14 MARCH 2022: SUBMISSION TO THE COMMERCE COMMISSION REGARDING THE GAS DPP3 RESET

Entrust supports the Commission's focus on investment cost-recovery

Entrust supports the Commerce Commission (Commission) prioritising and addressing investment cost-recovery as part of the 2022 gas default price-quality path (DPP3) reset.

From a consumer perspective, it is important Gas Pipeline Businesses (GPBs) have confidence they will be able to recover their investments, even if demand declines (the Commission's "wind-down" scenario). GPBs need to be able to invest to protect the integrity of their networks and the services they provide, including asset replacement and safety expenditure. The further out cost recovery is left, the higher the risk of partial capital recovery.

We also consider that it would be better for consumers if cost recovery is front-loaded when the consumer base remains relatively large. This would help alleviate the risk of future price shocks. A smaller pool of consumers who are unable to transition away from gas could end up having to pay for sunk gas pipeline investments. The impact on consumers could be particularly acute if future prices rise due to increases in interest rates.

Submission Summary

- **The main focus should be on ensuring full investment cost recovery:** Entrust agrees the gas industry faces "exceptional circumstances"[1] and the risk GPBs will not be able to recover the cost of their investments is increasing.

- **Incentives to invest are still important for maintaining service quality and reliability for consumers:** From a consumer perspective, it is important to recognise GPBs need to be able to invest to protect the integrity of their networks and maintain the quality of services they provide to consumers. Not all types of capex will decline if demand declines e.g. expenditure to ensure network safety on an aging network.

- **Entrust supports the draft decision to adopt accelerated depreciation**. This will bring forward investment cost recovery and partly mitigate the risk GPBs won't be able to recover the costs of their investments in the future. A key judgement is whether the draft decision goes far enough in mitigating this risk. It is not clear the draft decision "address[es] most of the stranding risk in DPP3".

- **We are unsure of the logical coherency of bringing forward capital cost recovery through accelerated depreciation while retaining deferral of capital cost recovery through RAB indexing.** The current approach of RAB indexing, and use of a weighted average price cap (WAPC) can impact the cost recovery profile and

[1] Commerce Commission, Resetting default price-quality paths for gas pipeline businesses from 1 October 2022, Process and Issues paper, 4 August 2021.

GPB revenue recovery risk. If these matters are not addressed as part of the DPP3 reset determination, we support their consideration as part of the statutory review of the Input Methodologies (IMs).

- **Current low interest rates provide an opportunity to bring forward investment cost recovery, while avoiding "price shocks"** for consumers. This could help smooth prices over subsequent regulatory periods. Even though the Commission is proposing to allow prices to be increase they will still be about 25% lower in real terms than they were a decade ago.

- The Commission could adopt a more aggressive acceleration and/or removal of RAB indexing, and prices would still be low.

- **Decisions should be based on up-to-date information:** If the Commission caps the capex allowance based on historic expenditure Entrust supports the Commission's intention to use Vector's 2021 capex to determine its forecast.

- **Entrust supports update of TAMRP and debt issuance costs:** The draft decision to adopt changes to align WACC settings with its Chorus fibre price-quality regulation decisions should result in a more accurate estimate of the cost of capital.

Entrust's Submission

Entrust is sympathetic that one of the challenges the Commission faces is the publication of the Government's emissions budget coincides with the Commission's final DPP3 reset decision. This isn't ideal. This clash heightens the uncertainty under which the Commission must make its decisions. The draft decision to adopt a 4-year regulatory period will help to mitigate against this uncertainty.

There will be a clearer understanding of the Government's climate change policies when the IMs review is undertaken. By then, the Government should have finalised the emissions budgets and a related emissions reduction plan that will cover the period from 2022 to 2035.

The Government's climate change policies impact investment-cost recovery

The 2022 DPP reset is not 'business as usual'. As the Commission has recognised, "Climate change initiatives are already having an impact on the supply and demand for natural gas".

Entrust considers that having regard to the 2050 target and emissions reduction plan under section 5ZN of the Climate Change Response Act 2002 (CCRA) should help achieve the Part 4 Commerce Act purpose. The Government's climate change policies will impact "reasonable investor expectations" to recover prudent and efficient investments.[2]

It should be non-contentious one of the implications of the Government's climate change policies and transition to a low emissions economy is that recovery of sunk investments in gas networks could become increasingly difficult.

This means it is appropriate for the Commission to focus on making sure the DPP reset helps ensure GPBs can recover their capital investments. The best way to do this is to bring forward investment cost recovery while network utilisation is more certain. This can be done by accelerating depreciation (as proposed by the Commission) and removing inflation indexing of regulated assets (as Vector has proposed).

[2] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], paragraph [605].

Entrust supports the Commission's accelerated depreciation proposal

Entrust considers adoption of accelerated depreciation is an NPV neutral, no-regrets, option for the Commission to adopt, which would reduce the risk of partial capital recovery. The adoption of accelerated depreciation means GPBs would be able to recover the cost of their investments while demand is still strong. This would help mitigate the risk that if demand declines in the future, and consumers disconnect from gas supply, it will become increasing difficult to recover network investment costs.

Entrust agrees with Mercury that adoption of mechanisms such as accelerated depreciation will "ease concerns over the risk of partial capital recovery of long-life assets".[3]

This should help provide regulated suppliers in all industries, including electricity, gas and telecommunications (fibre), confidence to invest in the expectation they will be able to recover their prudent and efficient investment costs, and to ensure they provide services at a quality that consumers' can fairly expect meets their needs.

There is an opportunity to use low interest rates to help smooth prices beyond a single regulatory period

Entrust has previously submitted support for accelerated depreciation on the basis that it "is likely to provide an element of price smoothing where it is adopted during periods of low interest rates"[4] by increasing capital recovery at a time when network charges are suppressed. This is no different to a household paying off the mortgage faster when interest rates are low.

While the draft decision may result in price increases for current consumers, the Commission has noted it "will [also] provide headroom to manage future consumer price shocks as New Zealand moves to a low carbon economy". The price increases are relative to current prices rather than historic gas prices. To put the price increases into context it may be useful to compare them in real terms against the prices that were in place immediately before the start of the first price reset (DPP1).

Since the first price reset in 2012, Vector's gas prices have gone down by over 33% in real terms. Even though the Commission is proposing to allow prices to be increase they will still be about 25% lower than they were a decade ago.[5] This provides the Commission with considerable leeway to front-end capital cost recovery while keeping prices low. Consumers will still benefit from prices that are low by historic standards even if the Commission adopted a higher acceleration rate.

Vector made similar observation in relation to the last DPP reset: "Had the Commission not implemented its DPP[2] price changes, the current inflation inclusive annual distribution network charge for an Auckland residential user would be approximately $80 dollars more per annum than with the DPP price changes. Therefore, even with aggressive tilting of depreciation (including removing the deferred recovery of inflation) the annual Auckland residential charges could increase by less than what customers historically paid for their distribution network. This is what is needed in the current context".[6]

[3] Mercury, Resetting default price-quality paths for gas pipeline businesses from 1 October 2022.
[4] Entrust, Price-quality regulation settings need to ensure lines companies can invest, adapt and meet changing consumer needs, 18 July 2019.
[5] Based on price information provided by Vector.
[6] Vector, Gas Pipeline Business Reset, Resetting prices for 2022-2027 period.

No compelling reasons against accelerated depreciation have been provided

Entrust considers that there haven't been any compelling submissions against accelerated depreciation, or other mechanisms to bring forward investment cost-recovery:

- MGUG's inter-generational equity argument would be detrimental to the interests of a potentially smaller group of future consumers who have less ability to switch away from gas to other energy sources.

- MGUG also suggested bringing forward investment cost recovery could "hasten the outcome looking to be avoided". This argument contradicts MGUG's view that the risks to cost recovery are over-stated.[7]

- Nova questioned whether "the expected market changes or uncertainty over the period to October 2026 are sufficient to warrant assuming that gas volumes will reduce significantly over DPP3".[8] Methanex made similar arguments.[9] With respect, these arguments miss the point that bringing cost recovery forward reduces the difficulty of recovering the costs in future periods when demand may be less certain. It is the certainty about demand over the next four years which makes it attractive to bring forward cost-recovery.

- Methanex submitted that "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".[10] It is unclear what Methanex meant by an "over-reaction". Accelerated depreciation would be NPV neutral so could not result in excessive returns.

  Entrust agrees with the Commission that "if decarbonisation makes it unlikely that businesses will achieve financial capital maintenance (FCM) over the life of their assets, then allowing businesses to earn higher short-term revenues is unlikely to result in excessive profits".[11]

The approach of RAB indexing and use of a price cap can impact risk

Matters such as the current approach of RAB indexing and use of a WAPC can impact the cost recovery profile and GPB revenue recovery risk. For example, RAB indexing delays capital cost recovery and could run counter to accelerated depreciation. The Commission should consider how the current approach of RAB indexing versus adopting an unindexed RAB in conjunction with accelerated depreciation would impact cost recovery profile over-time and test the extent to which accelerated depreciation and adoption of an unindexed RAB can be considered genuine substitutes.

If these matters are not addressed as part of the DPP3 reset determination, we support their consideration as part of the statutory review of the IMs.

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[7] Major Gas Users Group, Re: GPB DPP3 Reset – Process and Issues Paper – Cross Submission, 13 September 2021.
[8] Nova Energy, Resetting default price-quality paths for gas pipeline businesses from 1 October 2022, 3 September 2021.
[9] Methanex, 2022-27 DEFAULT PRICE-QUALITY PATH RESET FOR GAS PIPELINE BUSINESSES.
[10] Methanex, 2022-27 DEFAULT PRICE-QUALITY PATH RESET FOR GAS PIPELINE BUSINESSES.
[11] Commerce Commission, Resetting default price-quality paths for gas pipeline businesses from 1 October 2022, Process and Issues paper, 4 August 2021.

Decisions should be based on up-to-date information

Entrust considers that the Commission should rely on the information from Vector's 2020 Asset Management Plan (AMP), in which Vector updated its 10-year forecasts based on its understanding of the Government's Net Zero 2050. The DPP2 capex allowance was less than AMP forecasts and ended up being less than actual capex. This could be repeated based on the draft DPP3 capex allowance.[12]

We support Vector's recommendation that the Commission maintain a 10% margin to the historical average capex projections, as this would mitigate the reduction in Vector's allowance for asset replacement and renewal, and for reliability, safety and environment.

If the Commission caps the capex allowance based on historic expenditure, Entrust supports the Commission's intention to use Vector's 2021 capex to determine its forecast.

Recommendations

Entrust **supports** the Commerce Commission's draft decisions to:

- "address concerns about material risk of economic stranding" in DPP3;
- adopt accelerated depreciation, including departing from the approach applied in electricity by applying accelerated depreciation to to all GPBs rather than by application;
- apply price smoothing to avoid potential consumer price shock;
- update its forecast of Vector's capex based on actual 2021 capex;
- update WACC settings to align with its Chorus fibre price-quality regulation decisions (specifically, the adjustment to TAMRP and debt issuance costs); and
- adopt a 4-year regulatory period, rather than the standard 5-years.

In addition, Entrust **recommends** the Commerce Commission:

- consider whether the current low interest rate environment provides an opportunity to bring forward additional investment cost recovery;
- maintain a 10% margin to the historical average capex projections;
- base its capex forecast decisions on the most up-to-date information from Vector's 2020 Asset Management Plan; and
- review the current approach of RAB indexing and use of a WAPC.

Concluding remarks

Entrust welcomes the substantial changes the Commission has made to its gas DPP settings, particularly the adoption of accelerated depreciation. The changes appropriately recognise the "uncertainty about the role of gas in New Zealand's pathway towards net-zero carbon emissions".

[12] Entrust acknowledges and supports that the Commission's "… final decision analysis will incorporate Vector's DY21 actual capex in calculating the historical average capex projections".

Entrust also welcomes the Commission's clear guidance that the changes it is proposing for DPP3 are a first step in adjusting how GPBs are regulated, and there will be further scope for change, including consideration of asset value indexing and further depreciation acceleration, as part of its statutory review of the IMs.

This year's reset is especially important. The decisions the Commission makes to help ensure GPBs can recover their prudent and efficient investments are critical to ensure regulated suppliers in all industries have confidence to invest and can provide services at a quality that satisfies consumer demand.

Kind Regards,

Alastair Bell
Chair of Regulation and Policy Sub-committee

About Entrust
Entrust (formerly Auckland Energy Consumer Trust) is a private trust that owns the majority of Vector on behalf of its 346,000 beneficiaries.

Entrust owns 75.1% of shares in Vector. The shares are held in trust for energy consumer beneficiaries in Auckland, Manukau, northern parts of Papakura and eastern Franklin who are paid a cash dividend each year.

The organisation was created in 1993, to ensure that power lines remained in the control of electricity consumers and was established under a trust deed for 80 years on behalf of electricity consumers in the area that used to be served by the Auckland Electric Power Board.