A RESPONSIBLE CARE® COMPANY

Level 3, 36 Kitchener Street
PO Box 4299, Shortland Street – 1140
Auckland, New Zealand

T: (09) 356 9300
F: (06) 356 9301

4 August 2016

Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
Commerce Commission
PO Box 2351, Wellington 6140

By email: im.review@comcom.govt.nz

INPUT METHODOLOGIES REVIEW AND GAS DPP CONSULTATION

SUBMISSION BY METHANEX NEW ZEALAND LIMITED

Methanex New Zealand welcomes the opportunity to make a submission to the Commerce Commission on the package of information supplied as part of the Input Methodologies (IM) review in regard to gas pipeline regulation.

Methanex operates two methanol production facilities located at Waitara Valley and Motunui in the Taranaki region. We consume natural gas as a feedstock to produce methanol and as a fuel source to supply energy to our plant. We are the largest consumer of gas in New Zealand and when operating at capacity our gas demand exceeds 90 PJ per annum, or nearly half of all gas produced in New Zealand.

All New Zealand's operational gas fields are located in the Taranaki region, from the Kupe and Maui fields located off the coast of south Taranaki to the Pohokura, Mangahewa, Turangi and Kowhai fields in the north of the region, all of which are located in close proximity to our plant.

We take a significant quantity of the gas we require through direct pipelines connected to nearby gas fields. We also make use of the 70 km section of the Maui Pipeline running between Oaonui in the south and northernmost gas injection points at Tikorangi and Turangi (both of which are located a short distance north of our plants).

Methanex does not make any use of gas distribution pipelines nor does it make use of the Vector gas transmission system. Consequently, the focus of our submission concerns the regulation of gas transmission businesses (GTBs) and specifically the Maui Pipeline, now owned by First Gas Limited.

In respect to the matters being addressed by the Commerce Commission, we have four broad objectives:

1. To ensure regulated revenues are set at an efficient level and do not provide for excess profits to be earned.

2. To ensure that capital and operating costs are not allocated to customers who do not benefit from the expenditures.

3. To ensure incremental capital expenditures are made only as needed to assure the integrity of the transmission network. Network expansion projects should only occur where there is a clear economic case and existing pipeline users are not exposed to cross-subsidisation or the allocation of costs for which they do not derive a benefit.

4. To ensure regulations minimise the risk of adverse commercial and operational impacts on users of the Maui Pipeline arising from integration of the Maui Pipeline and Vector gas transmission businesses under a single owner and the potential convergence of the Maui Pipeline and Vector operating codes.

Key submission points

In summary, Methanex:

- Supports asset valuation and treatment of taxation methodologies that ensure GTBs regulatory asset base (RAB) and tax RAB reflect the regulated value established prior to any asset transaction.

- Supports the draft decision to align the asset beta for gas pipeline businesses (GPBs) to the electricity asset beta.

- Supports the draft decision to change the leverage value to 41%.

- Considers that a pure revenue cap is an appropriate form of control for GTBs when combined with equitable wash-up mechanisms.

- Considers that the pure revenue cap approach should be accompanied by strengthened cost allocation requirements and pricing principles that will ensure GTB customers, collectively and individually, do not pay for assets or expenditures that do not benefit them.

- Considers that regulations should ensure that there is no prospect for cross-subsidisation of expenditures between the transmission and distribution activities of First Gas, nor between the separate Vector and Maui Pipeline transmission pipeline networks that First Gas has acquired.

- Recommends that an additional pricing principle should be added to the gas transmission IMs which requires that costs allocated to each customer reflect the cost of the services supplied to that customer.

- Supports reducing the cost and complexity of customised price-quality path (CPP) applications, provided that there remains the appropriate level of scrutiny to ensure the outcomes continue to meet the core objectives of regulation.

- Considers that, for GTBs, contingent project reopeners may be appropriate for mid-sized replacement and renewal projects. This is subject to there being sufficient scrutiny of the expenditure to ensure it is reasonable and the project is justified. We consider that in circumstances where large, one-off, projects are contemplated, a CPP is likely to be the most suitable approach.

- Considers that if the Commission relies on GTBs own expenditure forecasts for setting the default price-quality path (DPP), GTBs should be required to consult on those forecasts with their customers in advance. GTBs should then be required to provide the results of this consultation to the Commission and demonstrate how the responses have influenced the expenditure forecasts.

Asset and tax asset valuation

The asset valuation IM requires that First Gas' regulated asset base is derived from the initial RABs of Vector and Maui Development Limited updated for additions, disposals, revaluations and lost and found asset adjustments. We consider this approach remains appropriate and outcomes should not be influenced by the recent acquisition of the underlying businesses by First Gas. A similar protection applies in the treatment of taxation IM, which ensures the regulatory tax asset value is also not adjusted to reflect the purchase price. To the extent, if any, that the acquisition value of the assets purchased by First Gas exceeds the RAB or tax RAB, those costs should not flow through into end-user prices.

Cost of capital

Methanex supports the draft decision to align the asset beta for GPBs to the electricity asset beta. Analysis by Dr Lally and the Commission indicates that GPBs do not have notably different systematic risk than electricity distributors or Transpower.[1] We agree with Dr Lally's commentary and the Commission's own view that variations in the difference between electricity and gas asset betas over time are more likely to reflect measurement error than any fundamental, identifiable and systematic difference between the services provided.[2]

We note the 2010 decision to apply the asset beta uplift was made largely on the strength of theoretical considerations rather than empirical evidence.[3] The 2013 merits appeal judgment placed considerably more weight on empirical evidence in reaching its conclusions than on theoretical assessments. Had the Commission placed more weight on the empirical evidence at the time, it may

[1] Dr Lally: "empirical evidence on the extent of any such beta differential is inconclusive", page 3 of *Review of WACC Issues*, 25 February 2016 (with more detail on pages 7-8). Commerce Commission: "In some periods the gas beta is higher than the electricity beta, but in other periods the electricity beta is higher than the gas beta", paragraph 384 of *Input Methodologies review draft decisions Topic Paper 4: Cost of capital issues*.

[2] Commerce Commission, ibid, paragraph 335.

[3] Commerce Commission, ibid, paragraph 334.

well have concluded not to apply an asset beta uplift to GPBs in 2010. We note the theoretical evidence identified by Dr Lally in support of the uplift in 2010 is no longer seen as compelling (largely due to the different regulatory status of the GPBs).[4] Given the lack of compelling empirical evidence to justify the uplift we support the Commission's recommendation.

We consider that the risk profiles of First Gas and Transpower look similar. Both have a small number of large customers and a larger number of distribution connections. Both are subject to a revenue cap (and the form of control is likely to become more consistent). Both might face challenges if their largest customers disconnected from their transmission systems. For most customers of both transmission businesses, especially the larger customers, the product supplied (natural gas or electricity) is not feasibly substitutable with another fuel.

We support the change in the leverage value to 41% on the basis that it reflects updated information.

Revenue cap, cost allocation and pricing principles

Methanex supports the adoption of a pure revenue cap if combined with appropriate wash-up mechanisms and increased scrutiny of expenditure forecasts. It should be accompanied by strengthened cost allocation requirements and pricing principles to ensure that, as far as is practicable, costs are allocated to customers proportionate to the benefit the particular customer derives from the underlying assets or expenditures.

Cost allocation

As owner of the Maui Pipeline and the Vector gas transmission pipeline, First Gas is a large company with a significant asset and revenue base. Consequently, it should have the resources necessary to apply a comprehensive cost allocation methodology and do so in a cost-effective manner.

As a customer of First Gas, but only in respect to use of the Maui Pipeline, Methanex seeks to ensure that there are sufficient measures to ensure that First Gas' costs are appropriately allocated between distribution and transmission activities, and between the Maui Pipeline and Vector transmission pipelines. In particular Methanex wishes to ensure that there are no mechanisms or features in the regulations that allow cross-subsidisation or allocation of costs to customers who do not derive a benefit from the source of those costs.

To achieve this outcome we support tightening of the rules regarding the use of proxy cost allocators. Causal allocators should be used wherever possible as they are more likely to ensure that costs are allocated appropriately. We believe that more onus should be placed upon GTBs to produce a comprehensive cost allocation methodology which minimises the need for proxy cost allocators. We consider that the current rules provide First Gas with considerable discretion in selecting between causal and proxy allocators, which creates a risk that certain customers may contribute to expenditures they do not benefit from.

It is not yet clear whether First Gas will seek to apply the avoidable cost allocation methodology (ACAM) or the accounting based allocation approach (ABAA) to allocate its costs between the gas distribution and gas transmission activities and any unregulated services it may provide. We consider

[4] Dr Lally: page 6 of *Review of WACC Issues*, 25 February 2016.

First Gas should apply the ABAA methodology as a general rule on the basis that this should give its customers greater confidence in the pricing outcomes that result from its allocation of costs.

Pricing principles

Pricing principles are an area of the IMs which the Commission has indicated that it will leave unchanged. Methanex submits that the Commission should look more closely at the role of pricing principles in meeting its regulatory objectives. The pricing principles focus on prices being 'subsidy-free' – i.e. between stand-alone cost and incremental cost. We recommend the principles are strengthened to ensure that within the boundaries of stand-alone and incremental cost, more stringency is applied to ensure that, as far as is practicable, asset values and costs are allocated to those parties that cause the asset value or cost to be incurred. We suggest this objective would be assisted by adding an additional pricing principle (which could be added to clause 2.5.2(1) of the Gas Transmission Services IM Determination):

> "To the extent practicable, prices are set for individual customers that reflect the direct costs of the services provided to that customer, plus a reasonable allocation of shared costs"

Changes to CPP requirements

Methanex supports changes that will reduce the cost and complexity of CPP applications as we see advantages in making CPPs more accessible for GTBs. However, this support comes with the proviso that there is a sufficient level of scrutiny by the Commission and customers to ensure that CPPs are appropriate, timely and customer-driven. There needs to be confidence among customers that proposed expenditures will only be permitted when it is clear that the benefits of the investment outweigh the costs and those costs are only attributed to the customers who benefit from the expenditure.

DPP and CPP relationship

The draft decisions provide for an increased set of reopeners that can apply to the DPP and some simplification of the CPP requirements. For the 2017 DPP reset for gas pipelines, we understand that the Commission plans to develop expenditure allowances that are based on suppliers' forecasts . We support the intent of bringing more rigour to the development and scrutiny of DPPs and at the same timing making CPPs more accessible and cost-effective. However, as an evolving policy we think it important to ensure that the lines between the application of, and methodologies applied to, DPPs and CPPs do not become blurred.

We note the draft decision that GTBs should not be able to apply for a contingent projects reopener as part of the DPP. We submit that for GTBs, which have lumpy capex profiles, contingent project reopeners may be appropriate for modestly-sized replacement and renewal projects. This is subject to there being sufficient scrutiny of the expenditure to ensure it is reasonable and the project is justified, which may be manageable within the DPP. The benefit would be increased scrutiny over projects that may not be large enough to justify a CPP but still represent a step-change in expenditure. We consider that in the event that large, one-off, projects are contemplated, a CPP approach remains a suitable basis.

Forthcoming expenditures

We believe it is entirely appropriate to provide mechanisms to incentivise GTBs to undertake remedial works where required to ensure the integrity of the pipeline network provided that those decisions are cost effective, timely and customer-driven.

However, one of the most important considerations for Methanex is to ensure that it does not bear costs associated with assets and expenditures for which it is not a beneficiary. To the extent that those works address issues located on the Vector transmission system or that are located on the Maui Pipeline to the north or south of the section of the pipeline that Methanex makes use of, we will derive no material benefit from those projects. Consequently, Methanex seeks to ensure that the IMs and associated regulations do not have the effect of enabling cross-subsidisation or allocation of expenditures to customers who do not derive a benefit from the underlying assets or expenditures.

Scrutiny of expenditure plans

We understand the Commission is currently carrying out an assessment of GPBs' Asset Management Plans (AMPs). The intention is to use the AMP forecasts as inputs to the price reset decisions due next year, provided the results of some assessments of the data demonstrates the forecasts can be relied upon.

We recommend that GTBs expenditure plans and demand forecasts are subject to review and consultation with customers prior to any determinations by the Commission. This will help ensure the final forecasts that are used in price setting are robust and reflect expenditures that GTB customers agree are prudent and efficient. GTB customers may have information that is useful to inform future investment needs and may be able to identify ways of reducing or deferring expenditure.[5]

Methanex supports GTBs providing their best expenditure forecasts for review and, subject to the results of review by the Commission and customers, these being relied upon for price setting. However, in respect to First Gas, it has not, as at the date of this submission circulated its draft AMP. Given our previous comments on ensuring that there is sufficient scrutiny by customers, we are concerned that when First Gas does provide its draft AMP it will leave insufficient time for customers to be able to adequately respond before final determinations are made by the Commission. Given that it is an extraordinary situation to have regulations under review at the same time as a major change in industry ownership structure is taking place we request that the Commerce Commission considers introducing further flexibility in its IM/DPP/CPP implementation process and timetable to enable sufficient time for First Gas to consult with customers on its AMP and for the Commission to give consideration to the customer feedback.

[5] We recognise this issue relates more to the gas DPP reset than to the IM review. However, we consider it would be useful to raise this issue now so the Commission has time to consider it before the policy paper consultation in September.

In closing, we would like to thank the Commission for its engagement with pipeline stakeholders and we look forward to further opportunities to make contributions to the ongoing development and implementation of GTB regulations.

Yours sincerely

Kevin Maloney
Managing Director
Methanex New Zealand Limited