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12 October 2016

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Regulation Branch
Commerce Commission
Wellington

Dear Tricia,

Cross-submission on policy for setting price paths and quality standards in DPP for gas pipeline services from 1 October 2017

This is a cross-submission by First Gas on the Gas DPP 2017 reset paper published by the Commission on 30 August 2016 titled "Policy for setting price paths and quality standards" (the 'policy paper').

Overview

We have focused our comments in this cross-submission on what we see as the three main areas of policy in the DPP reset:

- **Forecasting expenditure.** Changes are required to the approach proposed by the Commission to promote the expenditure objective in a low-cost way. In this cross-submission, we suggest some improvements to assessing whether forecast expenditures are 'business as usual'. We also support the calls made by other regulated suppliers for greater clarity on what information is expected as part of supplier scrutiny and the consequences of failing to satisfy the Commission that forecasts are consistent with the regulatory objective.
- **Forecasting constant price revenue growth (CPRG).** The approach proposed by the Commission is fit for purpose. We recommend that the Commission resist calls to introduce wash-up arrangements for CPRG, particularly where forecasting is made more uncertain due to 'out of area' investments (such as that proposed by GasNet in the Bay of Plenty).
- **Setting standards for quality of service.** Submissions on the issue of new quality standards highlighted vast differences in interpretation of what the Commission is actually proposing. We support quality standards that reflect service levels consumers are either already paying for or are willing to pay more for in the future. We consider that a reporting requirement for major outages caused by regulated transmission or distribution providers could meet this test. However, introducing new liabilities and risks would not. We therefore suggest that, unless the quality standard can be narrowly prescribed and clearly defined, new requirements are better suited to information disclosure.

A cross-cutting theme in the DPP reset that the Commission will need to tackle is that gas transmission is fundamentally different from gas distribution, particularly now that First Gas is the sole GTB. Our comments on the relevance of this distinction for forecasting expenditure are noted in the policy paper, although the differences do not appear to influence how the Commission proposes to approach the reset. We think that this is an issue that requires further thought, and we remain open to engaging with the Commission on how to approach price-quality for gas transmission to avoid trying to adopt the same approach when it would be inappropriate to do so.

Forecasting expenditure

There appears to be broad support for the Commission's proposed approach to use supplier forecasts provided in supplier Asset Management Plans (AMPs) to inform regulatory expenditure allowances. The hard part is developing a low-cost process to assess supplier forecasts to build confidence that they meet the expenditure objective.

Following review of the submissions on the Commission's approach to forecasting expenditure we believe adjustments are required to strike the right balance between ensuring robust expenditure allowances while gaining constructive supplier input and buy-in to the process. This can be achieved by:

- avoiding specifying metrics and ratios that define the boundaries of 'business as usual' (BAU) expenditure, and focusing instead on assessing whether overall opex and capex forecasts are objectively consistent with the expenditure objective or whether additional scrutiny is warranted;
- broadening out the assessment of BAU expenditure to rely on historical expenditures for each supplier over several years (rather than an individual year), and using objective benchmarks of efficient costs (particularly for opex) where available;
- adopting clear, realistic expectations on the information that should be provided through supplier scrutiny in order to avoid the prospect of competing engineering assessments of efficient expenditure.

We continue to support the expenditure objective proposed by the Commission

The policy paper proposed to adopt an expenditure objective that focuses on ensuring that expenditure allowances reflect the efficient costs that a prudent supplier would incur to meet demand in the regulatory period and over the longer term. This aligns the objective under the Default Price-quality Path (DPP) with the objective that applies under the Customised Price-quality Path (CPP).

We supported this expenditure objective in our submission, and were surprised that some other suppliers opposed the expenditure objective proposed by the Commission. For example, Powerco stated (at paragraph 55 of its submission) that "the expenditure objective for CPP applications is inherently unsuitable for the DPP context, a point that is demonstrated by the complicated and costly proposal in the consultation paper that flows from the choice of expenditure objective."

In our view, the Commission is right to say that the DPP and CPP can have the same goal but use different methods to achieve that goal. We suspect that the concerns raised by suppliers about the expenditure objective relate more to *how* the Commission gains comfort that supplier forecasts are prudent and efficient (concerns that we share), rather than the objective itself.

The metrics and ratios proposed by Strata are not useful

Submissions from other suppliers reinforce our view that Strata's proposed metrics are unlikely to be useful or practical for assessing AMP forecasts presented by gas pipeline businesses in New Zealand. The Commission needs to determine what light the metrics and ratios actually shed on whether supplier forecasts actually promote the expenditure objective.

Our view was based on the lack of usefulness of Strata's proposed metrics for our gas transmission business. Methanex appear to agree (at least in part) stating that "we disagree with the view that ICPs are an important measure that ultimately contributes to the costs of gas delivery seen by consumers, particularly given that a substantial portion of gas transported on transmission pipelines is supplied directly to larger end users, such as Methanex".

Other submissions suggest that the metrics are also of limited use to distribution businesses.

- Orion stated that "it appears to us that the Strata reports read too much into small variances. For example, Strata seeks to draw conclusions from changes in expenditure per unit supplied, but these are likely to reflect the large portion of fixed costs corresponding to variable throughput. There is not necessarily any efficiency insight that can be gained from changes in such metrics." Reflecting on this, we suggest that a theoretically justifiable approach could be to review metrics that relate to and drive the variable costs of a business. For businesses that mostly have fixed costs, however, such an approach is barely useful.
- Vector commented on the changes to its and our businesses resulting from the transactions between Vector and First Gas. We agree that those changes mean that metrics based on historical disclosures need to be carefully interpreted in saying anything about future expenditures for Vector's remaining GDB and our GDB and newly merged GTB.
- Powerco and GasNet provided detailed lists of many problems with Strata's spreadsheet and assumptions as applied to their GDBs.

BAU expenditure should be assessed over multiple years

Strata's assessment of forecasts proposes to compare expenditures in each year of the forecast period against the lowest expenditure year from the last three years of available data. We already noted in our submission that using a single base year is inappropriate for our GTB. After reviewing other submissions, we consider that it would also be more appropriate to use a multi-year period to develop a sense of BAU expenditure for GDBs as well.

Several submitters commented on the inappropriateness of selecting the lowest cost year as base year for BAU comparisons. GasNet also made the valid point that comparisons should be made for expenditures forecast over the duration of the regulatory period, rather than focusing on annual changes. In reality, changes in forecasts from year-to-year are not particularly important because the timing of expenditure is unlikely to be sufficiently precise. What really matters for consumers is what level of expenditure is reflected in the prices that they pay, where annual expenditure variations are smoothed out anyway.

So in effect, the right question for the Commission to ask is "what is the level of total expenditure (opex and capex) required over the next five years to provide the regulated services at the expected levels of quality?" How that expenditure is passed by suppliers over the next five years is a management and operational decision for suppliers.

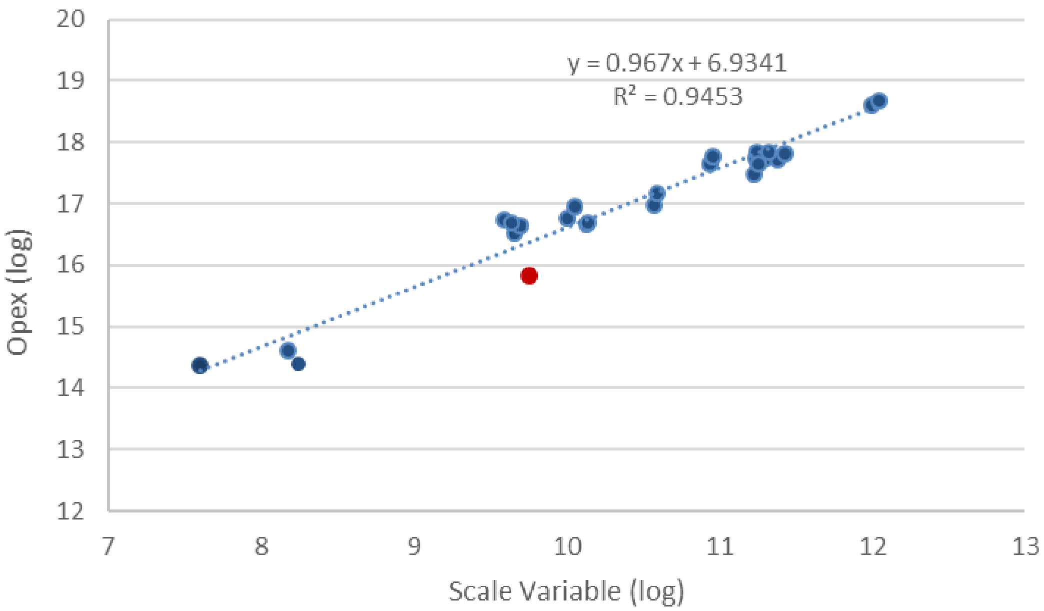
BAU should not be determined solely by historical levels of expenditure

In order to assess the expenditure forecasts made by GDBs, we think the Commission should not limit itself purely to historical expenditures. MGUG suggests (at paragraphs 20-23 of its submission) that the Commission should also be informed by supplier benchmarking. We note that the Commission has already carried out an initial analysis of GDB opex changes determined by scale (measured by kilometres of network and ICPs), with the results of this analysis summarised in paragraph B34 of the policy paper.

We agree with MGUG that supplier benchmarking can potentially play a useful role in informing whether expenditure forecasts are consistent with the regulatory objective. At its simplest, this would involve using the Commission's existing 'step and trend' model to assess how each supplier's forecasts compare with a modelled level of expenditure at the supplier's scale. In this case the purpose of the analysis changes from trying to understand how changes in scale affect opex to trying to understand whether particular levels of forecast opex represent "efficient expenditure" in line with the proposed expenditure objective.

This analysis would focus on the relative position of each supplier against industry averages, rather than focusing on the impact of scale on opex. To illustrate how this analysis would work, we have added our 2017 AMP forecasts of opex and scale (in red) to the dataset of Australian and New Zealand GDBs compiled by the Commission. This shows that the level of opex that we forecast is efficient for the scale of our business.

Figure 1: Relationship between operating expenditure and scale of GDBs



While we consider this type of benchmarking could be useful, it does have some important limitations:

- **Any benchmarking should be informative, rather than determinative.** We think this benchmarking could be used as part of the low-cost screening approach to determine if additional scrutiny of supplier opex forecasts is required. For example, we would expect that any increase in forecast levels of opex for our GDB would only require scrutiny if we were already sitting on or above the trend line. In addition, the Commission could scrutinise supplier forecasts that are consistently above the trend line. In both of those situations, simply relying on historic information on actual costs would not actually fulfil the proposed expenditure objective in a low-cost way.
- **The Commission needs to ensure that it complies with s53P(10) of the Commerce Act.** MGUG alluded in its submission to the legislative restriction on using comparative benchmarking to reset starting prices. In our view, if the analysis is used as part of the process of screening for forecasts that are BAU (as suggested above), then there is less chance of breaching this restriction.
- **The analysis is better suited to opex than capex, and requires a sufficient number of comparators to be robust.** The lumpy, network specific nature of capital expenditure means that industry benchmarking of capex is unlikely to be useful. We also note that carrying out a similar analysis of our GTB is difficult given the fact that fewer comparable transmission businesses exist.

This example is for illustrative purposes, and evaluating the efficiency of different opex forecasts will clearly require further work. However, we do see this as a useful addition to considering the reasonableness of supplier forecasts by broadening out an assessment of 'business as usual' away from simply relying on historic levels of expenditure.

The Commission needs to provide more guidance on supplier scrutiny

Much of the opposition to the Commission's proposed approach to determining expenditure allowances comes from the uncertainty generated by supplier scrutiny. Despite the work that has been carried out to date by the Commission and Strata, suppliers are still unclear what type and level of information will be required as part of the supplier scrutiny process, and what the consequences are of failing to convince the Commission that forecast levels of expenditure are efficient.

This suggests that the Commission should provide more guidance on how supplier scrutiny will work in practice. Both Powerco and GasNet have proposed modifications to the process that would place additional boundaries around the supplier scrutiny process and increase certainty. We think the Commission should seriously consider those proposals in order to generate greater buy-in to the process, while still achieving the objective of having better, more tailored forecasts.

As we highlighted in our submission, we think the Commission needs to adopt clear, realistic expectations on the information that should be provided through supplier scrutiny that avoids the prospect of competing engineering assessments of what constitutes efficient expenditure. We agree with other suppliers that detailed business cases and supporting Board papers are not going to be available to expenditure scheduled over the next five years, but we accept that some information on project need, timing and cost should support our forecasts.

Forecasting constant price revenue growth

We consider the proposed approach remains fit for purpose

We support the Commission's proposed approach to forecasting CPRG based on the fact that it has proved fit for purpose over the current regulatory period. We accept that no demand forecast is ever 'right', so the best that can be achieved is for the forecasts to be reasonable and to provide positive incentives for suppliers to promote greater use of their networks.

MGUG has raised the question of whether supplier demand forecasts should be used instead of the proposed reliance on independent forecasts. As MGUG notes, this would align demand forecasts with use of supplier forecasts for expenditures. It would, however, present similar problems for the Commission as discussed above in relation to expenditure forecasts. This would likely lead the Commission to confirm supplier forecasts with independent forecasts, such as those provided by Concept Consulting. On balance, we therefore think that it is more practical to use those independent forecasts from the outset.

We do not support sub-regional wash-ups for CPRG forecasts

In view of GasNet's greenfield investment in the Bay of Plenty, the Commission proposes to tailor the demand forecasts for GasNet's GDB (since this growth would not otherwise be reflected in CPRG). GasNet's submission indicated the possible value of "a constant price revenue growth wash-up that would apply where the forecast turns out to be materially wrong". It also indicated that this would be particularly useful for its new developments in the Bay of Plenty region.

Assuming that the Commission makes equal and offsetting adjustments to the CPRG forecast for our GDB (the Bay of Plenty growth will now be split between two GDBs and cannot be entirely allocated to First Gas), then we are essentially exposed to the same risk. That is, if the forecast adjustment does not fully compensate us for the lost growth opportunity then we will face a revenue shortfall. On balance, this is a risk we are prepared to take since the overall impact of these adjustments on our price path should be small. We therefore do not believe the risk justifies the complexity that would be required for introducing sub-regional wash-ups for CPRG forecasts. We also urge the Commission to avoid shifting any more risk of proposed greenfield investments from suppliers' shareholders to their existing customers.

Setting standards for quality of service

New quality standards need to be understood with reference to the price path

A threshold question for introducing a new quality standard is whether it provides incentives to achieve service levels that consumers are either already paying for or are willing to pay more for in the future. In our view, this is unlikely to be the case for the proposal to introduce a new quality standard around major interruptions to gas transmission or distribution services.

Submissions on this issue highlight that the 'gap analysis' presented in the policy paper is inconclusive at best. The Commission listed the many existing regulatory requirements for gas pipeline quality. The Commission also refers to the issues paper on "Gas Transmission Security and Reliability" published by Gas Industry Co (GIC) in April 2016, which concludes that GTBs "have strong incentives – reputational, commercial and statutory – to deliver effective S&R". Neither the Commission nor GIC has previously identified issues with lack of pipeline quality management at GDBs (even after previous major interruptions).

We agree with Vector that a quality standard relating to major outages is unlikely to fill a gap in incentives, but will increase potential liability for suppliers when major outages do occur (on top of existing financial consequences). It must be the case that exposing suppliers to additional liability will lead to additional costs – either through additional risk mitigation or through exposure to penalties. As stated by Powerco: "… the potential imposition of penalties under section 87 of the Commerce Act is a very real cost to GDBs…". This is particularly true of a zero-outage standard, which could be used to justify very high levels of cost.

This highlights the link between proposed new quality standards and the expenditure forecasts used to set price paths. Given the uncertainty on how expenditure allowances will be set, we currently face the risk of having to meet new quality standards without adequate funding to do so. This outcome would clearly not be in the long-term interests of consumers, who want risk to be well-managed through efficient expenditures.

The scope of any reporting on major interruptions needs to be narrowly prescribed

The Commission's proposal to introduce a new quality standard that requires information reporting after any 'major interruption' has been interpreted in different ways with very different consequences for our business.

We broadly supported this proposal on the understanding that the requirement would be limited to information provision from suppliers following events that are narrowly prescribed and clearly defined. However, MGUG appears to envisage a wide-ranging interim and final reporting obligation after each Critical Contingency, subject to public consultation, followed by a determination by the Commission on whether a supplier has acted as a Reasonable and Prudent Operator, with potential prosecutions in Court. This is a vastly different proposition – and one that we believe is not in the long-term interests of consumers.

If "major outages" are considered as part of an assessment of quality performance of a gas pipeline business then they must relate to an outage of the respective gas transmission or gas distribution service. This is quite distinct from an interruption to gas supply. Gas pipeline businesses provide a transport service; not a supply service.

For our GTB, we consider that critical contingencies are not a suitable criterion to assess gas transmission service outages. We note that since the CCM Regulations came into force on 21 January 2010 only five critical contingencies have occurred. One was caused by the Maui pipeline outage in October 2011, while the other four were caused by production station outages. So 80% of the critical contingencies that have occurred to date have not related to the supply of gas transmission services.

For a GDB, the appropriate outage measure is even less clear. As Methanex argued in its submission (in relation to GTB outages) there can be a hierarchy of customers that have a different level of value at risk compared with other customers. While suppliers will not normally hold information that allows them to assess value at risk for individual customers, we do understand the point that outages for some customers are more serious than for others.

Reporting requirements are likely to be better suited to Information Disclosure

It appears to us that consumers are mostly asking for additional information with respect to major outages. This was stated succinctly by Methanex: "We believe the Commission has a role to play in assuring sufficient information sharing occurs by suppliers to consumers and this could be achieved through setting more comprehensive reporting requirements in information disclosure."

The support expressed in our submission on the Commission's proposed quality standard reflects our willingness to provide additional information. It is clear, however, that the desires expressed by consumers to obtain information may exceed the information that we actually hold or can reasonably be expected to make available. Resolving those issues sits outside the scope of a DPP reset. Improving information disclosures should be part of the process for the next ID determinations.

If consumers want more information after critical contingency events, then the *Gas Governance (Critical Contingency Management) Regulations 2008* are the best tool for meeting that request. The relevant information following critical contingencies is not always held by regulated suppliers, and there is a particular governance process for these events, including a separate critical contingency operator.

We suggest that preparing appropriate definitions for a "major outage" for our GTB and for GDBs (if necessary) is also most appropriately handled as part of future work on updated information disclosure determinations.

Conclusion

We appreciate the opportunity to provide this cross-submission. We would be happy to provide additional clarifications and information. Please contact me if you wish to discuss this further at ben.gerritsen@firstgas.co.nz or 021 911 946.

Yours sincerely

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