³ [Commerce Commission "Fibre Input Methodologies Reasons Paper" \(13 October 2020\)](#), paras 6.301-6.306.

3.90 We consider that these amendments will promote the Part 4 purpose in s 52A of the Act more effectively than the current IMs. A WACC that is aligned with the length of the regulatory period better supports the provision of ex-ante real FCM and provides incentives for GPBs to invest in and maintain an efficient and reliable network.

Chapter 4 Draft decision not to amend the GDB and GTB Input Methodologies Determinations

Purpose of this chapter

- 4.1 This chapter describes our draft decision to not proceed with amending the change event reopener in the GDB and GTB Gas IM Determinations. We explain:
- 4.1.1 our current requirement;
 - 4.1.2 our proposed amendment raised in the process and issues paper for Gas DPP3; and
 - 4.1.3 how the proposed amendment is unlikely to promote an IM amendments framework outcome, as defined in Chapter 2, para 2.25-2.26.

Change event reopener

Current requirement

- 4.2 The GTB and GDB IMs include change event reopeners which are designed to allow an avenue to reopen a DPP in response to legislative or regulatory change.⁴⁴

Proposed amendment

- 4.3 In our process and issues paper for Gas DPP3 we sought views on introducing reopeners to address uncertainty affecting the gas pipeline sector and raised the potential for a reopener designed to be triggered in the event of a development in climate change policy which materially impacts GPBs and the operation of the DPP. Introducing a reopener to address climate change policy uncertainty would require amendments to the GPB IMs to create either an entirely new reopener provision, or more likely to amend the existing change event reopener.
- 4.4 The change event reopener does not cover Government policy statements or strategies. The emissions reduction plan and the national energy strategy are examples of climate change policy which may be announced during the DPP but not yet implemented by statute. The change event reopener could be amended to cover policy announcements to capture significant announcements for the gas pipelines sector.

⁴⁴ [Commerce Commission "Gas Distribution Services Input Methodologies Determination 2012](#) and [Gas Transmission Services Input Methodologies Determination 2012 \(3 April 2018\)](#), clause 4.5.2.

How the proposed amendment is unlikely to promote an Input Methodologies amendments framework outcome

- 4.5 The benefit of introducing a climate change policy reopener is that it may enable a more efficient response to unforeseen policy changes during the regulatory period. However, this would come at the cost of additional complexity and would be unlikely to provide much additional value given the other actions we are taking, particularly the four-year regulatory period.
- 4.6 The existing change event reopener can be triggered in the event of a legislative or regulatory change, which will be required to implement new policy. It is also likely that climate change policy will have longer-term impacts rather than have an immediate material impact on DPP3. It is not clear that such an amendment would promote the Part 4 purpose or IM purpose more effectively, and it would entail further complexity. Stakeholders do not appear to view a climate change policy reopener as a priority. No strong arguments were made in submissions in favour of introducing such a reopener.
- 4.7 We are therefore proposing not to amend the change event reopener trigger to include policy announcements.