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Sent via email: regulation.branch@comcom.govt.nz

Dear Andy

Cross-submission: Resetting DPPs for gas pipeline businesses from 1 October 2022: Process and issues paper

This is First Gas Limited's (Firstgas) cross-submission on the Commerce Commission's (the Commission) consultation paper "*Resetting default price-quality paths for gas pipeline businesses from 1 October 2022: Process and Issues paper*". We are making this submission on behalf of our gas transmission business (GTB) and our gas distribution business (GDB).

Opening comments

Firstgas welcomes the opportunity to progress the process for resetting gas Default Price Quality Paths (DPP3) and the specific issues that the Commission should prioritise for this reset. We found the submissions from other parties useful in laying out the areas of consensus and points of difference between stakeholders. In this cross-submission, we assess these areas and provide our response.

We hope that the three expert reports[1] that we submitted in conjunction with Powerco and Vector have been helpful for the Commission and stakeholders to understand the issues currently facing regulated gas pipeline businesses (GPBs). We chose to submit these reports early in the DPP reset process to help inform a robust debate on the extent of change affecting the gas industry and the regulatory mechanisms that best help manage that change.

Areas of consensus on process and issues for DPP reset

We have identified several areas of consensus amongst submitters. These areas are primarily centred around the mechanics of the DPP reset and are discussed below.

Preference for setting prices based on current and projected profitability

Submitters expressed a preference for continuing to set prices based on the current and projected profitability of GPBs (a "building blocks" approach), rather than simply rolling over prices from the current regulatory period. Methanex stated that it is unconvinced that a rollover of starting prices for DPP3 is "*an appropriate device for compensation for the impacts of increased network stranding risk*" nor is it *"necessary as a means of compensating for increased demand uncertainty facing the GTB*

[1] Reports from Frontier Economics, Houston Kemp and Oxera, all published on the Commerce Commission website here: https://comcom.govt.nz/regulated-industries/gas-pipelines/gas-pipelines-price-quality-paths/gas-pipelines-default-price-quality-path/2022-2027-gas-default-price-quality-path?target=documents&root=260725

during DPP3".[2] As noted in our submission, we agree with Methanex that other regulatory mechanisms are better suited to addressing the impacts of stranding risk, such as accelerated depreciation or removing indexation of the Regulatory Asset Base (RAB).[3]

The Major Gas Users Group (MGUG) does not believe that "*forecasting four to five years ahead is any more problematic than it has been for the other regulatory periods*" and noted that GPBs are already factoring in the current policy uncertainty to their Asset Management Plan (AMP) forecasts.[4] We agree with MGUG on this point, and our submission highlighted how we have reviewed and adjusted the expenditure profiles presented in our 2021 AMP Updates, which included reductions in expected growth expenditure.[5]

While the Commission has outlined potential issues that will need to be addressed if expenditure allowances are based on current and projected profitability,[6] we do not believe that any of these issues are unsurmountable. The Commission will soon have all current expenditure information from GPBs 2021 AMPs / AMP Updates and has Information Disclosure (IDs) schedules for the current DPP regulatory control period up to FY2020.[7] We are also willing to progress our FY2021 IDs to be used for the final DPP reset decision so that the most up-to-date information is available to the Commission.

Support for a four-year regulatory control period

Many submitters outlined their support for the use of a four-year regulatory control period for DPP3, rather than the standard five years.[8] Nova considers the potential impact on gas demand from Government policy and the Climate Change Commission's (CCC) recommendations gives reason for limiting the term of the DPP3 to four years.[9] This point is echoed by MGUG who submit that the Commission should set a "*4-year path to counter the residual uncertainty in year 5"* and to act as *"mitigation to avoid a number of the other measures the Commission considered adopting",* including changes in form of control and price reopeners.[10]

We agree that adopting a four-year regulatory period for the next DPP is a pragmatic option given the uncertainty facing the sector. We also agree with MGUG that the length of the regulatory period only serves to limit the risk that regulatory settings deviate further from an optimal path over time. Therefore, we encourage the Commission not to see a four-year regulatory period as a reason to delay improving regulatory settings at this reset.

Current quality standards are fit for purpose

Several submitters[11] expressed the view that the current quality standards for both the GTB and GDBs are fit for purpose for DPP3. Other submitters did not discuss quality standards in their submission at all, which in our view reinforces the fact that this is not a priority area for this reset. We support the Commission retaining the current quality standards for this DPP reset.

A point that was highlighted in submissions is the importance of GPB expenditure to ensure security of gas supply and to enable the gas sector to support the electricity sector, as we transition to net zero by 2050. Mercury states that their "*primary interest in the resetting process is to ensure final decisions*

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[2] Page 2 of the Methanex submission.

[3] As discussed on pages 7 – 9, *Resetting DPPs for gas pipeline businesses from 1 October 2022:Process and issues paper*, Firstgas submission to the Commerce Commission, 30 August 2021, https://firstgas.co.nz/wp-content/uploads/Firstgas-submission_DPP-reset-issues-_-process-paper_Aug-2021.pdf

[4] Pages 2 – 3 of MGUG submission.

[5] Pages 5 -6, Firstgas submission.

[6] Attachment B, *Resetting DPPs for gas pipeline businesses from 1 October 2022: Process and issues paper*, Commerce Commission, 4 August 2021.

[7] FY2020 is the financial year/ gas year ending 30 September 2020.

[8] MGUG, GasNet, Nova, Firstgas.

[9] Page 1, Nova submission.

[10] Pages 2 and 4, MGUG submission.

[11] MGUG, GasNet, Powerco, Vector

help support the maintenance of, and ongoing investment in, a reliable and secure supply of gas."[12] MGUG highlighted "*a shift in the Government's attitude to gas in the last eight months - There is a greater appreciation that gas has an important role to play in the energy transition implying an acceptance that gas has a longer-term future in New Zealand".*[13]

We consider that these points support continued expenditure by GPBs to provide a safe and reliable gas supply to the many gas customers and business that will rely on this energy option in the short to at least medium-term. Stakeholders can also take comfort from the review of GPB risk management practices that the Commission released in 2019, which found that *"GPBs are approaching a best appropriate level of risk management based on the size and nature of the specific organisations, the services they provide, and the size and nature of the infrastructure that enables these services to be delivered"*.[14]

No strong call to change form of control

Submissions suggest limited desire to change the form of control for either GTBs and GDBs, and form of control did not appear to be a priority area for any submitters. MGUG considers the current forms of control for GDBs and GTB as fit for purpose for DPP3. MGUG also noted that for parties connected to the transmission system, revenue cap wash-ups haven't presented any significant prices shocks.[15]

We remain of the view that there is no pressing need to review the form of regulatory control that applies for DPP3, particularly given the limited time / resourcing available for this reset and the other more pressing issues that need to be debated and addressed (see sections below on level of uncertainty and when to act to address this uncertainty)

Areas of contention and debate

While agreement can be observed on the mechanics of the DPP reset, there are several points of difference between regulated businesses and stakeholders. These areas of contention relate to the true level of uncertainty facing GPBs, the need to act at this DPP reset (rather than leaving any change to later periods), and the most appropriate regulatory mechanisms to address any uncertainty. We discuss each of these areas below.

1. The true level of uncertainty facing GPBs

All parties seem to agree on the issues that are currently facing GPBs – New Zealand's legislated net zero target, the recommendations from the Climate Change Commission's (CCC) final report, the Government upcoming response to the CCC report (expected by December 2021), and the policy measures that will follow to meet our carbon budgets. Submitters also commented on the risks in the interlinkages between the gas and electricity sectors,[12] and supply issues in the upstream gas market.[16]

However, there is no agreement on the true level of uncertainty facing the gas sector, and whether the circumstances for DDP3 are really that different from the previous two resets. We set out quotes from submissions in the table below, which highlight the spectrum of views.

[12] Page 1, Mercury submission.
[13] Page 4, MGUG submission.
[14] Risk Management Review of Gas Pipeline Businesses (comcom.govt.nz)
[15] Page 2 and 5, MGUG submission.
[16] Page 1, Nova submission.

Table 1: Examples of views around level of uncertainty facing GPBs

High level of uncertainty facing GPBs	Uncertainty has been overstated
Greymouth Gas[17] *Greymouth considers that significant uncertainty exists in the New Zealand gas sector and future direction will be influenced by Government decisions on climate change policy.*	**Methanex**[18] "*…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 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*"
Mercury[12] *The Climate Change Commission has outlined in its advice, a decarbonisation pathway that would result in a decline in natural gas use alongside a potential role for low carbon gases. The Government will respond to the advice by 31 December 2021. This means the future of gas consumption is uncertain.*	**Major Gas Users Group**[19] *"While we agree that the medium to long term future of gas consumption is uncertain, we don't consider that the pathway for gas within the shorter timeframe for the next regulatory period (2022-2027) is subject to the same levels of uncertainty. We therefore submit that the Commission's perception of "significant uncertainty underpinning its further thoughts is overstated."*

We believe that the legal advice from Chapman Tripp (provided as part of Vector's submission) highlights the relevance of the 2050 target to the Commission's decisions for DPP3. It states that:

> *"…while the process and specific policies may be uncertain, the Government has already committed to achieving its 2050 targets…..Given the legislative commitment, for the purposes of the Commission's decision making the 2050 target is not uncertain, and nor is the development of an emissions reduction plan to achieve it"*
>
> *….In any event, there is sufficient information available for the Commission to conclude that policies are forthcoming that will affect suppliers' ability to recover capital."*[20]

This supports the Commission's own view that "*the background for this reset is a period of change and uncertainty*"[21], and until the Government provides its response to the CCC recommendations, the "*immediate future for the energy transition, particularly in the gas sector, is highly uncertain*."[22] We believe the evidence provided through submissions supports this view.

2. The need to act at this DPP reset

Whatever the true level of uncertainty facing the gas sector, parties hold very different views on whether action needs to be taken now or whether changes to the regulatory framework can wait until the Input Methodologies (IMs) review[23] and subsequent price-quality resets. Some submitters say that it is unlikely that aggregate gas demand will fall much before 2030 – i.e., "*it is unlikely that the demand for natural gas will be materially displaced before 2030 — well within the timeframes of this reset period*" (Nova). [24] This point is echoed by MGUG in the quote in Table 1 above.

To be clear, changes in gas demand over the next four or five years are not our primary concern for this reset. Rather, our concern is centred around whether there is sufficient gas demand after 2030 at

[17] Page 1, Greymouth Gas submission.
[18] Pages 3 – 4, Methanex submission
[19] Page 2, MGUG submission
[20] *The relationship between Section 52A of the Commerce Act 1986, FCM and the government's climate change response*, Chapman Tripp memo, 27 August 2021.
[21] Paragraph 3.6, Commerce Commission paper.
[22] Paragraph 3.14, Commerce Commission paper.
[23] Scheduled to be completed by December 2023.
[24] Page 1, Nova submission. A similar view is also held by MGUG.

acceptable prices that enable the recovery of the remaining asset values held by GPBs. As shown in the Frontier Economics report, there is approximately $1.8 billion in the current RAB.[25] Even without any further investment, there would still be $616 million of RAB unrecovered in 2050 under the current regulatory settings.[26]

The CEG report commissioned by Vector reinforces the need to act now, by modelling the relationship between the rate that capital is returned to investors, the expected cost of future asset stranding, and the compensation required for expected asset stranding. The report concludes that:

> *"If the window of opportunity to address stranding risk is missed, regulators may have no capacity to address the effects of stranding risk. If that is the case, then it is likely that at some future date there will be no chance to re-direct the recovery pathway*".[27]

In its submission, Nova outlines how "we can expect to learn much more about the potential for using the existing pipeline networks for transmission of renewable gases over the next five years". Therefore, it concludes that is appropriate to wait before making decisions. We agree that the gas sector will learn a lot, particularly about whether the production costs for biogas and hydrogen can compete with other zero carbon options. However, we do not believe that the current regulatory settings remain optimal in the meantime.

We agree with the view expressed by Greymouth Gas that the "*current regulatory regime for GPBs is fit for purpose for a gas sector only when there is a **stable long-term outlook***" [emphasis added]. Under either the "wind down" or "repurpose" scenarios discussed by the Gas Infrastructure Future Working Group (GIFWG) and the demand forecasts modelled by the CCC, the long-term outlook for GPBs could certainly not be characterised as stable. We believe that several 'no regrets' options are available in response.

3. Mechanisms that should be considered in the DPP3 reset

Given the debate around the significance of issues facing GPBs and the timing of any response required, it is not surprising that submitters have differing views on the mechanisms and IM amendments that are appropriate for DPP3.

Use of accelerated depreciation

Much of the discussion has focused on allowing accelerated depreciation to address increased risk of economic asset stranding. Firstgas supported the introduction of this regulatory tool in the 2016 IMs review, noting that it would be prudent to provide the same option to GPBs as is being provided to electricity distribution businesses (EDBs).[28] This continues to be one of our preferred approaches (alongside removing indexation of the RAB) to address the risk of asset stranding, and is supported by the new evidence provided in the three expert reports,[1] and the CEG report provided with Vector's submission.

We favour this regulatory tool as it is a Net Present Value (NPV) neutral solution – a factor the Commission favoured when it approved the use of accelerated depreciation for EDBs.[29] Nova, in its submission, noted that the Commission could consider "higher asset depreciation rates (shorter asset life), so long as the NPV for GPBs and consumers in neutral".[30] We also endorse the findings of the CEG report provided with Vector's submission, which recommends accelerated depreciation as a more appropriate tool to address the stranding risk facing by GPBs than ex ante compensation. CEG

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[25] Figure 3, Frontier Economics report.

[26] Across all GPBs, see paragraph 45, page 15, Frontier Economics report.

[27] Page 6, Competition Economics Group (report), provided with Vector's submission.

[28] Paragraph 101, page 582, *IM review - Final reasons papers*, Commerce Commission, 20 December 2016, https://comcom.govt.nz/__data/assets/pdf_file/0022/60529/Input-methodologies-review-decisions-Consolidated-reasons-papers-20-December-2016.pdf

[29] Paragraph 84, page 577, *IM review - Final reasons papers*, Commerce Commission, 20 December 2016.

[30] Page 2, Nova submission.

recommends that "*an ex-ante uplift should only be relied on if accelerated depreciation cannot fully eliminate stranding risk*."[31] This is consistent with points raised in our submission, where we note that it would be challenging to set this uplift (if it was the only tool to address asset stranding).

We have recommended that there be no application process for GPBs to seek accelerated depreciation,[32] and suggest that the adjustment factor for accelerated depreciation is set as part of the DPP reset. However, Methanex states it is:

> *"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 "*[33]

We disagree with this statement. We consider that any process to amend IMs must allow the opportunity for stakeholders to scrutinise and comment on the appropriate rate for accelerated depreciation. From our review of the decision paper from the 2016 IMs review, it is not clear why the use of an application process for EDBs was deemed necessary. This may have been because the risk of economic asset stranding hadn't materialised yet – although the Commission acknowledged a rapidly changing environment for EDBs due to new technologies. Those circumstances are very different from current situation facing GPBs, where uncertainty has arisen from our legislated net zero target and the policy measures required to achieve this outcome.

CPP not the tool to address sector-wide uncertainty

Methanex states that "*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*". [34] While the CPP regime is available to GPBs, we don't believe that it should be relied upon as the primary regulatory mechanism to address the current uncertainty. A CPP is intended to address the individual circumstances and needs of a supplier. The current uncertainty resulting from climate change policy will broadly impact all GPBs in a similar way and is therefore appropriate to be dealt with on an industry-wide basis through the DPP reset process.

Are there significant differences between transmission and distribution risks?

Methanex raises the question of whether the approach to DPP3 and the issues facing the gas transmission business are different to those facing gas distribution businesses. Methanex states 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 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…."*
>
> *"….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."*[34]

We disagree with Methanex on this point. The same underlying driver, New Zealand's legislated net zero target for 2050, applies to both gas transmission and distribution. Achieving this target is expected to fundamentally reshape demand for natural gas – regardless of how gas is transported.

To explore this issue further, we have analysed the CCC forecasts for natural gas demand by sector – to see whether the demand and revenue for sectors supplied by gas transmission have fundamentally

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[31] Page 6, CEG report.

[32] Pages 8 – 9, *Firstgas response to open letter on fit for purpose regulation*, submission to the Commerce Commission, 28 May 2021, https://firstgas.co.nz/wp-content/uploads/Firstgas-submission_ComCom-open-letter_28-May-2021_FINAL.pdf.

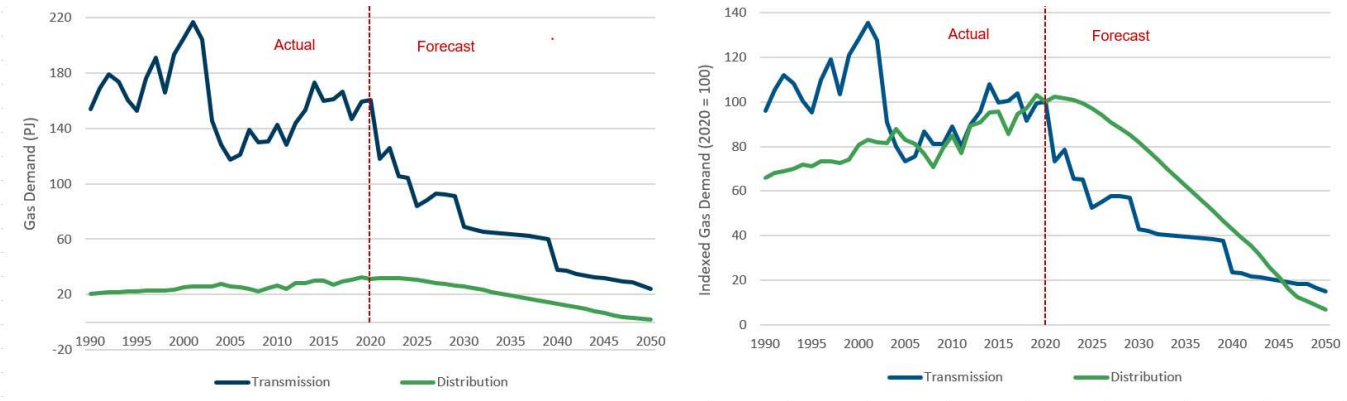
[33] Page 6, Methanex submission.

[34] Pages 1 – 2, Methanex submission.

different prospects than gas distribution. Carrying out this analysis has required us to make some general assumptions on the proportion of demand and revenue from each sector attributable to gas transmission and gas distribution. While these assumptions are broad and there are significant variances in pipeline usage and tariffs within different sectors, the assumptions are appropriate for the purposes of investigating whether economic asset stranding risks are materially different for gas transmission.

Figure 1 presents historic gas demand and the forecasts made by the CCC. The left-hand graph shows aggregate demand and the right-hand graph indexes past and future changes to a 2020 baseline (2020 demand = 100). The left-hand graph shows that over the last 30 years, sectors supplied by gas transmission have seen significant demand volatility – particularly due to year-on-year changes in petrochemical demand and electricity generation from gas. In contrast, gas distribution volumes have grown steadily over the past 30 years. The CCC forecasts substantial declines in the use of gas for sectors served by both transmission and distribution networks. The right-hand graph shows that the decline profile is steeper and earlier for transmission but ends up at less than 20% of current demand – slightly higher than proportionate use of gas distribution systems at that time.

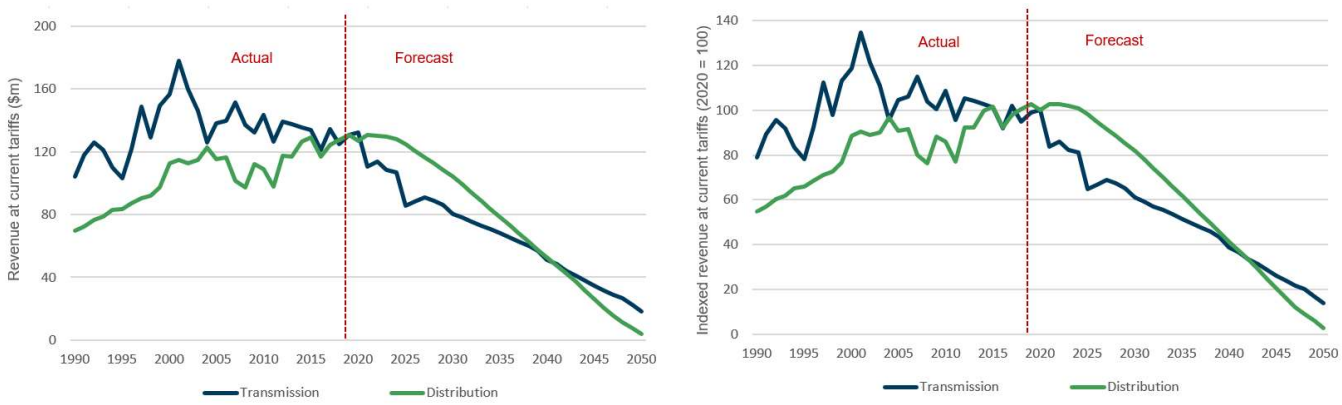
Figure 1: Climate Change Commission forecasts of gas demand by sector



We accept that the real determinant of asset stranding risk is future revenue, whereas the graphs above (and the analysis presented in submissions) focuses on demand. This effectively uses demand as a proxy for the ability of pipelines to generate sufficient revenue to recover capital. However, if users that currently pay higher pipeline tariffs (or are willing to pay higher tariffs) continue to use gas, then the risk of economic asset stranding will decrease.

We investigated whether focusing on revenue, rather than demand, might create a reason for thinking different about the regulation of gas transmission and distribution networks. Figure 2 below presents our results – obtained by simply multiplying the levels of demand shown above by average pipeline tariffs by sector. This shows that at current average tariffs (i.e., relatively high tariffs for residential and commercial users, and relatively low tariffs for petrochemicals and electricity generation), there is no obvious difference in the future revenue prospects for gas transmission and distribution. This is consistent with the fact that around half of the revenue earned by our GTB comes from demand supplied from distribution networks, clearly linking the prospects of these regulated networks.

Figure 2: Transmission and distribution revenue at current average pipeline tariffs by sector



An important caveat on this analysis is that it does not consider willingness to pay across different sectors. As we mentioned in our submission,[35] we expect GPBs to examine their pricing methodologies over the coming years to mitigate any loss of demand caused by increasing pipeline tariffs. What this analysis shows is that based on current tariffs, the challenge of capital recovery is equally significant for transmission pipelines as for distribution businesses.

Overall, this analysis shows that forecast trends in system utilisation and revenue are similar for GTBs and GDBs and do not justify a different regulatory approach at this DPP reset. A differentiated approach does not fit well in the context of DPPs, which are "*set in relatively low-cost way and are not intended to meet all the circumstances that a GPB may face*".[36] Taking a different approach to capital recovery for GTBs and GDBs at DPP3 would introduce complexity and cost, without any compelling rationale.

Call for early decision on approach to DPP reset

Given the broad range of points raised through submissions, we believe it is increasingly important that the Commission establish a clear direction for how it intends to progress the DPP3 reset (i.e., use of the building block approach versus a roll-over of DPP2 prices, which targeted IMs amendments will be consulted on). As outlined in our submission and others,[37] there is a relatively short timeframe for the Commission to determine its final decision. A formal decision on approach in October 2021 would enable the sector to focus its efforts and resources.

Given the range of views presented by submitters and new evidence presented as part of this consultation process, we believe workshops should be a key tool over the coming months as the Commission develops its draft decision. We believe workshops will be an effective way to debate the key topics for this reset and provide parties from all sides an opportunity to input on the discussion.

[35] Pages 6 – 7, Firstgas submission
[36] Paragraph 2.9.1, Commerce Commission consultation paper.
[37] Powerco and Vector submissions.

If you have any questions regarding this submission, please contact Karen Collins, Regulatory and Policy Manager, on 027 472 7798 or via email at karen.collins@firstgas.co.nz.

Yours sincerely

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