CROSS-SUBMISSION

Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022

Draft reasons paper

First Gas Limited
24 March 2017

Executive Summary

This is the First Gas cross-submission on the “Default price-quality paths (DPPs) for gas pipeline businesses from 1 October 2017 to 30 September 2022: Draft reasons paper” (the draft decisions). We have focused our cross-submission on the following points raised in the submissions made by other parties:

Area	Recommendation
1. Improvements to the supplier scrutiny process	
The Commission has followed a new approach to resetting DPPs that involves scrutinising supplier expenditure forecasts. We generally welcome the productive engagement that has occurred through this process. We agree with PowerCo and Vector that the process would be improved by enabling more interaction between the Commission, regulated businesses and other stakeholders to facilitate a better understanding of supplier forecasts.	We recommend that the Commission incorporates more interaction with regulated businesses to provide adequate opportunity to ensure that expenditure forecasts are well understood.
2. Acquisition of GasNet’s Papamoa distribution assets	
The Major Gas Users Group (MGUG) has commented on the treatment of First Gas’s acquisition of GasNet’s Papamoa assets. First Gas has disclosed requested purchase details to the Commission, and we consider that the Commission has subjected the transaction to a level of scrutiny that is appropriate for the small size of the transaction. This cross-submission provides further information on our existing distribution networks in Papamoa and the assets we have acquired from GasNet. This should help to put the scale of the transaction in context and illustrates that it did not result in the removal of any overlap in networks.	First Gas supports the Commission’s proposed decision to add the purchase price of our GasNet acquisition to the opening RAB of our GDB.
3. Treatment of economies and diseconomies of scale	
Vector submits that the Commission has not applied a consistent approach to assessing the scale impacts arising from gas pipeline transactions completed in 2016. We disagree with Vector and consider that the Commission’s approach consistently passes on any economies or diseconomies of scale that arise at the next DPP reset. While this is a consistent regulatory approach, the outcomes of the analysis differ for Vector and First Gas. This is because the scale effects arise at different times – diseconomies of scale are known and occur immediately, whereas economies of scale are uncertain and take time to be realised.	First Gas supports the Commission’s proposed treatment of the economies and diseconomies of scale resulting from gas pipeline transactions.
4. Improvements to inflation forecasts	
We share Vector’s concern that the Commission’s inflation forecasts are likely to over-estimate inflation for the next regulatory control period. This raises the risk of outcomes that are not consistent with the principle of financial capital maintenance (NPV=0).	We recommend that the Commission considers whether pragmatic changes can be made to inflation forecasts for the DPP reset to better align with market expectations of inflation.

1. Introduction

First Gas operates 2,500km of gas transmission pipelines (including the Maui pipeline), and more than 4,800km of gas distribution pipelines across the North Island. These gas infrastructure assets transport gas from Taranaki to major industrial gas users, electricity generators, businesses and homes, and transport around 20 percent of New Zealand's primary energy supply. For further information on First Gas, please visit our website www.firstgas.co.nz.

First Gas welcomes the opportunity to cross-submit on the "Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022: Draft reasons paper" dated 10 February 2017 (the draft decisions).

Structure of our cross-submission

Our cross-submission focuses on the key points raised by other regulated businesses and the Major Gas Users Group (MGUG) in their submissions on the draft decisions. We outline:

- Our support for incorporating more interaction between the Commission, regulated suppliers and our customers in the DPP reset process (as raised by PowerCo and Vector);
- How our recent purchase of GasNet's Papamoa assets has been subject to an appropriate level of scrutiny by the Commission at this DPP reset, and why we consider the transaction is in the best interests of consumers (in response to comments made by MGUG);
- Why (unlike Vector) we support the Commission's proposed treatment of economies and diseconomies of scale arising from First Gas's purchases of gas transmission and non-Auckland gas distribution assets; and
- Our concerns that the Commission's inflation forecasts will again over-estimate inflation for the next regulatory control period (echoing concerns raised by Vector).

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We continue to extend our invitation to Commissioners, Commission staff, and the Commission's consultants to talk through any of the material presented in this cross-submission and our original submission. As noted in section 2 below, we believe that discussing material presented through the reset process can help to ensure better regulatory decisions.

2. Improvements to supplier scrutiny process

We endorse the views expressed by Powerco and Vector that the process used to scrutinise supplier expenditure forecasts should involve more interaction to ensure that forecasts are well understood.

General agreement on areas for process improvements

We agree that Commission has sought to openly engage with all gas pipeline businesses (GPBs) as it has developed incremental refinements to the regulatory process, and overall, the process has been helpful and generally worked well.[1] Notwithstanding this, we agree with the point raised by Powerco that:

> *"It may be useful for [GPBs] to have an opportunity to present any additional information to the Commission. This would allow the Commission to ask any further questions or seek clarification on any points. The Commission could at that time highlight any areas that they did not consider answered in full and an updated version of the written report could be provided."*

Suppliers agree that the questions raised by the Commission (and its adviser's Strata) during the supplier scrutiny process were too high-level, and did not provide an adequate opportunity to respond with the information needed to fully inform the Commission's draft decisions. We appreciate that the Commission and its advisors were being cautious not to go into a level of detail that might be more consistent with a Customised Price-quality Path (CPP) – but in our case, getting to an appropriate level of detail earlier in the process would have been valuable.

As outlined in our submission, we consider that discussing the material with the Commission can help to ensure a better understanding of our position and would enable the Commission (and its adviser's Strata) to ask any questions in a timely manner to clarify any information provided by the GPB.

We also consider that direct customer engagement on expenditure forecasts as part of the DPP reset is valuable (particularly for our gas transmission business). We met with MGUG on 23 March 2017 to discuss the information we have provided to date in support of our expenditure forecasts, and why we believe these expenditures are needed to reliably meet demand and efficiently grow the use of our networks.

Our recommendations on how to improve the DPP reset process

We recommend that the Commission adapts its supplier scrutiny process to incorporate more interaction with regulated businesses where the Commission is not convinced of the rationale for expenditure forecasts. We recognise that in usual circumstances, the Commission would not seek to incorporate new steps a regulatory process, particularly at this late stage (i.e. following draft decisions). However, given this is the first time the supplier scrutiny process has been applied, we welcome further interaction.

As noted above, we acknowledge that these processes need to be undertaken within the bounds of a low-cost DPP process. However, we consider that this is achievable, particularly given the relatively small number of GPBs.

[1] Page 2, *Powerco submission to default price-quality paths for gas pipeline services from 1 October 2017 to 30 September 2022 – Draft reason's paper and draft determination*, Power Limited, 10 March 2017.

3. Appropriate regulatory treatment of GasNet Papamoa asset acquisition

MGUG has commented on the treatment of our recent acquisition of GasNet's Papamoa distribution assets. MGUG's submission outlines that, from a customer's perspective, it believes the acquisition is not consistent with Part 4 of the Commerce Act and subsequently the investment is not efficient.[2]

We appreciate that Commission's draft decisions reasons paper provides little information on the process used to assess this acquisition. However, we believe that when the small scale of the transaction is considered alongside the information we have provided, the Commission's approach of incorporating the purchase price into our opening Regulatory Asset Base (RAB) is appropriate.[3]

Further information on the nature of the acquisition

The assets that we acquired from GasNet (and the resulting asset value) are relatively small when compared with either of our networks. The Papamoa assets are around 10km in length, which amounts to around 2.5% of GasNet's total distribution network of around 400km, and 0.2% of our total distribution network of 4,800km. This small size of the transaction supports the proposed approach of adding the purchase price to our opening RAB. As noted in our submission, this approach is consistent with how the costs would be treated if we had engaged a third party (i.e. not another regulated supplier) to construct 10km of distribution pipelines.

Another important point to clarify is that the assets we acquired do not overlap with our existing distribution network in the Bay of Plenty. This is shown in the map provided in **Appendix A** (of Papamoa East), where our existing networks are shown in red and the assets we acquired are identified in green. This demonstrates that the acquisition has not dampened or removed any actual competition in this area of the network (a concern raised in MGUG's submission).

The Commission had information on the transaction when making its draft decisions on the DPP reset. On 12 January 2017, we received an email from the Commission requesting details of the transaction. In response, we disclosed the asset list and purchase price to the Commission, and asked the Commission to keep the purchase price confidential. We consider that the Commission has subjected the purchase price to suitable scrutiny, given its limited materiality.

Why the acquisition is in the long-term interests of consumers

As highlighted in our submission, First Gas is taking a very different approach to supporting distribution growth than the previous network owner (Vector). The previous owner had not extended networks into substantial subdivisions in the Papamoa area. We understand that at the request of developers in the area, GasNet filled the void that had been left and invested in system growth.

First Gas, in contrast, is seeking to actively promote the use of gas in its networks and has taken a different approach through a proactive approach of dealing with developers and builders, and through revising our capital contributions policy. We strongly believe that our approach is in the long-term interests of consumers and therefore consistent with purpose of Part 4. If we can attract more customers to use reticulated gas, then prices will fall over time as our asset utilisation increases.

[2] Paragraphs 10 – 13, Re: Gas DPP 2017 Draft reasons paper 10 February 2017, Major Gas Users Group, 10 March 2017.

[3] Section 5.2.1 of the draft decisions.

4. Support for the Commission's approach to scale impacts

Unlike Vector, First Gas considers that the Commission has appropriately addressed any scale effects arising from gas pipeline transactions that occurred in 2016.

Summary of Vector's concerns

In its submission, Vector has stated that it does not support the Commission's approach to treating economies and diseconomies of scale following the transactions. Vector disagrees with the Commission's draft decisions where it has:

- Not identified any economies of scale (efficiency gains) arising from the transmission merger undertaken by First Gas; but
- Has identified some diseconomies of scale (efficiency losses) in Vector's distribution business (but not First Gas' distribution business). The Commission subsequently proposes a downward adjustment in Vector's capex ($0.6 million) and opex ($1.6 million).[4]

Vector is concerned that the Commission's policy of treating economies and diseconomies of scale contradicts the position the Commission took in its 2010 Input Methodologies paper regarding the sharing of efficiency benefits, and delivers an unhelpful precedent for the treatment of mergers and acquisitions under Part 4.[5] Vector engaged the Competition Economists Group (CEG) to review the Commission's draft decisions.[6] Based on CEG and its analysis, Vector recommends that the Commission adopts a policy of considering economies and diseconomies of scale as they arise on a forward-looking basis when setting a DPP or CPP.

This position differs from the view that Vector expressed in its submission on the DPP policy paper, where it noted (at paragraph 44) that "Vector considers it reasonable for FGL to have a period of time to achieve such efficiencies, as proposed by the Commission (i.e. for economies of scale efficiencies to be considered at the 2023 reset)".[7] It is not clear from Vector's submission on the draft DPP decisions why its position has fundamentally changed.

Scale effects can be realised over different timeframes

While regulatory settings should aim to treat the effects of scale from transactions in a consistent way, this will not necessarily result in symmetrical outcomes. This is because the timeframes over which economies and diseconomies of scale are realised can differ. In the case of the gas pipeline transactions that took place in 2016, we observe that:

- It will take time for First Gas to realise any economies of scale from the acquisition of the two transmission businesses. Our expenditure forecasts explicitly do not incorporate any efficiencies from common ownership, as stated in section 2.2.1, page 11 of our Gas Transmission Asset Management Plan. This is for the simple reason that while we will actively seek out efficiencies, we do not yet know what (if any) efficiencies will be achieved from the merger. In contrast;
- The diseconomies of scale from Vector selling its transmission and non-Auckland distribution are known and occur from the date of completing the sale to First Gas. As outlined in the draft decisions, Vector's non-network and business support expenditure is now allocated across a smaller customer base, and while costs are expected to decrease, they will not decrease in

4 Section 5.25 of the draft decisions.

5 Page 3, Submission to the Commerce Commission on the default price quality paths for gas pipeline businesses – draft reasons paper, Vector submission, 10 March 2017.

6 *Treatment of changes in economies of scale due to transactions*, Competition Economists Group, March 2017.

7 Page 11, Submission to the Commerce Commission on Gas Pipeline Business Default Price Path Reset, Vector submission, 28 September 2016.

proportion to the size of Vector's remaining customer base. The challenge for Vector is to determine how to adjust to the decrease in scale that comes from the sale.

As the effect of the diseconomies of scale is known now, we consider that the Commission is right to address these impacts at this DPP reset.

Should expenditure forecasts be "forward looking"

We strongly disagree with Vector's contention (summarised at paragraph 30) that incorporating future economies of scale into prices would be more consistent with incentive based regulation. We think the opposite is true. As consistently maintained throughout this process, we believe that incentive based regulation relies on suppliers enjoying the benefits of any efficiencies before these are passed on to consumers through the DPP reset process. Accounting for these efficiencies through the reset process eliminates any upside to suppliers and removes any incentive to deliver more efficient outcomes.

We also disagree that the passage from the 2010 IMs Reasons Paper quoted at paragraph 31 of Vector's submission "clearly specifies a forward looking estimate of efficiencies for the resetting of a DPP or CPP". We think the statement actually says the opposite – that realised efficiencies are reported as part of information disclosure (backward looking actual costs), which enables those savings to be passed on to consumers at the next price reset.

Information used for the Commission's analysis

Vector considers that the Commission is holding Vector to a different standard than First Gas by using different information sources to assess the effects of the transactions – solely relying on AMP information for First Gas, but also looking at historical expenditure estimates for Vector (see paragraph 16 of Vector's submission). We recognise that on its face this treatment appears inconsistent. However, if the Commission instead relied on actual costs to assess whether any economies of scale are implied by our forecasts, this would more starkly highlight the absence of any economies of scale.

Precedent for treatment of future mergers and acquisitions

Vector states that Commission's proposed policy of treating economies and diseconomies of scale resulting from this First Gas transaction sets an "unhelpful precedent for the treatment of mergers/acquisitions"[8] and "is unlikely to work for price-quality regulated electricity distribution businesses."[9]

We consider that the Commission's decisions are unlikely to have significant impacts on the incentives for future transactions. Any negative effects could only arise where a party with multiple regulated businesses sells one or more of those regulated businesses to another party (as Vector did in this case). Such a scenario seems like the exception rather than the rule, with future transactions more likely to involve the complete disposal of regulated assets. In that case, where the purchaser is another regulated entity then the Commission's approach would encourage such transactions.

We also consider that the size of the adjustments proposed by the Commission are too small to materially affect a vendor's view of the economics of an asset sale. The Commission has proposed adjustments of $1.6 million to opex and $0.6 million to capex over the five year period, compared with a sale price received by Vector for its gas pipelines of $952 million.

8 Page 3, Vector submission.
9 Paragraph 40, Vector submission.

5. Improving DPP inflation forecasts

We share Vector's concerns that the Commission's inflation forecasts will overestimate inflation for the next regulatory control period.

The Commission is forecasting inflation exceeding or equalling two percent for four out of the five years of the next regulatory control period. This forecast intuitively seems low given recent experience – as Vector points out "the only time inflation has exceeded two percent in this decade occurred coincident with an increase to the goods and services tax (GST) rate".[10] The Commission has also acknowledged that it over forecast inflation for the initial DPP (2013-2018), and we are therefore concerned that the Commission may not be addressing this issue sufficiently for the upcoming DPP period.

First Gas also observes that the principle of financial capital maintenance (NPV=0) will be violated if the implied forecast of inflation in the WACC differs from inflation reforecasts used to revaluate RAB. Evidence suggests that this is possible. For example, the Reserve Bank's survey of expectations predicts inflation staying under 2 percent over the next two years.[11]

We appreciate that Commission is constrained by the current Input Methodologies on the estimates of inflation applied in the DPP.[12] However, to address submitters concerns, we recommend that the Commission considers whether there are any pragmatic solutions available to reach a more realistic (i.e. lower) forecast. If changes are unable to be made for this DPP reset, we recommend that the Commission looks at its approach to inflation forecasts during the next IMs review.

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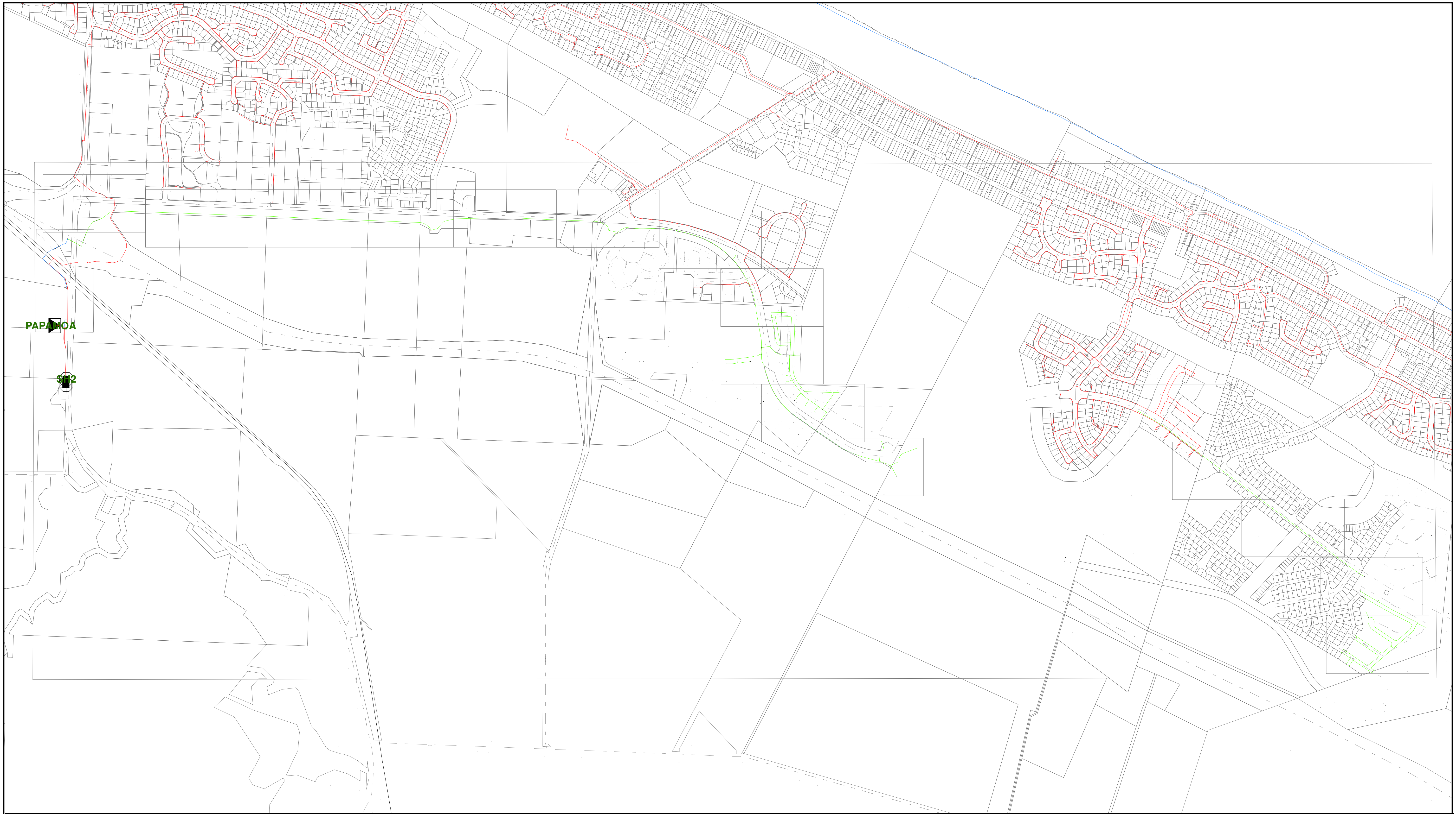
[10] Paragraph 51, Vector submission.

[11] Survey of expectations – March 2017 quarter, Reserve Bank of New Zealand, http://www.rbnz.govt.nz/-/media/ReserveBank/Files/Statistics/tables/m14/Survey-of-expectations-March-quarter-2017.pdf

[12] Definition of "forecast CPI for DPP revaluation" as set out in both the gas transmission and gas distribution Input Methodologies Determinations 2012, consolidated as at 28 February 2017.

Appendix A: Map of GasNet acquisition and existing First Gas network



LOCATION DETAILS		METER AND WORK MANAGEMENT		
No:	Unit:	Meter #		
Street:		Meter Fitted	Yes	No
Suburb:		ICP #		
Town / City:		Work Order ID		
Date Printed: 20/02/2017	Scale: 1:14,103	CAS #		

Firstgas

THIS PLAN IS FOR THE PRODUCTION OF AS-BUILTS BY INTERNAL STAFF ONLY

WORK CARRIED OUT BY

Signature:

Contractor:

Legend

First Gas

GasNet Pressure

- IA
- IP10
- MP20
- PP

Information Uncertainty

Active Project

Proposed Project

WARNING: TRANSMISSION PIPELINES
Indication only additional data is required

Prior to commencing work please contact First Gas on **0800 800 393**, or email locations@firstgas.co.nz for **FREE** on site locations and permits. A minimum of two working days notice is required.

OTHER GAS FEATURES

All dimensioning are in metres unless otherwise stated.

Gate Station	Valve Open	CP Rectifier	Squeeze Off
District PRS	Valve Closed	CP Test Point	End Cap
Service PRS	Reducer	CP Anode	Coupling
Meter	Shortstopp	Rectifier Cable	Tee