27 April 2017

Tricia Jennings
Project Manager, Gas DPP reset 2017
Commerce Commission
44 The Terrace
WELLINGTON

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

Dear Tricia

## Draft default price-quality path (DPP) reset decision – technical consultation

This is the First Gas submission on the Commerce Commission's "Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022" technical consultation companion paper ("technical paper") dated 13 April 2017. This submission supports the proposed drafting of the DPP determinations, and suggests some minor changes to further improve clarity. Most of this submission explains why we oppose any change to the regulatory treatment of the distribution assets we acquired from GasNet.

### Revised draft determinations give effect to draft decisions on DPP reset

First Gas has reviewed the draft determinations for both gas distribution businesses (GDBs) and gas transmission businesses (GTBs), and we are comfortable that the Commission has correctly given effect to the February 2017 draft decisions.[1] We also consider that the DPP determinations will be workable in practice. We particularly welcome the Commission's decisions to:

- Remove the requirement for annual price changes not to exceed 10% and therefore to remove the method for calculating the average increase in price for GTBs;
- Extend the reporting period for GTB Major Interruptions from 50 working days to 60 working days; and
- Measure the reporting period for GTB Major Interruptions from the termination of the Critical Contingency, as defined in the Gas Governance (Critical Contingency Management) Regulations 2008.

These are all sensible amendments that will ensure the DPP determinations are workable and reflect the existing and upcoming developments in the gas industry, such as the development of a single gas transmission access code.

We have provided some minor suggestions on the drafting of the DPP determinations in **Appendix A**.

### We strongly oppose any change in the treatment of the GasNet acquisition

First Gas has serious concerns with the Commission's proposal to reconsider the regulatory treatment of the Western Bay of Plenty distribution assets purchased by First Gas from GasNet.[2] We consider that the Commission has not followed good regulatory practice in its consideration of this matter. The technical paper does not refer to the clause(s) of the GDB Input Methodologies (IMs) that might be used to establish an alternative treatment for the transaction, nor does the paper provide any analysis

[1] *Default price-quality paths for gas pipeline businesses form 1 October 2017 to 30 September 2022, Draft reasons paper*, Commerce Commission, 10 February 2017.

[2] As outlined in paragraphs 1.8 to 1.14 of the technical consultation companion paper.

of the application of the IMs to the relevant facts. This makes it difficult for stakeholders to provide useful input to inform the Commission's decision.

What we take from the technical paper is that the Commission is exploring a change in approach due to a concern that the application of clause 2.2.11 of the IMs proposed in the draft DPP decisions would not achieve the policy intent. This is because the Commission believes that First Gas purchased the relevant assets at a price substantially above GasNet's construction costs. We therefore focus our comments below on whether an alternative application of clause 2.2.11 is available to the Commission, and whether we in fact paid a price substantially above GasNet's construction costs.

In summary, we continue to support the Commission's draft decision announced in February 2017 that the assets enter our Regulatory Asset Base (RAB) at their sale price, plus any subsequent commissioning costs. This draft decision was made on the basis that "the assets were still works under construction at the time of the sale and had not yet been used by GasNet to provide any regulated services".[3] This approach is consistent with Generally Accepted Accounting Practice (GAAP) and the way that other assets acquired from a third party would be valued for the purposes of inclusion in the RAB, unless any of the exceptions specifically provided for in clause 2.1.11 of the IMs apply.

**Our expectations of good regulatory practice when interpreting the IMs**

We consider that the Commission has not followed good regulatory practice in reconsidering its treatment of the assets that First Gas has purchased from GasNet. The technical paper provides a very brief description of the issue and provides no evidence to establish why the Commission is reconsidering its approach to this issue. Neither does the Commission set out what particular clause(s) of the IMs are being relied upon to propose an alternative treatment of the assets for inclusion in our RAB.

Our view is that, at the very least, a consultation paper on this matter would clearly specify:

- What factual evidence the Commission has used to draw the conclusion that First Gas has paid substantially in excess of construction costs;
- What clause in the IMs the Commission could rely upon to take an alternative approach to accounting for the transaction; and
- An application of the relevant IMs to the facts in this case.

We believe that the lack of information on any of these points may limit the usefulness of submissions on this matter. Parties also have limited time to respond to the technical paper, due to the tight submission deadline of 27 April 2017.[4] We encourage the Commission to offer to meet with parties that submit on this issue in early May (before final decisions are made) to discuss and further clarify any points that made in submissions. This will ensure the Commission has the best information available, in the time possible, to make an informed decision.

**Only one possible interpretation of IMs applies to this acquisition**

In our view, the February 2017 draft decision is the only possible approach available to the Commission under clause 2.2.11 of the IMs. Given that the assets were still "works under construction at the time of the sale and had not yet been used by GasNet to provide any regulated services",[5] the draft decision aligns with the plain meaning of the words of clause 2.2.11(1) of the IMs.

When First Gas assessed the impact of the acquisition of the GasNet assets on our RAB prior to the transaction, we relied upon the plain meaning of the relevant IMs. Our interpretation of the IMs is that assets we intended to purchase for the purpose of providing gas distribution services would enter our RAB at the purchase price that we paid, unless one of the exceptions listed in clause 2.1.11 applied (sub-clauses (a)-(i)). We do not consider that any exception applies in this case, and the technical paper does not refer to any applicable exception.

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[3] Paragraph 1.9 of the Commission's technical consultation companion paper.

[4] Which includes the Easter and ANZAC holidays, reducing the submission timeframe to a total of 8 business days.

[5] Paragraph 1.9 of the Commission's technical consultation companion paper.

The Commission now states that its draft decision is not consistent with the policy intent of the IMs relating to asset sales and purchases between regulated suppliers. The Commission is specifically considering whether it should "apply the same approach to the valuation of the assets that would have applied had they been commissioned at the time of their sale" – i.e. apply the cost of construction plus any associated financing and commissioning costs.

While the Commission does not refer to any specific clauses of 2.2.11, its proposed alternative most closely reflects the wording of clause 2.2.11(e) – the only sub-clause that addresses acquisitions from another regulated supplier. However, the assets were purchased prior to commissioning and were not used for the "supply of regulated goods or services". Accordingly, clause 2.2.11(e) of the IMs does not apply.

**Commission cannot retrospectively change the IMs**

If the Commission is concerned that the outcome of applying the IMs fails to achieve its policy intent, then the appropriate response is to consult upon and change the IMs. However, good regulatory practice suggests that any change cannot have retrospective application. Regulatory certainty requires businesses to be able to transact in good faith according to the rules that apply at the time.

As set out above, First Gas conducted the transaction with GasNet based on the IMs as set out at the time of acquisition, which is consistent with the approach applied in the Commission's February 2017 draft decision. The Commission has provided no legitimate basis for applying an alternative interpretation of the IMs.

**Unclear how the Commission has determined that First Gas paid "materially" more than GasNet's construction costs**

As noted in our cross-submission on the DPP draft decisions,[6] First Gas disclosed the asset list and purchase price to the Commission's Regulation Branch in January 2017. We consider that the Commission has subjected the purchase price to suitable scrutiny, given its limited materiality. The Commission's technical paper states (at paragraph 1.10) that "we are now aware that First Gas has purchased assets at a price materially in excess of GasNet's cost to construct them".[7]

It is unclear from the technical paper how the Commission has drawn this conclusion. Since the assets were never commissioned by GasNet, we fail to see when an equivalent number would have been disclosed or what that number would include. For example, while information would be available on the construction costs GasNet paid to third parties, how has GasNet's own development costs (management time, project management costs, etc.) been treated? What assumptions have been made on the additional work that would have been required to get the assets to a commissionable state under GasNet ownership (compared to the costs now incurred by First Gas)? Such information and analysis should be presented when drawing factual conclusions like the one in paragraph 1.10 of the technical paper.

The reality is that First Gas does not know what it cost GasNet to construct the assets that we have purchased. This is normal for an arms-length asset acquisition. We based our offer to GasNet on our own estimate of construction costs for the pipelines using the same cost models used to plan First Gas distribution projects, plus the commercial goodwill that GasNet had established through the development. First Gas had no knowledge of the actual construction costs incurred by GasNet, and we negotiated at arms-length as we would with any third-party supplier, construction company or asset owner.

Given the Commission's strong conclusion on a material difference, our distribution asset experts have revisited the cost estimates that underpinned our offer and the ultimate purchase price that we paid. Our assessment is that it if all costs are treated appropriately by GasNet, then it is unlikely that Commission's conclusion would be correct. We continue to believe that the transaction represents value for money for customers on our distribution networks.

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[6] *Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022: Draft reasons paper*, First Gas cross-submission to the Commerce Commission, 24 March 2017.

[7] Paragraph 1.10 of the Commission's technical consultation companion paper.

**Commission should confirm its draft decision on GasNet acquisition**

Given the analysis set out above, we consider that no alternative treatment of the GasNet acquisition (to the one set out in the Commission's February 2017 draft decisions) is possible under the IMs. Indeed, it is directly contrary to IMs for the Commission to apply clause 2.2.11(e) as it currently stands since the factual requirements for establishing a commissioned asset were not present in this case. We therefore recommend that the Commission confirms its February 2017 draft decision that the GasNet acquisition enters First Gas' RAB at the purchase price, plus any commissioning costs incurred by First Gas.

If the Commission is concerned that clause 2.2.11 of the IMs does not achieve its policy intent, then this clause should be reviewed using the appropriate process with stakeholder consultation (with any changes applied as usual with forward-looking effect).

If you have any questions regarding this submission, please contact me on 04 979 5368 or via email at karen.collins@firstgas.co.nz.

Yours sincerely

**Karen Collins**
Regulatory Manager

## Appendix A: Detailed comments on determinations

### Revised draft determination for gas transmission businesses

| Clause | Commentary | Recommended amendment |
|---|---|---|
| 4.2 | We are concerned that the definition of "Major Interruption" is too broad and won't meet the Commission's intent for the new quality standard<br><br>As noted in the Commission's draft decisions paper, it is intended that "events caused entirely by disruptions upstream of the transmission system" (producers) are excluded from the Major Interruptions quality standard.[8] However, the current definition of "Major Interruptions" could still see an event caused by a producer captured by this definition. | **Major Interruption** means any declaration of a Critical Contingency caused or contributed to by an incident on the transmission assets owned or controlled by the GTB ~~transmission system~~, which results in curtailment directions being issued in respect of any band beyond Band 1. |
| 9.5 | For clarity of the two requirements set out in this clause, we recommend that this clause be split into two separate clauses.<br><br>We have also suggested further refinements to increase clarity of the requirements on a GTB. | 9.5 A GTB must notify the Commission in writing of any Major Interruption within 5 Working Days of ~~any~~ the Major Interruption being declared as a Critical Contingency.~~,~~<br><br>9.6 A GTB must ~~and~~ provide the Commission with the following information within 60 Working Days of the termination of the Critical Contingency leading to the Major Interruption: |
| 9.5 | First Gas queries whether it would be appropriate to provide GTBs with a greater timeframe to notify the Commission of a Major Interruption or whether the Commission will provide GTBs with any lee-way with meeting the "5 working day" requirement.<br><br>During a Major Interruption, the GTB will be focused on resolving the interruption and firstly meeting its CCM requirements. Notifying the Commission will be incorporated into the CCM processes but due to resource pressures, the GTB may not meet the deadline. | We request that the Commission clarify how it will treat any breach of the "5 working day" requirement. |
| 9.5 (b) | For clarity and consistency in approach, we recommend that the Commission avoid using the term "supplier" and instead use the defined term "GTB" (as is done throughout other sub-clauses in this section). | (b) whether the risk of the interruption was identified in advance, and any steps the ~~supplier~~ GTB took to reduce or mitigate that risk; |
| 9.5 (e) | | (e) the direct cost of the interruption (including repair costs) to the ~~supplier~~ GTB; and |

[8] Paragraph 7.34, Draft decisions paper.

| Clause | Commentary | Recommended amendment |
|---|---|---|
| 9.5 (f) | | (f) what actions (if any) the ~~supplier~~ GTB intends to take to avoid similar interruptions in future. |
| 9.7 | We recommend that this clause be amended to clarify exactly how a GTB may apply for an extension of time. | Where a GTB is not reasonably able to provide the Commission with some or all of the information required in clause 9.5(a) to (f) within the prescribed 60 Working Day period, it may apply in writing to the Commission for an extension of time to provide it with such information. The extension request should set out why the information is unavailable and the proposed timeframe for supplying the information to the Commission. |
| Schedule 5, clause 5 | This clause is a repetition of clause 3. | Delete this clause. |
| Schedule 6 and 7 | To aid parties in applying the formulae set out in these two schedules, we recommend that the Commission consider also including the formulae with all the variables. | Addition of an explanatory note with the revenue wash-up formulae and variables that match the descriptions in schedule 6 and 7. |
| Schedule 6, clause 1.3 | The Commission proposes a discount rate of 5.38% for use in calculating the wash-up amount for the first period. As noted in the draft decisions paper, "this rate is the discount rate specified in the Schedule 6 of the DPP for the regulatory period ending 30 September 2017 for time value of money adjustments in relation to pass-through and recoverable costs".[9] We query why the Commission is applying a discount rate from a prior regulatory period for the upcoming DPP period. | We request that the Commission clarify if it will be updating the discount rate used for the DPP for 2017 – 2022. |

## Revised draft determination for gas distribution businesses

| Clause | Commentary | Recommended amendment |
|---|---|---|
| 10.5 | To ensure clarity, we recommend that this clause be amended to state how any further information should be provided to the Commission. | Any information not practically available under clause 10.4 at the time of the notice must be provided to the Commission in writing as soon as practicable after it becomes available. |

[9] Paragraph F58, draft decisions paper.