

18 August 2016

Ms. Keston Ruxton  
Manager, Input Methodologies Review  
Regulation Branch  
Commerce Commission  
Wellington

Dear Keston,

## Cross-submission on Input Methodologies review draft decisions (excluding cost of capital)

This is one of two cross-submissions by First Gas on the draft decisions papers for the Input Methodologies review (including the report on the IM review, but excluding draft determinations) published by the Commission in June 2016. Our other cross-submission (due on 25 August 2016) will focus on cost of capital issues for Gas Pipeline Businesses (GPBs). This cross-submission covers all other issues that we would like to respond to as a result of submissions from other parties.

The table below summarises the views expressed in this submission. Each point is discussed in further detail under the subheadings below.

Form of control	We agree with the Commission's draft decisions to apply a pure revenue cap with wash-ups to our GTB and a weighted average price cap to GDBs.
Wash-up arrangements	We recommend having a single wash-up pool to deal with any over- or under-recovery of revenue and pass-through/recoverable costs. There should be no cap on the amount entering into that pool, but there could be limits on how much can be drawn down from the wash-up pool in any year. We suggest that such limits are expressed with reference to changes in allowed revenues.
Wash-up of forecasts for recoverable and pass-through costs	Since the outcomes are NPV neutral, we suggest that suppliers have the option of either forecasting pass-through/recoverable costs and washing up any difference, or continuing to apply the current approach requiring pass-through/recoverable costs to be ascertainable when prices are set.
CPP requirements	While the Commission has made several proposals that aim to reduce the burden of applying for a CPP, some parties remain concerned about the viability of this option. We encourage the Commission to look carefully at the cost and complexity of the CPP application process. We also encourage the Commission to promote approaches such as DPP reopeners and single issue CPPs that will provide many of the benefits of a CPP, without much of the cost.

Next Closest Alternative for unworkable IMs	We suggest the NCA proposals need to be further reviewed and refined in light of the concerns raised in submissions on this issue.
Easement valuation	Easements should be added to the RAB in the year in which any rights are acquired.
Pricing principles	We are embarking on the process of drafting a new transmission code now that all transmission pipelines are owned by First Gas. This will be accompanied by a new gas transmission pricing methodology. We are keen to ensure that the regulatory oversight of that pricing methodology achieves consistency with the new code and reflects the particular dynamics in the gas industry.

### Form of control

We agree with Methanex that “a pure revenue cap is an appropriate form of control for GTBs when combined with equitable wash-up mechanisms”.

MGUG has maintained its view that GTBs could also be subject to a weighted-average price cap because MGUG “see no distinction between GDB and GTB customers with regard to demand risk”. We disagree. As explained in our previous submissions on form of control, we consider that as a supplier of both gas transmission and distribution pipeline services, we have a much greater ability to influence demand for gas distribution. MGUG’s view is also difficult to reconcile with its statement (at paragraph 5) that “contrary to the many references made by the Commission in its draft reasoning gas is not a discretionary fuel for our members who have made long term capital investments in plant and processes reliant on gas.”

Gas transmission demand is driven by the interplay between producers of gas, that need to monetise the results of their exploration and production activities, and industrial users of gas (including MGUG’s members) that typically enter into long-term contracts for gas supply. There is very little that we can do to influence either the supply or demand for gas at the industrial level. Supply changes can be lumpy, as new gas fields are found and put into production or as the reserves in existing gas fields are re-determined. Demand changes can also be lumpy, as the recent closures of thermal power stations have illustrated. Neither of those lumpy types of changes are within our control, and they cannot be reliably forecast over a 5-year regulatory period.

The situation is quite different for GDBs. As MGUG illustrated in an earlier submission, aggregate distribution throughput, across all GDBs, is less than 20% of gas transmission throughput and is much more stable. That includes throughput for industrial users connected to gas distribution networks. On the distribution side, however, revenue for GDBs is largely driven by small commercial and residential users. Gas is usually a discretionary fuel for those types of consumers – that can typically substitute gas appliances with electrical appliances. Changes in their demand can be influenced by GDB pricing (including policies on capital contributions) and by our ability to promote the use of gas (for example in new housing subdivisions). These activities will only lead to incremental changes in throughput, making them well-suited to a regulatory regime that incentivises growth. Therefore, both the forecasting predictability and the ability for GDBs to influence demand is much higher than for GTBs.

We continue to support the Commission’s draft decisions on form of control for GDBs and our GTB.

## Wash-up arrangements

The Commission received a wide range of responses on the various wash-up arrangements proposed in the IM review draft decisions and in the Gas DPP 2017 reset paper. We have provided all of our views on wash-up arrangements in this cross-submission.

### Wash-up complexity and redundancy

Many submitters have commented on the unnecessary complexity of the wash-up arrangements and on the redundancy of proposing a cap on weighted average price increases as well as on annual wash-up draw down amounts.

- The submissions from other parties strengthen our view that there is no need for any cap and collar mechanism based on weighted-average prices to be included in the revenue wash-up arrangements.
- We maintain the view that the simplest way to limit price volatility for consumers is to limit the amounts that can be added to or subtracted from allowable revenue in each year. This could be expressed as a proportion of allowable revenue.
- Allowable revenue would be expressed as the sum of price-path determined revenue, adjusted for CPI, plus pass-through and recoverable costs and wash-ups.
- That value would then be subject to a percentage cap on changes from year to year within the regulatory period.
- Any such percentage limits would need to be deflated by CPI, in order to avoid an extreme scenario in which the CPI adjustment by itself could exceed the nominal cap. In other words, the volatility cap should be 'real' instead of 'nominal'.

Applying this approach, we would expect that there would only be one wash-up pool. The balance of the pool is the result of a range of items, including recoverable costs. Once an item enters the wash-up pool there would not be any need to track individual items or sub-balances within the pool. As the ENA observed, the only function for the wash-up pool is to allow an adjustment in the calculation of allowable revenues from year to year.

### Cap on wash-up amounts

We note widespread opposition from regulated suppliers to the Commission's proposal to impose a cap on amounts that can enter into the wash-up pool in any year. We agree with the statement from PwC that:

"There is no principled reason why small variations in revenue should be washed up but large negative revenue shocks should not be."

Keeping that in mind, we also support the statement from MGUG that:

"For example should the Maui pipeline fail through a geotechnical event at an already identified location of weakness (Whitecliffs) we see no reason why consumers should be asked to share in the loss of transmission revenue because of the supplier's failure to act on a known risk in a timely fashion."

As we indicated in our original submission, under our transmission codes we already bear the risk from events that make us unable to supply gas transmission services.

In essence, our position is that we are willing to accept the risk that there will be financial consequences for our business in the event that we cannot supply our services. However, we do not consider it appropriate under a revenue cap to accept demand risk.

## **Collars or limits on undercharging**

We note submissions from ENA, Powerco and Unison that express concerns about the risk of ending up with a 'use it or lose it' situation if suppliers are constrained in their ability to set pricing below their cap. We share those concerns.

We have previously submitted that caps on revenue volatility for our GTB should not be set too low. However, that does not mean we would want to, or even be practically able to, always price up to the maximum revenue that is allowed. It may be more desirable, and in the interests of consumers as well, to spread a price increase over multiple years instead of applying it in a single year. Assuming that wash-up balances arising from this are subject to time-value-of-money adjustments at the WACC rate, such a choice will be NPV neutral.

## **Revenue forecast certification**

We note the following comment from MGUG, in paragraph 7 of their submission on the Gas DPP 2017 reset paper:

“Our view is that GPBs already forecast quantity internally for purposes of budgeting (opex, capex and revenue) and that these budgets would be approved at board level. The Commission should be able to request the forecast detail under confidentiality and have it supported by a Director Declaration that it reflects a reasonable estimate of the expected market demand for the year ahead.”

Our Asset Management Plans already provide public disclosure of our forecasts of opex and capex. Our annual disclosures of pricing methodologies and price changes include forecasts of demand and revenue. These disclosure documents are already subject to director certification. Therefore, we do not see the need for additional Director Declarations.

## **Wash-up of forecasts for recoverable and pass-through costs**

The Commission proposes to adopt a pass-through balance approach in relation to recoverable and pass-through costs for GDBs, as applies currently for EDBs. We supported this proposal, together with GasNet, while Powerco and Vector considered the proposal unnecessary. We do not have experience applying this approach, and therefore appreciate the views expressed by Powerco and Vector, both of which own EDBs. After considering their views, we do not have a firm preference on whether a pass-through balance approach should be applied.

Assuming that the time-value-of-money adjustment for the wash-up is applied at the WACC rate, the chosen arrangement should be NPV neutral. This allows the Commission to make the forecasts for recoverable and pass-through costs optional. Suppliers that are willing to make such forecasts then only need to wash-up the difference between their forecasts and the pass-through and recoverable costs actually incurred. Suppliers that do not wish to make such forecasts (which is effectively equivalent to making a zero forecast) can wash-up the full value of actual costs after they have been incurred. Providing that choice may allow the Commission to gain more insights into the operational practicality for suppliers of forecasting such costs.

## **CPP requirements**

The Commission's topic paper on CPP requirements led to a range of responses. We note that the Commission is planning to consult on CPP requirements for GPBs next year, but we expect that many of the core elements will be the same as for EDBs. Our issues for this cross-submission on the current IM review are set out below.

## **CPP viability**

Other submitters have made the following comments about the viability of applying for a CPP.

"Vector supports the Commission reducing the compliance burden associated with a CPP application. However we do not consider that the proposals go far enough to reduce cost and complexity for applicants, particularly given the level of uncertainty under a CPP application / assessment."

"GasNet notes that even if the gas CPP requirements are changed in a similar manner to the electricity CPP requirements, the cost, time and resource needs of a CPP application would still be excessive for GasNet. We do not expect that a CPP will be affordable for us at any foreseeable time in the future."

We also remain concerned about the significant commitment of resources and time that would be needed if we engage in a CPP process. Even with the improvements that the Commission proposes in the draft decisions – which we hope will be included in the CPP requirements for GPBs as well – concerns clearly remain on the practical viability of engaging in the CPP process.

### **DPP reopener**

In view of concerns about the viability of applying for a full CPP, we support the comments from other submitters that encourage the use of DPP reopeners or single issue CPPs.

Methanex: "We note the draft decision that GTBs should not be able to apply for a contingent projects reopener as part of the DPP. We submit that for GTBs, which have lumpy capex profiles, contingent project reopeners may be appropriate for modestly-sized replacement and renewal projects. This is subject to there being sufficient scrutiny of the expenditure to ensure it is reasonable and the project is justified, which may be manageable within the DPP. The benefit would be increased scrutiny over projects that may not be large enough to justify a CPP but still represent a step-change in expenditure."

ENA recommends: "... if a revenue cap is introduced as the form of control we submit that a DPP reopener for unforeseen major connections is included."

"WELL is open to further discussion with the Commission on any additional criteria, but maintains there is a gap in the regulatory framework for circumstances where historical expenditure is not sufficient, yet a full CPP application is not warranted".

Aurora: "We support provision for 'single issue' CPPs. This would enable low cost CPPs which don't require an opening of the entire books. This would mirror arrangements for Transpower grid-upgrade approvals. We consider that the grid-upgrade provisions provide a relevant and useful precedent. The operation of the grid-upgrade provisions has been very successful, as highlighted by the Government currently considering extending these arrangements to Chorus, under the Telecommunications Act."

Orion: "... reopening a CPP relating to urgent projects. We agree with this proposal and support a similar reopener being applied to DPPs."

We are not particularly concerned about the distinction between single-issue CPPs or DPP reopeners. However, we maintain that the Commission should provide for a reopener that can accommodate projects that are narrow in scope, without the need to incur the commitments, expenses and delays required under a CPP to reassess and further refine all existing components of a DPP.

### **Recovery of project expenditure incurred prior to a CPP application**

Several submitters, including PwC and WELL, made the point that prudently incurred expenditure for projects should not only be recoverable in the period after a CPP application but in the period leading up to such an application as well. Powerco made the most extensive submission on this issue and we support the views expressed in that submission.

## **Capex wash-up recoverable cost allowance for CPPs**

PwC pointed out:

“We note that it is proposed that the urgent project allowance excludes any costs which are treated as commissioned assets. We support this exclusion on the condition that the capex wash up recoverable cost, which was introduced for DPPs prior to the 2015 DPP Determination, is extended to CPPs. This adjusts for the difference between forecast and actual commissioned assets in the year immediately prior to the new (DPP or CPP) price path taking effect. We submit that the rationale for introducing this wash-up for DPPs applies equally to CPPs.”

The ENA made the same point as well. We support their views on this topic.

## **CPP consultation**

We note that submitters expressed different views on the role of a verifier in CPP consultation. MEUG proposed a separate verifier for this part of the CPP application process. We do not know how that proposal could work in practice, but we agree that a verifier with skills in assessing cost proposals is unlikely to also be an expert in public consultation.

Submitters also expressed views on the extent to which public consultations should consider investment alternatives. We did not submit on that point earlier, because it seems clear to us that public consultation should be limited to alternatives that are material for the CPP application. We would now like to explicitly support the view that the key reasons for a CPP application should drive the consultation scope and should limit the number of alternatives to be considered.

## **Next Closest Alternative for unworkable IMs**

Serious questions have been raised by various submitters, including the ENA, PwC and Orion, about the Commission's proposed arrangements to set a Next Closest Alternative (NCA) for unworkable IMs. We continue to support the concept that the Commission should be able to use some kind of NCA if an existing IM is indeed unworkable. However, that concept may need to be subject to tighter constraints. Perhaps it should only apply if, and for so long as, the Commission is unable to have an amended IM in place. We also agree with PwC that it is difficult to think of circumstances where the Commission would need to reopen a price-quality path for an unworkable IM without having the ability to amend that IM first. We suggest the NCA proposals need to be further reviewed and refined.

## **Easement valuation**

We note the submissions from Powerco and the ENA that describe the potential discrepancies between the treatment of easements as applied to Transpower, and as set out in the IM Reasons Paper of December 2010, versus the text in the existing IMs for EDBs and GPBs. We agree that such discrepancies should be eliminated and the IMs clarified, as necessary, to ensure that easements can indeed be added to the RAB in the years in which their rights are acquired.

## **Pricing principles**

We note that the submission by Methanex expresses concern about the pricing principles for our GTB. Methanex even proposes the addition of a fifth pricing principle.

We do not express an opinion on the merits of the Methanex proposal, but it reinforces our concerns about the retention of the current pricing methodology provisions for gas transmission in the IMs. The issues raised by Methanex effectively echo the issues that are under discussion by the Electricity Authority in relation to the electricity Transmission Pricing Methodology. Can a large gas consumer that is relatively close to production stations be cross-subsiding transmission to other gas consumers that are farther away in the North? In view of the Electricity Authority's experience, this issue is obviously not resolved quickly and easily.

The issue is complicated by the fact that our pricing applies to Shippers of gas. It does not apply directly to end consumers of gas. It is not obvious to us how we should apply pricing principles to Shippers.

We agree with Methanex that pricing methodology for gas transmission needs to be reviewed and discussed. We consider that should take place as part of the wider discussion on pipeline access terms and conditions that will be reflected in a new gas transmission operating code.

### **Conclusion**

We appreciate the opportunity to provide this cross-submission. We would be happy to provide additional clarifications and information if this is helpful. Please feel free to contact me at any time at [jelle.sjoerdsma@firstgas.co.nz](mailto:jelle.sjoerdsma@firstgas.co.nz) or in our Wellington office on (04) 460 2535.

Yours sincerely



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