Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
Commerce Commission

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Dear Keston

Re: Input Methodologies Review: Form of Control

1 Introduction

First State Investments (FSI) is pleased to make this submission on the Commerce Commission's (Commission) review of the Input Methodologies (IMs) related to the form of control for gas pipelines.

We welcome the Commission's emerging view that gas transmission businesses (GTBs) should be subject to a 'pure' revenue cap, and reiterate our view that a weighted average price cap (WAPC) continues to be appropriate for gas distribution businesses (GDBs).

We discuss GTBs and GDBs respectively in the sections below. FSI intends to submit separately on the implications of form of control on the DPP in submissions on the DPP reset, as requested by the Commission.[1]

2 Gas Transmission

We support the Commission's emerging view that a pure revenue cap for GTBs with wash-ups of over and under recovery will better support the purpose of Part 4 of the Commerce Act 1986 (the long-term interest of consumers). GTBs cannot influence demand, so it is more appropriate to retain the existing approach of a revenue cap.

We also agree with the Commission that the existing approach should be improved by moving to the use of actual quantities to assess compliance. While using lagged quantities has provided GTBs with greater compliance certainty:

- It has unintentionally exposed GTBs to the financial consequences of demand risk they cannot influence

[1] Commerce Commission 'Default Price-Quality Paths for Gas Pipeline Services From 1 October 2017: Process and Issues Paper' 29 February 2015.

- It risks obstructing efficient convergence of gas pipeline operating codes, including the introduction of more efficient pricing structures (which the Commission cites as a key reason for its emerging view that EDBs should be under a pure revenue cap)[2]
- The benefit of compliance certainty will also be achieved through a pure revenue cap.

The form of control for GTBs should be specified in the input methodologies

Given that the primary rationale for the revenue cap is the inability of GTBs to influence demand, we encourage the Commission to specify the pure revenue cap for GTBs in the IMs. We do not see remaining value in the current approach of basing form of control on criteria that are secondary to the main point that GTBs cannot influence demand. The current criteria are:

- Whether a pipeline is under common carriage or contract carriage
- The extent of non-standard customer arrangements.

While our input into the code convergence process is in its early stages, we see both of these items as squarely within that workstream (led by the Gas Industry Company). Retaining these criteria in the IMs therefore risks creating barriers to making decisions that best suit operating code requirements. The criteria themselves may also be rendered unsuitable by code convergence.

The Commission does not state an emerging view on whether the IMs should allow for a choice of form of control in the DPP, but with the Commission's primary emerging view being to place GTBs under a pure revenue cap, stating this choice in the IMs seems to reduce certainty in the regulatory framework (consistent with section 52R of the Act). Enhancing regulatory certainty is particularly significant to promoting efficient evolution and convergence of the operating codes on the transmission systems. We welcome the Commission's appreciation of the link between the form of control and facilitation of the GIC's work on this matter.

3 Gas Distribution

A weighted average price cap for GDBs continues to be the form of control that best promotes the purpose of Part 4. While we recognise that certain factors have led the Commission to develop the emerging view of a revenue cap for EDBs, this rationale does not justify a similar move for GDBs.

GDBs want to bear demand risk because they can influence it

As the Commission states, a key reason for choosing a WAPC over a revenue cap is where the regulated business is able to influence demand because it incentivises the efficient management of demand risk.[3] GDBs may differ from GTBs in that they have more influence over demand and more comfort with the risk associated with forecasting demand in a DPP

[2] Discussed in Commerce Commission 'Input Methodologies Review: Emerging Views on Form of Control', 29 February 2016 at para 24.2.

[3] Discussed in Commerce Commission 'Input Methodologies Review: Emerging Views on Form of Control', 29 February 2016 at Attachment 1.

reset process.

We see potential to grow the use of gas transported through distribution systems. Residential and commercial end-users together contribute less than 8 percent of total gas consumption.[4] The fact that Powerco and FSI (and Vector in the past)[5] have expressed a preference to manage demand risk—and have consistently held this position—itself suggests that a WAPC is appropriate. GDBs want to bear this risk so that they are incentivised to grow the use of gas and be exposed to the commercial value of doing so. The benefits of managing demand risk come through greater utilisation of shared network assets, with these benefits then regularly passed on to consumers through resets to the DPP.

The factors driving the Commission's emerging view for EDBs do not justify a revenue cap for GDBs

The Commission has asked for feedback on the applicability of the Commission's rationale for moving EDBs to a revenue cap to GDBs. Those factors are:[6]

- **The ability to set constant price revenue growth forecasts.** While there is always uncertainty in demand forecasts, the key is to ensure that regulatory forecasts are not systematically biased one way or another. We also consider that forecasts should be set on a "business as usual" basis (for example, not assuming new or innovative marketing or pricing practices on the part of gas distributors or retailers). We are confident that by engaging with the Commission and providing information, that forecasts will be fit for purpose. Once the forecast is set, GDBs will then have strong incentives to beat that forecast by promoting gas as a fuel of choice
- **Facilitating efficient pricing structures/levels.** We do not see a WAPC being a barrier to efficient pricing in the same way as was argued for EDBs. For example, the ability to store gas through the line pack of distribution networks means that introducing peak charging signals is less valuable in gas than electricity. As noted above, we intend to focus our efforts to improve the pricing efficiency on gas transmission services through the code convergence process
- **Incentivising businesses to win new connections.** Central to our submission is that a revenue cap would remove the incentive on GDBs to win new connections. Given that gas is a fuel of choice, a WAPC is better than a revenue cap at promoting efficient use of the gas distribution capacity that exists.

The further reason why a revenue cap was favoured for EDBs was to incentivise EDBs to promote energy efficiency and demand-side management initiatives.[7] As noted by the Commission, this rationale does not apply to GDBs.[8]

The Commission has also asked for feedback on whether any WAPC for GDBs should use lagged or unlagged quantities for the purposes of assessing compliance. For consistency with transmission, we think unlagged quantities should be used. This achieves the regulatory

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[4] Ministry of Business, Innovation and Employment 'Energy in New Zealand – 2015' at p.36, accessible at this link.

[5] Vector 'Submission on the Commerce Commission's Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper' 27 May 2011 at para 5, accessible at this link.

[6] Commerce Commission 'Input Methodologies Review: Emerging Views on Form of Control', 29 February 2016 at p.6.

[7] Discussed in Commerce Commission 'Input Methodologies Review: Emerging Views on Form of Control', 29 February 2016 at para 24.3.

[8] Commerce Commission 'Input Methodologies Review: Emerging Views on Form of Control', 29 February 2016 at Attachment 2.

intent of providing compliance certainty to regulated business, while also ensuring that GDBs are exposed to risks they can manage.

4 Conclusion

Thank you for the opportunity to make this submission. We look forward to continuing our engagement with the Commission on developing and applying the regulatory settings for gas pipelines in New Zealand.

Yours sincerely

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