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Commerce Commission
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Methanex submission on draft decisions on the IM Review 2023

Methanex welcomes the opportunity to provide its views on the draft decisions on the IM Review 2023 published by the Commerce Commission on 14 June 2023 as part of its 2022/23 Input Methodologies Review ("IM Review").

Methanex's interest in the IM Review related to issues affecting the regulation of gas pipeline businesses ("GPBs") and in particular the ramifications of the Commission's decision to incorporate measures to address perceived increased asset stranding risks facing GPBs implemented in the 2022-26 regulatory period ("DPP3").

Methanex's use of gas pipeline services is restricted to use of the Maui Pipeline; consequently, the focus of its interest is the regulatory settings that relate specifically to gas transmission businesses ("GTB").

SUMMARY

It is of primary importance to the long-term interests of consumers that the principles that underpin the revenue expectations of suppliers and the allocation of risk between suppliers and consumers in the Input Methodologies are clear and widely understood. The application of those principles must be underpinned by robust analysis. The mechanics of how the risk allocation is implemented is of secondary importance, provided there is sufficient flexibility in the methodology to reflect risk and revenue expectations appropriately.

Methanex supports the decision not to pursue the changes to the Input Methodologies for GTBs canvassed in the Input Methodologies Review[1] as the current approach is sufficiently flexible.

[1] https://comcom.govt.nz/__data/assets/pdf_file/0016/302452/IM-Review-2023-Options-to-maintain-investment-incentives-in-the-context-of-declining-demand-20-December-2022.pdf

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The alternative methodologies presented were not sufficiently mature to enable full evaluation and, to the extent that they could be evaluated, did not offer a clear benefit in addressing possible asset stranding risks compared to the current methodology.

Methanex also supports reducing the WACC percentile for GDPs from the 67th percentile to the 50th percentile as there is no compelling reason to use a WACC for gas distribution businesses that is anything other than the Commission's best estimate of the true cost of capital.

However, as far as the DPP3 reset is concerned, it remains Methanex's view that the Input Methodologies and the key economic principles have not been applied in a manner that meets the long-term interests of the consumer because the perceived risk of asset stranding has been inadequately assessed and likely lower than suggested during the DPP3 price reset.

OPTIONS PAPER ALTERNATIVES

Methanex supports the decision to retain the status quo methodology and not adopt one of the options for addressing asset stranding risks that were presented in the Options Paper. The options were insufficiently developed to offer a viable choice, and none appeared to offer an overall benefit to consumers. However, the alternatives to the status quo did have the potential to increase complexity, uncertainty, cost and risk.

Maintaining the status quo methodologies for addressing asset stranding will simplify the process of future adjustment and compensation if asset stranding risks are found to be lower than assumed in the DPP3 price reset. To this end, Methanex welcomes the acknowledgement that asset lives can be extended under the current framework:

> *The current mechanism allows for further adjustments as part of future DPP resets – to decrease or increase asset lives. While in DPP3 it was used to shorten lives, it may be appropriate to use it to lengthen lives in subsequent DPPs, depending on the circumstances. For example, if it became clear that long term demand for gas pipelines would decline at a slower rate than currently expected.*[2]

While we agree that supplier over-recovery in a prior period can and should be addressed by a subsequent asset-life extension, revision of asset lives alone may not be sufficient to compensate current consumers for costs incurred during a period of excess supplier revenue.

Methanex has previously noted that the process of adjusting asset lives in later regulatory periods to compensate for earlier over-recovery would be a costly exercise for consumers.[3] In part because consumers would be expected to have a higher WACC than suppliers (large, regulated monopolies). This means that the accelerated costs will negatively affect consumers more than the accelerated revenue will benefit the suppliers on a present value basis. Therefore, any adjustment to revenues in a later period to return suppliers to an NPV-neutral position will leave consumers with a negative NPV compared to if the period of excess supplier revenue had not occurred.

[2] Part-4-IM-Review-2023-Draft-decision-Financing-and-incentivising-efficient-expenditure-during-the-energy-transition-topic-paper-14-June-2023.pdf (comcom.govt.nz), Section 3.230.2

[3] Methanex-Submission-on-Gas-DPP3-draft-decision-15-March-2022.pdf (comcom.govt.nz) paragraph 9.(iv)

WACC PERCENTILE

Methanex supports the decision to change the WACC percentile from the 67th to the 50th percentile for GPBs.

Methanex's view is that deviating from the mean WACC percentile to address a perceived investment asymmetry is of dubious merit in general, as measuring the degree of asymmetry and determining the appropriate response is difficult. The primary drivers of asset integrity spend should be the quality standards and the consequent penalties for breaching these. For GPBs, the case for a percentile uplift is particularly weak, given it is based on analysis done for electricity distribution[4]

Methanex also observes that providing for both accelerated depreciation to address asset stranding risk and higher than mean WACC percentiles to stimulate investment is counter-intuitive and there is a risk of double-dipping on incentives for asset integrity spend. Moving the WACC percentile to the 50th percentile mitigates that risk.

ASSET STRANDING RISK

As discussed above, Methanex's view is that the Input Methodologies have not been applied in a manner that meets the long-term interests of the consumer because the risk of asset stranding has been inadequately assessed in DPP3. The Input Methodologies consultation does not take the opportunity to address how asset stranding risk should be evaluated in the future, for example:

- How to define the basis on which the phase-out of gas should be assumed. The complete phase-out of natural gas is neither a requirement of, nor consistent with, the 2050 net zero carbon target.[5]
- How the potential for alternative uses of the pipeline should be assessed. The Commission did not adequately consider the prospect of existing pipeline assets having an economic life beyond the phase-out of natural gas or transporting of alternative gases.
- In assessing asset stranding risk it appears the Commission focussed on the expected overall decline in gas demand and gave insufficient attention to the nature of demand for gas pipeline services among different customer types and geographic locations.

Compatibility with Net Zero Targets

In DPP3, pipeline asset life was shortened to reflect economic asset life rather than physical asset life. This was done to account for the current government's expectation that gas will be "phased out" to achieve the country's net zero targets[6] and to account for other factors that are putting pressure on gas demand[7]. However, the rate and degree of wind-down and the extent to which it constitutes an asset stranding risk is far from clear.

[4] Part-4-IM-Review-2023-Draft-decision-Cost-of-capital-topic-paper-14-June-2023.pdf (comcom.govt.nz), section 6.100

[5] Section 5Q of the Climate Change Response Act 2002

[6] DPPs-for-gas-pipeline-businesses-from-1-October-2022-Final-Reasons-Paper-31-May-2022.pdf (comcom.govt.nz), Section 3.2

[7] DPPs-for-gas-pipeline-businesses-from-1-October-2022-Final-Reasons-Paper-31-May-2022.pdf (comcom.govt.nz), Section 3.3

Methanex's operation and ability to decarbonise are important for the assessment of the future gas demand because Methanex has up to 60 PJ of gas demand across its three New Zealand plants that does not create emissions. This is because two thirds of Methanex's gas demand is required as physical input (or feedstock) in the manufacture of methanol which is exported. Only one third of the gas Methanex buys in New Zealand is used for process heat.

In its advice that informed the current Emissions Reduction Plan, the Climate Change Commission saw continued fossil gas production, excluding Methanex's demand, of 20-25 PJ in 2050. Since then the government has clearly signalled that New Zealand will not "decarbonise through de-industrialisation"[8] and the Climate Change Commission's draft advice recommended additional help for businesses like Methanex to decarbonise.[9]

Methanex's feedstock demand (as opposed to process heat demand) in addition to the Climate Change Commission's estimate for gas required by other sectors in 2050 gives potential gas demand of 80-85PJ. With possible demand at that level, it is far from clear there is a long-term stranding risk and even less so for the Gas Transmission Assets that Methanex uses.

Supply-induced asset stranding is also a theoretical risk. However, gas has been "running out" for approximately twenty years (since the Maui reserve write-downs in the early 2000s) and the upstream industry has been able to consistently develop reserves beyond short-term expectations. Current barriers to investment in the upstream gas industry are to some extent political and may not endure as gas is the best available alternative to provide additional low emission energy security to the electricity sector.[10]

Alternative Pipeline Uses

Methanex understands that the Commerce Commission sees that Part 4 of the Act does not allow consideration of alternative gases in the scope of regulated pipeline services. While this is an unfortunate, and presumably unintentional, quirk of the Act, Methanex assumes that this will be remedied in the not-too-distant future given the ongoing work being done by the country's largest gas pipeline owner to bring both biogas and hydrogen into the pipeline[11], existing developments being bought onstream[12] and the untapped biogas[13] and hydrogen[14] potential in New Zealand.

The danger Methanex sees is that the emergence of alternative gases that would otherwise sustain pipeline assets beyond 2050 will be forestalled. This is because pipeline connection costs can be significant and increased costs will make new renewable gas developments less viable. Increasing barriers to the development of alternative gases at a time when the decarbonisation of gas is being pursued and encouraged is counter-productive.

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[8] Decarbonise, don't de-industrialise – Woods | BusinessNZ Energy Council (bec.org.nz)
[9] CCC4940_Draft-ERP-Advice-2023-P02-V02-web.pdf (climatecommission.govt.nz), see proposed recommendation 14
[10] National confirms end to offshore oil and gas ban if elected in 2023 | Stuff.co.nz
[11] Gas is Changing | Firstgas Group
[12] Projects — Ecogas
13 Biogas and Biomethane in New Zealand Report | Beca
[14] Firstgas-Group_Hydrogen-Feasibility-Study-Summary_A4_web.pdf

Gas Quantities and Pipeline Revenue

In early 2022, Methanex highlighted that the quantity of gas transported is not the only driver of pipeline revenue and, even if gas demand was to be relatively low compared with current levels, that would not translate to a commensurate reduction in feasible pipeline revenues[15] This is because the number of pipeline interconnections is also a strong driver of pipeline revenue allocation.

The IM consultation does not discuss the basis on which asset stranding risk should be quantified. Methanex has previously suggested that the appropriate analysis would include:

- Multiple sensitivity analyses of future feasible pipeline revenues to inform the commission's view on the levels of gas use, and end users (types and quantities) are supportable before tariffs become unsustainable.
- An assessment of the "willingness to pay" of different user segments as input to establishing the risk faced by pipeline owners.
- Price elasticity assessments for pipeline tariffs; accelerating allowable pipeline revenues now may have the perverse and unintended outcome of accelerating the decline of the underlying revenue base, increasing the risk of a premature stranding event actually occurring.

CONSEQUENCE

Methanex operates in a competitive global market for a bulk chemical product where maintaining sufficient margins requires tight control of costs. Competitively priced gas, including delivery costs, is essential to maintaining such competitiveness.

Since the DPP3 came into effect Methanex has been exposed to pipeline tariff cost increases of over 10% in 2022 and more than 30% in 2023. This, combined with other regulatory imposed costs (e.g. ETS costs), means that the proposed changes will make Methanex NZ's operations less competitive globally.

SUMMARY

Methanex supports the decision not to pursue the changes to the Input Methodologies for GTBs canvassed in the Input Methodologies Review as the current approach is sufficient.

Methanex supports the decision to change the WACC percentile from the 67^{th} to the 50^{th} percentile for GPBs.

Methanex suggests that the methodology, process, and analysis that will be used for assessing asset stranding risks warrants further discussion and consultation. Particularly in relation to the:

- The longevity of gas supply and demand
- The potential for re-use of pipelines with alternative gases
- The modelling of pipeline revenues.

The changes in settings following DPP3 have reduced the competitiveness of Methanex NZ compared to global comparators. While Methanex appreciates the work the Commission has undertaken to

[15] Methanex-Submission-on-Gas-DPP3-draft-decision-15-March-2022.pdf (comcom.govt.nz), paragraph 27

assess pipeline asset stranding risk, there is an opportunity to deepen that assessment and avoid the risk of unnecessarily undermining the competitiveness of NZ industrial consumers.

Methanex would be happy to discuss any of the matters raised in this letter should that be of interest to the Commission.

Yours sincerely,

[redacted]

Stuart McCall
Managing Director