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2022-27 DEFAULT PRICE-QUALITY PATH RESET FOR GAS PIPELINE BUSINESSES

Methanex thanks the Commerce Commission for providing an opportunity to respond to its Process and Issues Paper dated 4 August 2021 ("Issues Paper"), addressing the upcoming reset of default price-quality paths ("DPP reset") for gas pipeline businesses ("GPBs").

Methanex' use of regulated gas pipeline services is limited exclusively to transporting gas on the Maui Pipeline so our responses are focussed on those matters pertaining to Gas Transmission Business ("GTB") regulation and we have limited our responses where they relate to Gas Distribution Businesses ("GDBs"). We have however, sought to draw particular attention to issues that we consider need to be clearly differentiated in treatment between GDBs and the GTB.

1. The main themes of our submission are:

    (1) The DPP3 reset timeframe and process is not suited to consideration and incorporation of fundamental changes. The appropriate process for addressing such issues is the forthcoming Input Methodologies (IM) Review.

    (2) The DPP mechanism as a generic, low-cost approach to price-quality regulation is not suited to addressing complex, uncertain or emerging issues, or particular issues that may affect a specific pipeline business, that would be best addressed by way of a Customised Price-Quality Path (CPP).[1]

    (3) Substantial amendments to IMs are best considered as part of a comprehensive, periodic review that enables all IMs to be thoroughly considered as a complete and integrated package of measures. To the extent that specific pipeline businesses consider that their particular circumstances require application of new or amended IMs then they can apply for a CPP at any time after the IM Review and avoid the need to wait until the next DPP reset to take advantage of any changes made as a result of the IM Review.

    (4) Notwithstanding (1) to (3), the urgency or exceptional circumstances that might warrant significant changes to the DPP3 settings or reset approach are not evident, at least in terms of Gas Transportation Business ("GTB") settings. We accept that the range of matters raised in the Process and Issues Paper warrants further consideration which can be more appropriately addressed during the forthcoming IM Review.

    (5) This leads to our final point that a differentiated approach to DPP3 settings may need to be considered. In particular, there may be issues emerging in respect of the GDBs that

[1] *As discussed by the Commission in Paras 2.8-2.10 and 4.6 of the Issues Paper*

warrant addressing during DPP3, but deviating significantly from a business-as-usual approach in regard to the DPP3 settings for the GTB does not appear to be justified.

2. We have divided our comments into five topics:

   (i) **The risk of network stranding,** particularly in the context of DPP3 settings.
   (ii) Addressing **short-run demand uncertainty during DPP3**, which we contrast from the longer-term stranding issue.
   (iii) The prospect of **amendments to IMs** for incorporation in the DPP3 reset.
   (iv) **Rollover versus reset** as alternative options for setting starting prices.
   (v) Consideration of **shortened asset lives and ex-ante allowances** as alternative measures for application in DPP3.

3. Our views in summary are:

   (i) **Economic network stranding risks facing** GPBs have increased to some extent with policy decisions made to transition away from fossil gas use in the long term. However, we consider that the scale of risk and anticipated timeframes for network stranding have been exaggerated in calls made for urgent or significant changes to be incorporated into DPP3 settings. We do not consider there is evidence to suggest the increase in stranding risk is of a sufficient scale nor do we believe that the timeframe for potential economic stranding to occur is such that the issue needs to be addressed with urgency as part of the DPP3 reset. We agree that stranding risks affecting gas pipeline businesses warrant further evaluation but this must be done in a measured and careful manner which would include consideration as part of the forthcoming IM Review.

   (ii) In regard to increased **uncertainty in forecasting gas demand and projected profitability** within the next regulatory period, we also believe that the risks have been exaggerated, at least in the case of the risks facing the GTB and its consumers during DPP3. We accept that issues affecting GDBs and their consumers in this regard may be more significant.

   (iii) We do not believe that changes to DPP3 settings that require **substantial or fundamental changes to IMs** is a feasible proposition in the timeframe and context of a DPP reset.

   (iv) We are unconvinced that a **rollover of starting prices** is justified:

      (a) We do not consider it to be an appropriate device for compensation for the impacts of increased network stranding risk.

      (b) It is also not necessary as a means of compensating for increased demand uncertainty facing the GTB during DPP3:

         1. under the revenue cap form of control the GTB is substantially insulated from demand shocks within a regulatory period, those risks fall on consumers facing increased tariffs; and

         2. the 'business-as-usual' ("BAU") revenue impact for the GTB arising from potential demand shocks that might occur in DPP3 (and by extension the subsequent impact on tariffs faced by consumers) is itself exaggerated.

(v) **Shortening asset lives or ex ante allowances:** should a sufficient case be ultimately made to address network stranding, then one of these measures might prove to be justified provided that sufficient analysis and consideration was given. Our view is these, or any other measures for that matter require the level of analysis and evidence that the Commission has not so far provided and which we consider would be infeasible to address within the scope and timeframe of the DPP3 reset.

NETWORK STRANDING RISK

4. In our assessment of the prospects for future network stranding risks facing GPBs we have relied on gas demand forecasts used by the Climate Change Commission ("CCC") in its analysis undertaken to support its advice to the Government.[2]

   In all of its scenarios, the CCC has forecast that considerable remaining natural gas demand will persist into the late 2030s with natural gas demand of between 73 and 87 PJ in 2039 depending on scenario. When giving reasonable consideration to the prospect of future network stranding under a 'wind-down' scenario, and also disregarding the possible emergence of 're-purposing' revenues, the decline in natural gas demand out to end of the 2030s is insufficient to trigger an economic stranding event affecting the GTB. Pipeline tariffs may increase substantially over that time but are unlikely to reach a level by the late 2030s that would imply an imminent 'death spiral' effect. Again setting aside the prospects for re-purposing of the gas pipeline network to provide new sources of revenue over the next two decades, the evidence does not support a network stranding event occurring on the gas transmission system until well into the 2040s.

5. Before considering measures to address stranding risks in a 'wind-down' scenario, the Commission should also consider that the extended timeframes involved for the decline in natural gas demand increases the prospect that 're-purposing' will provide additional new revenues to support long-term financial capital maintenance in time to head off a fossil gas driven stranding event. Over-reaction now to the risk of network stranding threatens to lock-in excessive long-term profitability for suppliers as well as raising the prospect of unjustified wealth transfers from existing consumers to future consumers.

6. With a gradual rate of decline in natural gas demand and an emerging view that hydrogen in particular will become an important and necessary future fuel for some 'hard to transition' applications, we would expect a re-purposing scenario to be given significant weight as a future outcome. Biogas also provides a further re-purposing opportunity, estimated in a recent report at being able to contribute up to 20 PJ/year, as a like-for-like alternative to fossil natural gas.[3] We note that First Gas is sufficiently optimistic that hydrogen and biogas will be viable alternatives to fossil natural gas that it has requested an innovation allowance to support re-purposing its network.[4]

7. In summary, it is our view that the network stranding risk affecting gas pipeline businesses has been exaggerated in terms of scale and timeframes, as well as in terms of the urgency for it to

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[2] *We have used the data sets provided in support of the CCC's final advice to government and published on its website ("ENZ scenarios for 2021 final advice")*

[3] *"Biogas and biomethane in New Zealand", report of a joint study undertaken by Beca, Firstgas and Fonterra, page 4, release date 6 July 2021, report available at https://www.beca.com*

[4] *Firstgas response to open letter on fit for purpose regulation dated 28 May 2021, Table 1 and page 14.*

be addressed by incorporating fast-tracked mechanisms into the DPP3 reset. We believe that the argument to compensate for stranding risk during DPP3 is not supported with evidence. Further consideration by the Commission is necessary to determine the likely scale and timeframes associated with the increased risk as well as the appropriate level of compensation needed before conclusions can start to be drawn and decisions made on the particular measures to be taken.

ADDRESSING DEMAND UNCERTAINTY WITHIN DPP3

8. We recognise that there is uncertainty over gas demand for power generation during DPP3 that principally results from uncertainties concerning the future operation of the aluminium smelter and the prospect for a step-reduction in demand for gas-fired generation if the aluminium smelter closes during DPP3.

   However, closure of the smelter is not a certainty and given the efforts being made by Meridian to find alternative bulk power consumers the prospect of surplus South Island electricity causing a significant reduction in gas-fired generation during DPP3 is not a given.

   In any event we consider the actual revenue/tariff impact faced by the GTB or its consumers during DPP3 arising from a step-reduction in demand, should it occur, would be relatively modest on the basis that gas-fired power generators make up a proportionately smaller contribution to GTB revenue on a $/GJ basis than typical pipeline users. The pass-through tariff impact would thus be proportionately less than the % reduction in gas demand. In addition based on the CCC's forecasts, gas demand for power generation is expected to partially recover in subsequent years to meet increasing electricity demand even if there were to be a step-reduction.

AMENDING INPUT METHODOLOGIES

9. We wish to reinforce the Commission's findings referred to in Item 3.16 of the Issues Paper:

   (i) There are fundamental constraints to making fast-tracked amendments of specific IMs or introducing new IMs within the scope of the DPP3 reset; and
   (ii) The timing of upcoming Government decisions on emissions budgets and emission reduction plans further constrains the time available to properly consider amended or new IMs during the DPP3 reset process.

10. We disagree with the Commission's view of <u>exceptional circumstances</u>[5] prevailing at this time in general terms, and in particular as far as they relate to the GTB, to justify significant changes in approach, or substantial amendments to IMs for incorporation into DPP3.

11. In respect of the issues at hand and the prospect of fast-tracking IM amendments under Section 52X to address them, we consider it to be unfeasible to make substantial changes to IMs within the timeframe for the DPP3 reset and at the same time reasonably comply with Section 52V or 52T(2), or to reasonably demonstrate that the requirements of Section 52A are furthered in respect of those amendments.

[5] *Paras 2.34, 3.17 and 3.66, and Table X1*

ROLLOVER AS AN OPTION

12. We have made our comments regarding use of the rollover option provided for in Section 53P(2) on the basis that the main motivation of the Commission for proposing it appears to be to provide a higher level of revenue/price to GPBs than would be the case with a normal reset, as a form of additional compensation for increased risks faced by GPBs, be those risks related to network stranding or shorter-term demand uncertainties.[6]

13. We do not consider that applying a rollover of starting prices as a mechanism for providing additional revenue to pipeline businesses is a justifiable proposition, particularly in terms of satisfying Section 52A requirements.

    - There is no clarity as to the amount of additional revenues that would accrue to GPBs from a rollover as compared to a reset; and

    - There is no evaluation as to what would constitute a reasonable and appropriate level of compensation that would mitigate each of the increased risks faced by GPBs, or indeed align with the scale of those risks, while at the same time reasonably limiting the prospect of excessive profits.

As a compensation mechanism to address increased network stranding risk

14. The Commission has stated that it is considering rollover as a tool to generate higher starting prices than would occur under a reset approach in order to compensate GPBs for the increased risk of network stranding they face, in part as a means of avoiding the need for fundamental changes to IMs.[7]

15. Firstly, we reiterate our view that the risk of network stranding for the GTB has been exaggerated and does not require urgent action in the DPP3 reset in any event, whether by way of rollover or other alternatives.

16. We consider using rollover to provide additional compensation to address network stranding risk[8] is not justified for the following reasons:

- The network stranding risk has not been adequately evaluated.
- The level of increased compensation derived from rollover has not been evaluated.
- Urgency for providing additional compensation in DPP3 has not been established that might otherwise justify immediate action and possibly leave rollover as the only practicable option.

As a response to increased uncertainty

17. The Commission has noted that it considers it will be challenging to accurately project profitability given increased uncertainty[9] and has suggested using rollover to give better effect to Section 52A in this regard.[10]

[6] *Including Para X15, D28*
[7] *Para 5.13*
[8] *Para X21*
[9] *Para X12 and 5.6*
[10] *Paras 3.57*

18. We do not believe there has been a case made for compensation being needed to address the issue of increased uncertainty in respect of the GTB's DPP3 settings. We consider that rollover, if applied to address demand uncertainty in DPP3, would serve essentially as an ex ante allowance of significant but indeterminate value made to compensate for a scenario that may not actually eventuate.

SHORTENING ASSET LIVES OR EX ANTE ALLOWANCES

Shortening Asset Lives

19. As a consequence of the 2016 IM Review, the risk of partial capital recovery faced by EDBs was addressed by allowing electricity distribution businesses (EDBs) to apply for shorter asset lives but reasons were given at the time for not extending this provision to GPBs.

20. If the Commission were now to consider extending this provision to GPBs, we remain concerned that even if adopted in essentially a 'cut and paste' manner there are specific issues associated with application to GPBs that will not be able to be sufficiently addressed in the timeframe and context of the DPP3 reset, bearing in mind the decisions made in respect of allowing it for EDBs was as part of a thorough Section 52Y review process and were made to address a substantially different form of stranding risk facing EDBs.

21. We disagree with the proposal made by First Gas in its response to the Commission's Open Letter[11], to substantially modify the mechanism by:

    (i) Circumventing the application process; and
    (ii) Increasing the maximum allowable adjustment factor

22. **Regarding the merit of imposing a 15% cap on reduction in asset life for EDBs** – As part of the 2016 IM Review, the Commission made clear that the mechanism allowed for EDBs was intended to be limited as a *"precautionary and modest solution that is only aimed at partially mitigating the downside risk of network economic stranding, in the context of a DPP"*[12]. The Commission also made the point that in the absence of that limit, suppliers would have an incentive toward inefficient capital expenditures where *an "opex solution may be superior"*[13].

    The Commission then identified that a CPP application would be the appropriate mechanism for suppliers that considered DPP mechanisms as insufficient for their particular circumstances.[14]

23. In respect of the **"no application process for GPBs"** proposed by First Gas, we are unclear as to how this would be applied in a reasonable manner. We presume that First Gas is seeking an adjustment factor (set higher than the 15% capped level allowed for EDBs) to be fixed into DPP3 settings as essentially a 'no scrutiny or consent required' option for GPBs. This approach would subvert the Commission's ability to scrutinise the justification for shortening of asset lives on a case-by-case basis as well as satisfying the requirement for sufficient consultation with affected parties.

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[11] *Firstgas response to open letter on fit for purpose regulation dated 28 May 2021, page 8-9*

[12] *"Input methodologies review decisions - Topic paper 3: The future impact of emerging technologies in the energy sector", p38, Para 94.1*

[13] *ibid*

[14] *ibid*

Ex Ante Allowances

24. In respect of ex-ante allowances provided in Fibre Services regulations that might be applied in a similar manner for GPBs we have two primary concerns – sufficiency of analysis and comparability.

25. Substantial analysis appears to have been made in terms of evaluating the potential impact of network stranding on fibre businesses in terms of % chances of a stranding event occurring over a ten year time horizon and the % of the asset base affected[15]. This level of evaluation would be needed before contemplating it as a mechanism to address network stranding risk facing GPBs, which is unlikely to be feasible within the timeframe and context of a DPP reset. There is also a more fundamental discussion necessary – is the set of circumstances that define the network stranding risks facing fibre services comparable with or equivalent to the circumstances facing GPBs, that would provide guidance on whether this is an appropriate choice?

26. The principal conditions and risks faced by fibre services appear starkly different to those faced by GPBs. The fibre providers need sufficient incentive to invest heavily in building a new network with technologically exposed assets and at the same time have a mechanism to address the prospect of subsequent new and superior technologies suddenly rendering its selected asset choices obsolete or competitively threatened. This is not the same form of stranding risk faced by GPBs.

27. Consideration of the risk of network stranding in respect of fibre services has been framed around two scenarios:[16]

    (i) Sudden Death
    (ii) Exponential Decay

    Neither of these outcomes reflects the stranding risks faced by GPBs:

    - Sudden Death is not a reasonably feasible outcome for gas pipeline services where there is not an equivalently 'exposed' technological choice.

    - Exponential Decay does not align with the expected gas demand trend which indicates a moderated decline rate and a substantial gas tail persisting over the long term, together with the reasonable prospect of "re-purposing" assets preventing a "death spiral" event occurring when fossil gas demand does ultimately fade out.

28. In its consideration of ex ante allowances the Commission points to *"several positive impacts"*[17] but has only identified one example; of providing "*a strong incentive on suppliers to manage the risk of economic network stranding"*.[18] We don't believe this constitutes evidence of an advantage, particularly as the statement does not assess impacts in terms of Section 52A objectives, notably incentivising efficiency and limiting excessive profitability. In its next

[15] *"Fibre input methodologies: Main final decisions – reasons paper", which contains extensive analysis including systematic evaluation such as set out in Table 6.19 (p587)*
[16] *ibid, page 796*
[17] *Issues Paper D40*
[18] *Para D41*

statement the Commission recognises that modified incentives could lead to excessive compensation to suppliers.[19]

29. While an ex ante allowance might ultimately be proven to be the most efficient means of addressing network stranding risk for GPBs it first requires an appropriate level of analysis and consultation to have been undertaken, starting at a basic conceptual level before considering valuation, implementation and the necessary IM changes that would be required to give it effect. Consequently we believe that consideration of ex ante allowances as part of DPP3 settings is infeasible.

    We note that the Commission alludes to this in its subsequent statement that *"this would require fundamental changes to IMs that may be best considered within the broader context of the next IM review"*[20].

OTHER MATTERS

Whether or not exceptional circumstances prevail

30. We don't believe a sufficient case has been made to consider that exceptional circumstances exist at this time and disagree with the statement made by the Commission in that regard.[21] In this context we also wish to reinforce the Commission's statement that even were a case to be made for exceptional circumstances, *"it will not be generally appropriate to consider fundamental changes to the IMs as part of a section 52X amendments process."*[22]

31. Setting aside the generality of use of the term, in regard to specific instances that the Commission considers might qualify as an exceptional circumstance that it considers warrants an IM amendment outside of a Section 52Y review, it has identified only one specific case – the proposed change to the TAMRP.[23]

32. **Proposed changes to the tax-adjusted market risk premium ("TAMRP").** We believe that there may be a reasonable a case for making this change, but not because it represents an exceptional circumstance. It appears to simply be a matter of resolving an inconsistency (ie to the extent that TAMRP is an economy wide parameter that should be consistent across individual regulated sectors) and does not actually constitute a fundamental or substantial change to the IMs that would cause risks if contemplated under Section 52X while at same time it also appears to be consistent with Section 52A.

CLOSING REMARKS

Methanex wishes to thank the Commission for sharing its views and providing an opportunity for interested parties to provide feedback. We welcome further engagement on the DPP3 reset process and IM Review over the coming months. If the Commission wishes to make contact with Methanex regarding our submission please contact Ngaio Mārama (nmarama@methanex.com, or +64 27 455 6092).

[19] *Paras D40 and D41*
[20] *Para D42*
[21] *Para 3.17*
[22] *Para 2.33*
[23] *Para 2.34*

Yours sincerely

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