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The Commission's approach to addressing increased stranding risk for gas pipeline businesses is pragmatic and flexible to changing circumstances

Aotearoa New Zealand is preparing to rapidly evolve as the country embarks on an adaption and mitigation path in response to our global climate change commitments. The energy sector is delicately balancing how we can do our fair share to meet emission reduction targets, with consumer expectations for reliable and continuous supply of energy at an affordable price, and commercial realities around infrastructure investment in an uncertain regulatory environment. Powerco is one of Aotearoa's largest gas and electricity distributors, supplying around 340,000 (electricity) and 112,000 (gas) urban and rural homes and businesses in the North Island. These energy networks provide essential services and will be core to Aotearoa achieving a net-zero economy in 2050.

The Default Price-Quality Path (DPP) reset for gas pipeline businesses forms a crucial input to ensuring gas infrastructure can meet its safety and reliability obligations as a lifeline utility and support New Zealand's emissions targets over the medium and long-term. The Climate Change Commission's final advice to the Government projects a decline in natural gas use while recognising a potential role for natural gas pipelines to deliver low carbon gases. This uncertainty has introduced new issues, risks and forecasting challenges that need to be accounted for in the reset process. Powerco welcomes the opportunity to submit on the Commerce Commission's Gas Distribution Services Default Price-Quality Path (DPP) Draft Decision.

We support the Commission's package of regulatory settings contained in the Draft Decision. Powerco's submission to the Commission's 2021 issues paper recommended the Commission's prioritise addressing stranding risk in a way that had the ability to 'course correct' at the next reset to meet the long-term interests of consumers. The Commission's balanced approach delivers this:

- **A NPV neutral approach to address increased stranding risk** (accelerated depreciation) designed to be updated with new assumptions and flexible in its application to inform regulatory settings
- **A four-year reset period to mitigate the impact of forecast risk and policy change** in both demand and the stranding model, and allow further evolution through the IM review and to reflect policy settings (eg the emissions reduction plan and/or national energy strategy)
- **A pragmatic approach to demand forecasts and expenditure allowances** which supports gas pipeline businesses considering future stranding risk in their investment decisions. We recommend the approach to

non-growth capex be reconsidered to support prudent and efficient investment where it exceeds historical levels.

- **Sensible IM changes to allow re-openers** to reflect a range of circumstances which affect risk and unforeseen circumstances.

It will be important to assess draft settings interact with policy settings in the Emissions Reduction Plan and NZ Energy Strategy which will be released and developed later this year. We expect this will include clarity about the nature and scale of gas network infrastructure to support decarbonisation policy. This will have flow-on effects to the types of solutions needed for gas networks to deliver those outcomes. The Gas Infrastructure Working Group submission (submitted separately) provides a summary of these. It uses a similar modelling approach to the Commission, though considers a broader range of scenarios to inform policy choices.

Attachment 1 has our views about the key topics covered in the draft decision. We appreciate the engagement from Commission staff during the consultation period and the effort to develop a cohesive package of settings for DPP3. We look forward to the next steps in consultation process. If you have any questions on this submission, please contact Nathan Hill (Nathan.Hill@powerco.co.nz).



Andrew Kerr

Head of Policy, Regulation, and Markets

Attachment 1: Summary of Powerco’s feedback

Commission draft decision	Powerco view
<p>Economic network stranding risk</p> <ul style="list-style-type: none"> The average lives of new and existing assets are shortened, increasing the depreciation allowance over DPP3. The scaling factor is supplier specific and informed by assumptions out to 	<ul style="list-style-type: none"> Powerco’s 2021 submission to the issues paper recommended the Commission’s prioritise options to address stranding risk We agree with the Commission's assessment of an increased risk of economic stranding which compromises FCM and supports action now rather than later given the impacts on consumers assessed over the long term. We support the Commission’s conceptual approach to develop a tailored and repeatable model of accelerated depreciation based on actual and forecast asset data. This is preferable to a static and simplistic approach in place for EDBs (up to 0.85 scaling). Removing indexation would have further supported consumer outcomes (6.15, 6.143), especially in times of high inflation. A desirable attribute of accelerated depreciation is that It is NPV neutral - GPBs are not expecting to make any more return on their regulated investment. It can be re-run for the next reset to reflect a different view, and that will be NPV neutral too. It is also able to be tailored to each network’s characteristics. The list of attributes in 6.83 highlights the pragmatism of the Commission’s approach. In addition to those listed, the ability to review the settings and assumptions prior to DPP4 (eg late 2025) is a positive outcome and provides some comfort for all stakeholders that the period for review is close. Future assumptions will be able to be refined to reflect investment activity over the period, as well as any policy settings affecting future scenarios. The decision gives us confidence to continue to invest to maintain safety and reliability. Accelerating depreciation will align the capital recovery profile better with economic stranding risk and New Zealand’s climate policy. The Frontier model review (submitted separately) summarises their verification of the stranding model. They raise some points for the Commission to consider in the final model.
<p>Shortening the regulatory period to four years</p> <ul style="list-style-type: none"> The DPP3 period is 1/10/22 – 30/9/26 (a four-year period) 	<ul style="list-style-type: none"> Powerco supports the shortening of the regulatory period to four years as part of the broader package of settings to apply over a period of policy change

Commission draft decision	Powerco view
	<ul style="list-style-type: none"> • Choosing a four-year reset horizon is a good option to allow course correction to reflect the impacts of changes to policy settings over the coming years and mitigate the impacts of forecast variation and other settings eg asset life scaling. • This shorter period will also provide an opportunity to consider topics that were too complex for this DPP3 eg indexation/inflation risk (6.99) and the revenue cap.
<p>Forecasting capital expenditure</p> <ul style="list-style-type: none"> • Capital expenditure allowances set using a top-down approach • Suppliers' capex forecasts are capped at the historical average of the four years (2017-2020). • Capping occurs at the category level and there is no margin above the historical average. 	<ul style="list-style-type: none"> • Powerco recommends that the Commission's approach to non-growth capex be reviewed to allow prudent non-growth investment to maintain safe and reliable networks • Powerco supports a top-down approach to assessing GDB's capital expenditure allowances. While a targeted scrutiny of AMPs for non-network capex, historical values effectively set a cap on forecasts of network capex (5.7). • The Commission expects that GDBs DPP3 capex will not exceed historical average levels because of the increased risk of economic stranding and the expected decline in gas use (5.21, 5.27). Reopener provisions have been provided to mitigate the risk that the allowances are insufficient (5.22). • We think the approach to setting allowances should be reconsidered because prudent and efficient investment can justifiably exceed historical levels. • Unlike growth capex, 'non-growth' capex requirements are not necessarily responsive to changes in demand. For example, asset replacement and renewal expenditure depends on asset condition and the cyclic nature of long-life asset replacement. Expenditure in this category needs to be balanced appropriately to ensure that compromised safety and reliability of this asset class does not result in a growing number and frequency of failures and disruption of supply to customers. The re-opener mechanism is not designed for this circumstance. • An improved approach for setting DPP3 allowances could include a change to the margin applied to historical averages, targeted scrutiny, or a bespoke approach eg opex/capex payback period lengths aligned to the payback assessment applied to the scrutiny of non-network capex. • We would like to discuss this with the Commission prior to the final determination and in light of the responses from other stakeholders.

Commission draft decision
Powerco view

The remainder of this section highlights the impact of the approach to non-growth capex in the draft determination and some comments on potential solutions.

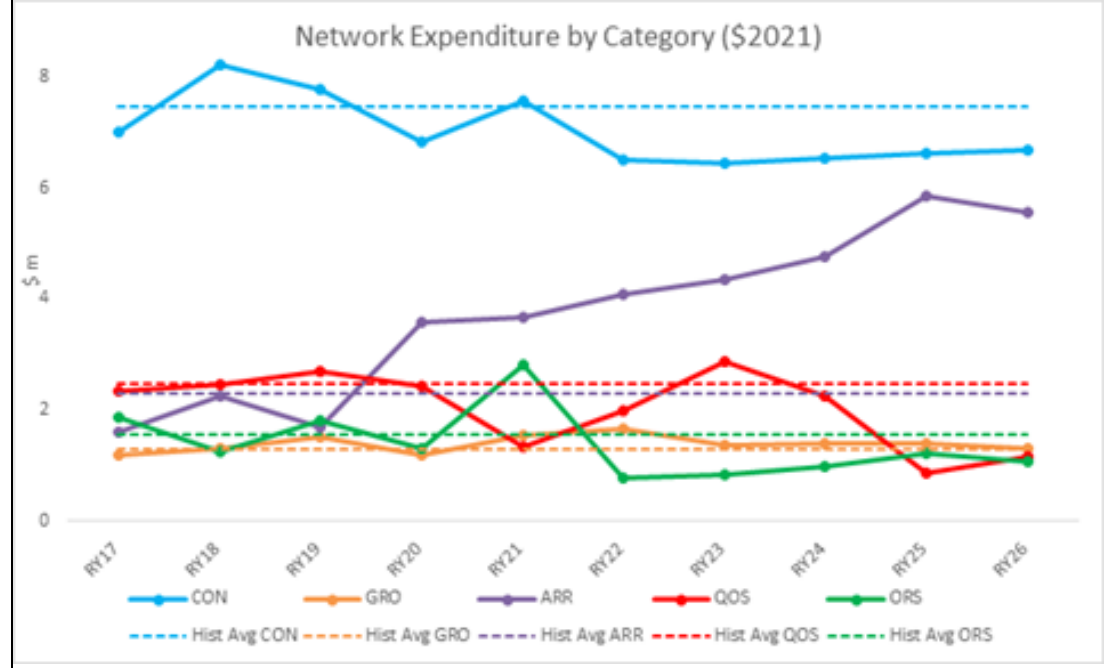
The figure below shows historical and forecast non-growth capex. The mismatch between historical four-year average and forecast capex is illustrated in the figure below. ARR capex (purple line) has been increasing steadily over the DPP2 period, with expenditure levelling off in the other categories.



The bulk of the forecast rise is attributable to our Pre-1985 polyethylene (PE) pipe replacement programme. This is discussed in Section 6 of our 2020 AMP, with the relative impact on capex forecasts illustrated in the figure below relative to other network capex categories.

Commission draft decision

Powerco view



Powerco’s ARR expenditure has been increasing steadily over the DPP2 period, with expenditure levelling off in the other categories. The impact of capping allowances at historical levels for non-growth capex does not support this capex investment where it is part of a cyclic asset replacement strategy to maintain a safe and reliable network. Specifically, reducing the allowance for non-growth capex would significantly impact our ability to deliver this programme. For example, our AMP update forecasts include \$6.5m for Pre85 PE replacement over the DPP3 period. However, the draft allowances effectively eliminate this (allowances over DPP3 are \$5.8m lower than forecast). Analysis of the underlying data indicates that around 40% of the forecast ARR capex included in our AMP update has a payback period by 2050.

Commission draft decision	Powerco view
	<p>There are alternative methods for setting allowances at prudent levels and in a low-cost way. One option is targeted scrutiny of the non-growth forecasts, mirroring the approach taken to growth forecasts (5.12). For DPP2, the Commission used quantitative explanations (ratios and metrics), qualitative assessment of AMPs (Asset Management Plans), and supplier evidence to judge whether to accept suppliers' category forecasts. An example of the scrutiny that could be applied is the cost driver test the Commission applied to EDBs (Electricity Distribution Businesses) asset replacement and renewal expenditure. That test was based on a view that, over the long term, ARR expenditure should be broadly proportional to depreciation. Applying this test to our GDB indicates that our forecast ARR capex is reasonable.¹</p> <p>We recognise there is a balance to be struck when setting capex allowances to reflect the increased stranding risk, and an approach applicable to all suppliers. The Commission recognises this too (A20). Ultimately, the regulatory framework should support capex investment where it is an efficient solution to maintain a safe and reliable network for DPP3 and beyond (6.60). For non-growth capex allowances, there is merit in reviewing the reliance on historical values to support this outcome being achieved.</p>
<p>Forecasting operating expenditure</p> <ul style="list-style-type: none"> Operating expenditure allowances set using base, step and trend modelling approach Suppliers' actual opex in Disclosure Year 2020 (DY20) was used to set base opex. 	<ul style="list-style-type: none"> Powerco supports the base-step-trend approach for setting operating cost allowances We believe our opex forecasts are robust and linked to our capex forecasts. Powerco's forecasts were not scaled back by the Commission's forecasting model (though not adjusted to reflect the impact of potentially scaled back capex forecasts).
<p>Quality standards</p> <ul style="list-style-type: none"> The Commission are not proposing to introduce new quality standards for GDBs 	<ul style="list-style-type: none"> Powerco supports the decision to retain the existing GDB quality standards. We are not aware of any additional standards that are useful to GDBs or consumers.

¹ Our average ARR to depreciation ratio is 0.28. If accelerated depreciation wasn't applied the ratio would be 0.33.

Commission draft decision	Powerco view
<p>Forecasting demand using GDB's own forecasts</p> <ul style="list-style-type: none"> GDB forecasts of ICP growth and natural gas demand to form the basis of supplier Constant Price Revenue Growth (CPRG) demand forecasts 	<ul style="list-style-type: none"> Powerco supports this approach in principle given that forecasts and expenditure allowances will be linked. Future settings may require a different approach to reflect policy or regulatory settings (eg a revenue cap or policy settings affecting customer connections).
<p>Starting prices / use of the x-factor to smooth revenue</p> <ul style="list-style-type: none"> Real MAR (Maximum Allowable Revenue) are capped at 10% per annum in real terms for all four years of DPP3 (including the starting price adjustment). 	<ul style="list-style-type: none"> Powerco supports the use of alternative rates of change to mitigate consumer price shock. Our understanding is that the 10% limit is a judgement call. We have no evidence to suggest an alternative limit, but we think it would be useful if the Commission developed a robust and transparent methodology.
<p>Form of control</p> <ul style="list-style-type: none"> The weighted average price cap is retained 	<ul style="list-style-type: none"> We think there is merit in alternative forms of control, such as revenue control. But given the materiality of other issues, it is reasonable to defer consideration of changes to the form of control. Because gas demand may be affected by policy decisions within the DPP3 regulatory period, the form of control for GDBs warrants further thought in the upcoming IM review and at the next gas DPP reset.
<p>Capex reopeners</p> <ul style="list-style-type: none"> Growth and asset relocation capex re-openers proposed to provide GPBs with some flexibility to seek additional expenditure in circumstances where capital contributions are not appropriate 	<ul style="list-style-type: none"> Powerco supports these mechanisms being included in the IMs. They provide sensible optionality to complement the approach taken to capital expenditure for DPP3 and beyond.