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Dear Charlotte

Options to maintain investment incentives in the context of declining demand

1. This is Vector's submission to the Commerce Commission's (Commission) consultation on options to maintain investment incentives in the context of declining demand.

2. Vector, along with Powerco and First Gas has obtained an expert report from Frontier Economics (Frontier) in response to this consultation paper. This has been submitted as part of this consultation.

3. Vector has submitted previous expert reports on managing asset stranding risk to the Commission's consultation on the default price-quality path from 2022 (DPP3) for gas pipeline businesses (GPB). We have not resubmitted these reports as we understand they are already on the record for this IM review and will be considered in the Commission's decision making for this consultation.

4. Nothing in this submission is confidential and we are happy for it to be published on the Commission's website.

Need to preserve ex ante financial capital maintenance (FCM)

5. We support the Commission's approach in considering options that preserve ex ante FCM through the building blocks model.

6. It is clear the Part 4 purpose is best served by maintaining an expectation of ex ante FCM. It will also better support the 2050 net zero target in line with s5ZN of the Climate Change Response Act 2002.

7. New Zealand's energy system is undergoing a transformation as the economy electrifies in response to climate change and the 2050 net zero. This will require significant investment and growing coordination and collaboration by energy stakeholders, including all parts of the supply chain.

8. In the gas sector, the future is uncertain. The gas network may be repurposed from natural gas into a clean gas network (e.g. hydrogen) or may ultimately cease to operate. However, as noted in the options paper:

   > "*natural gas remains an essential energy source for many homes and businesses. While the delivered volume of natural gas will likely decline over time, it is not clear how quickly this will happen or when any phase out will be complete*.

Investment is necessary to ensure the networks provide a safe and reliable supply of natural gas until they are no longer needed."[1]

9. Furthermore, investment into the gas network is needed to ensure an orderly transition occurs. Failure to deliver an orderly transition could result in security of supply issues, consumers paying higher prices than they otherwise would have, the network ceasing to operate despite remaining consumer demand; and could delay or disrupt the transition to net zero.

10. In the electricity sector, there is a need for significant increased investment to deliver electrification. We note precedent around FCM in the gas sector may also influence investor behaviour in the electricity sector. Particularly given the rapid pace of technological change in the sector, investors may be unwilling to invest if they lose confidence the regulatory regime will deliver FCM.

A combination of options A, B and C will best promote the Part 4 purpose

11. We recommend the Commission adopt the approaches suggested by Frontier in its expert report.

12. In relation to the Commission's proposed options, Frontier recommended that:

    - The Commission allow suppliers to propose the economic life of new and existing assets at each price reset (Options A and B); and

    - The Commission adopt approaches to front load the recovery of costs (Option C), including:
        - Methodologies that would align the depreciation allowance more closely to natural gas demand than the straight line method; and
        - Removal of RAB indexation.

13. Options A, B and C will better meet the Part 4 purpose than implementing a mechanism to provide ex ante compensation (Option D). Calculating the appropriate level of compensation under option D has an inherent risk of under-compensating or over-compensating suppliers.

14. In contrast, options A, B and C only impact the timing of cost recovery so are NPV neutral. Accordingly, they will better promote the Part 4 purpose. In particular, by avoiding any risk of compromising suppliers' ability to invest due to under-compensation (in line with s52A(1)(a) of the Commerce Act) and avoiding any risk to consumers of suppliers inadvertently extracting excessive profits due to over-compensation (in line with s52A(1)(d)).

15. Options A, B and C will also be the least complex (and therefore least costly) to implement given they are more consistent with the existing approach to asset stranding risk implemented in the GPB IMs. Furthermore, there is inherent difficulty and risk associated with calculating an appropriate amount of ex ante compensation.

16. The Commission should not consider an approach that would remove assets from the RAB (Option E). This would undermine the Part 4 purpose by reducing supplier and investor confidence that the regime will deliver FCM thereby compromising their ability and willingness to invest.

[1] Commerce Commission, *Input Methodologies Review: Options to maintain investment incentives in the context of declining demand* (20 December 2022) at para X22 – X23

17. While the Commission notes this option would be accompanied by ex-ante compensation, risks remain that the calculation of ex ante compensation either overcompensates or undercompensates suppliers. Furthermore, introducing the ability to remove assets from the RAB would be a significant departure from long established regulatory precedent under Part 4. This could severely undermine investment incentives and therefore harm the long-term benefit of consumers. This approach would also add significant complexity and therefore cost into the regime.

18. Accordingly, introducing the ability to remove stranded assets from the RAB has the potential to significantly undermine the long-term benefit of consumers and does not have any advantages relative to the other options proposed.

Allocation of risk

19. We note the Commission has discussed stranding risk in the context of the appropriate allocation of stranding risk between consumers and suppliers.

20. We consider the current allocation of long-term demand risk best promotes the Part 4 purpose (in line with our comments at paras 16 – 18). Frontier's report provides further explanation around why the current allocation of risk best promotes the Part 4 purpose.[2]

21. For example, Frontier explains:

"*In our view, the IMs should seek to minimise the risk of asset stranding—not for the benefit of suppliers, but for the benefit of consumers. Without preserving the incentives for suppliers to keep making the investments required to supply services as long as demand exists, consumers are likely to be considerably worse off. It is difficult to see how such an outcome would promote the Part 4 purpose.*

The Consultation paper explains that an important consideration for the Commission is the stranding risk that consumers might face: namely, the risk that consumers may invest in appliances and production processes and then find that they are unable to utilise those investments fully. In our view, the most effective way of preventing consumers' investments from becoming stranded would be to incentivise suppliers to not withdraw supply prematurely through underinvestment in their networks. That is, effective management of the stranding risks faced by suppliers would also help mitigate the stranding risks faced by consumers. This means that regulatory action by the Commission to manage suppliers' stranding risks would align the interests of consumers and suppliers, rather than put them in conflict."[3]

Price uncertainty

22. The Commission's options paper notes the risk of price uncertainty for GPB consumers having a 'chilling effect' leading to an inefficient decline in demand for gas networks.

23. The options paper states that, "*for price uncertainty to be a problem in the context of gas pipeline services, it would need to undermine the purpose of our regulation. Practically, there may be some threshold where uncertainty undermines consumer confidence in continuing to invest in and use gas (especially for major gas users).*"[4]

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[2] Frontier Economics, *Options to maintain investment in the context of declining demand: A report prepared for Vector, Powerco and First Gas* (25 January 2023), section 2.2
[3] Ibid, at para 43 - 44
[4] Commerce Commission, *Input Methodologies Review: Options to maintain investment incentives in the context of declining demand* (20 December 2022) at 2.41

24. We consider changing the allocation of stranding risk to manage price uncertainty would conflict with the Part 4 purpose since this could compromise the principle of ex ante FCM. This could result in significant harm to consumers by undermining investment incentives.

25. In addition, there are more appropriate ways of addressing consumer price uncertainty –
    - GPBs have an incentive to manage price volatility in their own pricing to avoid this outcome, regardless of regulated revenues. Implementing a revenue cap would also strengthen these incentives;
    - The Commission has existing regulatory tools to manage price increases if it considers this is necessary. For example, it smoothed price increases in DPP3; and
    - Front-loading the recovery of costs by changing the depreciation profile and un-indexing the RAB from inflation will reduce the risk of price shocks by ensuring more costs are recovered from a wider customer base.

Need for an un-indexed RAB

26. We do not consider retaining GPB RAB indexation can be justified in the current environment where networks face declining demand and asset stranding risk.

27. RAB indexation defers the timing of capital recovery relative to an un-indexed approach. This serves to inflate the scale of the stranding problem, undermine measures to address stranding risk (including accelerated depreciation implemented as part of DPP3) and leaves more cost recovery to future consumers (likely a much smaller customer base).

28. Frontier's expert report explains that front loading cost recovery (including removing RAB indexation) should be seen as a complement to, rather than a substitute for Options A and B:

    > "*The Consultation paper notes that the front-loading of cost recovery could be achieved in a more precise and controlled way using alternative depreciation approaches (better reflecting the using of assets over their economic lives) than the removal of indexation. We agree with that point. However, we do not think that the Commission should view the removal of RAB indexation as an alternative to other approaches it might adopt to front-load cost recovery. Rather, we suggest that the Commission view the removal of RAB indexation as a complement to other approaches it might implement to front-load cost recovery and manage the asset stranding risk faced by suppliers by preventing the unnecessary back-loading of costs.*"[5]

29. Accordingly, the Part 4 purpose is best promoted by un-indexing the RAB, in addition to implementing Options A, B and C to avoid unnecessarily backloading cost recovery and therefore undermining approaches to maintain investment incentives in the context of declining demand. We also note un-indexing the RAB is NPV neutral.

Form of control

30. Retaining the weighted average price cap as the form of control will also undermine the effectiveness of any approach adopted to preserve investment incentives.

31. This is because GPBs now face significant uncertainty in forecasting demand for natural gas (including in the short term) so the current form of control creates a real risk of cost under-recovery. GPBs will not be able to invest if they cannot recover their costs in practice.

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[5] Frontier Economics, *Options to maintain investment in the context of declining demand: A report prepared for Vector, Powerco and First Gas* (25 January 2023) at para 81

32. Along with long term demand uncertainty, GPBs also face significant demand uncertainty in the short term. This makes producing a credible forecast for the weighted average price cap unrealistic. For example -

- The Gas Transition Plan which will set out immediate steps on the Government's long term pathway for gas is expected to be completed by the end of 2023 and the New Zealand Energy Strategy is expected by the end of 2024. The Government is also progressing various workstreams supporting hydrogen in New Zealand.

- The impact of these plans (including on consumer behaviour) will likely not be known when GPBs prepare their demand forecasts ahead of the 2026 DPP.

- New Zealand's General Election scheduled for October 2023 creates further uncertainty around future government policy and its impact on gas demand.

- The current macro-economic environment, including significant cost of living pressures, supply chain constraints and potential economic recession will have an impact on consumer behaviour and infrastructure (including housing) development. Again, this creates uncertainty around gas demand.

- Indeed, as quoted earlier in this submission, the Commission's options paper recognises a decline in demand for natural gas overtime is likely but "*it is not clear how quickly this will happen*."[6]

33. Accordingly, the Part 4 purpose is better promoted by implementing a revenue cap as the form of control. This will ensure suppliers do not face disincentives to investment from demand forecast uncertainty.

34. Implementing a revenue cap will likely reduce complexity in the Part 4 regime. We expect the options proposed to address long term demand risk will be simpler for GPBs to implement under a revenue cap than a weighted average price cap.

35. Furthermore, the policy intent behind the weighted average price cap – to provide an incentive for GPBs to pursue new connections – is no longer appropriate in the context of New Zealand's net zero transition. Implementing a revenue cap would better support the net zero target in line with the Climate Change Response Act 2002.

36. If the Commission does not change the form of control, we consider a re-opener (or other mechanism) to manage volume forecast risk needs to be introduced to avoid compromising investment incentives.

Yours sincerely

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GM Economic Regulation and Pricing

[6] Commerce Commission, *Input Methodologies Review: Options to maintain investment incentives in the context of declining demand* (20 December 2022) at X22