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13 March 2025

Matthew Clark
Manager, Transpower and Gas
Commerce Commission
Wellington 6011
By email: infrastructure.regulation@comcom.govt.nz

Dear Matthew

Open letter on gas DPP4 2026 price-quality reset

1. This is Vector's response to the Commerce Commission's open letter on the gas DPP4 reset.

2. We appreciate the timeliness of the Commission's open letter. Early and ongoing engagement will allow stakeholders and the Commission to canvas the breadth of issues needed to determine a price-path that best supports the long-term benefit of consumers in a complex and uncertain environment for gas.

3. The table below summarises the key recommendations made in this submission.

Topic	Vector submission
Mitigating short term demand risk	Our experience in DPP3 has heightened our concern that the regulatory framework currently lacks appropriate mechanisms to mitigate or share short term demand risk. This compromises incentives to invest and threatens the financeability of the notional GPB. Given ongoing uncertainty, the risk that actual demand differs from forecast remains a significant concern in DPP4. We recommend the Commission implements: - A revenue cap; or - A volume wash-up; or - Alternative re-opener mechanisms if the Commission is not willing to introduce a wash-up.

	If short term demand risk is left unaddressed we consider a risk premium in the WACC would be justified to account for this risk.
Managing stranding risk	Recent market developments suggest a more aggressive approach to managing stranding risk is needed in DPP4 to preserve incentives to invest and ensure remaining consumers are not burdened with exponential price rises in later years. The risk of asset stranding is now materially higher than when the Commission made its decisions on DPP3 and the 2023 IM review. We recommend the Commission implement: - A higher adjustment factor to accelerate depreciation; - Un-indexing the RAB from inflation to avoid inflating the scale of stranding risk; - A more tilted depreciation profile; and - A higher risk premium in the WACC
Decommissioning costs	We recommend the Commission clarify its view on how decommissioning costs should be treated under the regulatory framework.
Expenditure	We consider using historic expenditure to determine allowances may not be appropriate in current environment. In the context of declining demand, GDBs will see reduced capex and increased opex. The approach to setting expenditure in DPP4 needs to account for: - opex / capex trade-off; and - A likely step up in opex;
Innovation	We recommend the Commission allow innovation funding for GDBs to trial new technologies that could preserve optionality as volumes decline, increase safety, or reduce overall costs.
Quality standards	We consider the current quality standards are fit for purpose and do not recommend the Commission consider any new quality standards in DPP4.

Context for the reset

1. We agree with the Commission's description of the context for the DPP4 reset where:

- The volume of gas delivered is expected to decline over time in order to meet New Zealand's commitment to net zero by 2050. The pace of this change, and extent of overall decline in volume and customer numbers, remains uncertain;

- Ongoing use of gas means incremental and ongoing investment is needed to ensure safe and reliable supply. This investment depends on maintaining GPBs' expectation that they will recover the cost of assets and make a normal economic return (i.e preserving ex ante financial capital maintenance); and

- The Commission's task for the DPP4 reset is to promote the long term benefit of consumers, including increasing focus on incentives to maintain a safe and reliable network to meet consumer demand balanced with risks that GPBs are unable to recover asset costs in the context of declining demand.

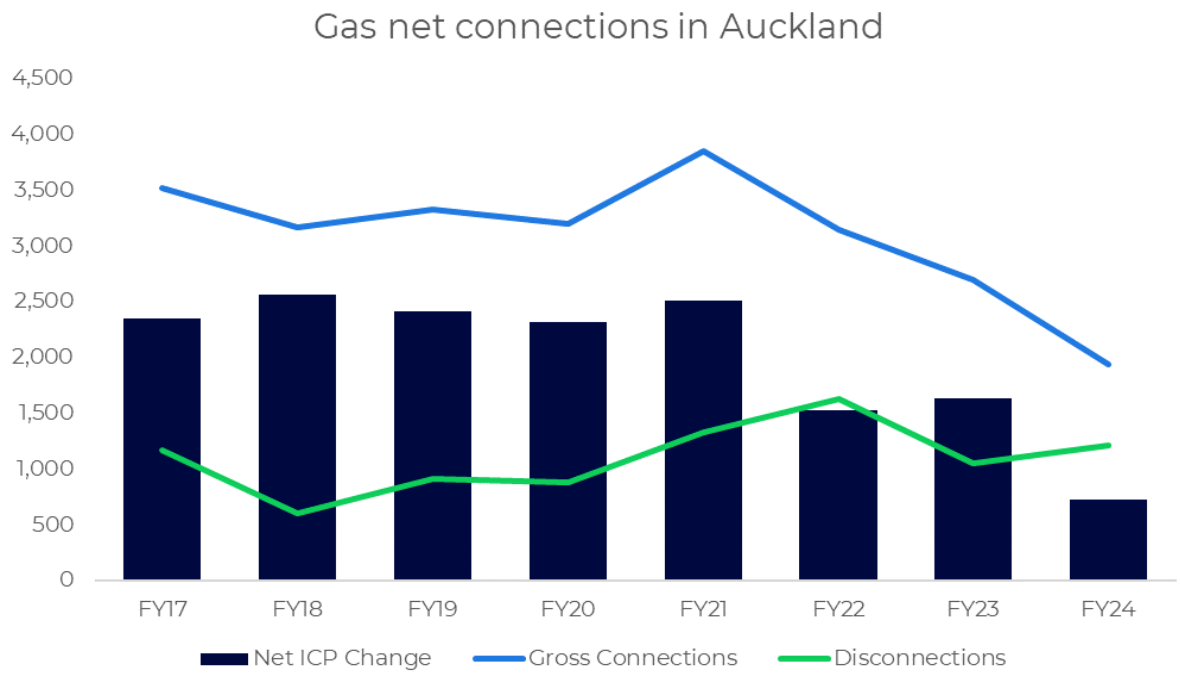
Context on Vector's network

2. Vector's network experienced declining gas volumes and declining new connections over DPP3. This included large industrial disconnections, for example, one of our largest consuming customers decommissioned in December 2024.

3. Similarly, gas volumes have been declining since FY18. We note most of our consumption is driven by commercial & industrial usage.

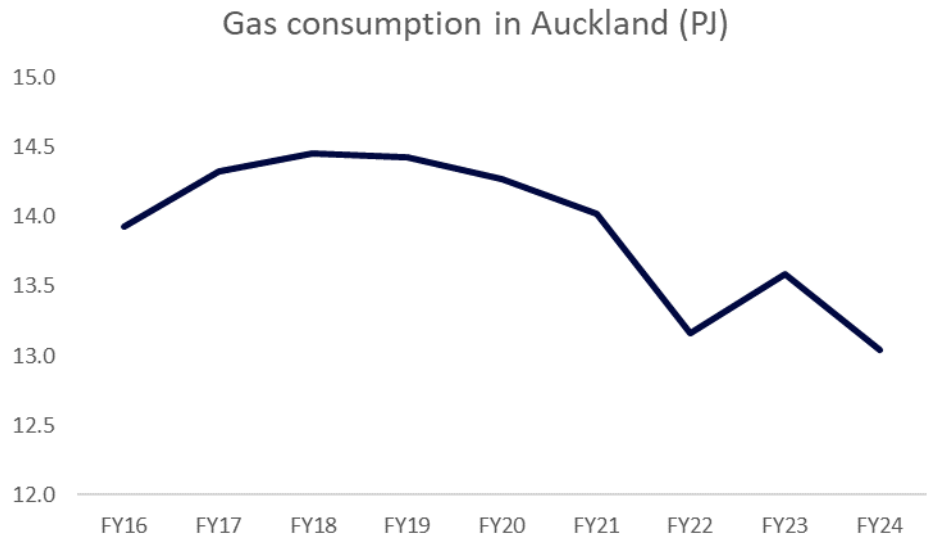
4. The following charts show the declining trend in connections and volumes over the period.

Chart one: Connections



5. Chart One shows declining gross connections and a slowing down in net connections.

Chart two: gas consumption



6. Chart two shows total consumption has been trending down since FY18.

Process for the reset

7. As discussed above, we appreciate the Commission's early engagement on the open letter. We consider the Commission's recent process resetting EDB price-paths will be useful to build on for this reset.

8. In line with the EDB DPP4 process, we consider workshops would provide a valuable opportunity for feedback and discussion between the Commission and stakeholders.

9. Our initial thoughts are the following topics would benefit from a workshop:
    - Volume risk and appropriate mechanisms to mitigate this;
    - Heightened asset stranding risk in the current context;
    - Managing the opex and capex trade-off under the GPB framework; and
    - Innovation funding for GPBs.

Mitigating short term demand risk

10. In order to promote the long-term benefit of consumers, managing the risk that that demand is lower (or higher) than forecast should be a key feature of DPP4.

11. Our experience in DPP3 has heightened our concern that the regulatory framework currently lacks appropriate mechanisms to mitigate or share short term demand risk. This compromises incentives to invest and threatens the financeability of the notional GPB. Over

the course of DPP3 our real revenue growth rate has been lower than the Commission's assumptions setting the price-path.

12. This will become a significant problem if it continues to occur in future price-paths.

13. Given ongoing uncertainty, the risk that demand differs from forecast remains a significant concern in DPP4. In particular, the behaviour of large industrial consumers (i.e. whether individual large industrials remain or exit) will have a major impact. This is an area GPBs have little influence over.

14. This risk needs to be addressed in DPP4 to avoid compromising incentives to invest and ensure the notional GPB remains financeable. Accordingly, we strongly recommend the Commission amend the IMs to introduce:
    - A revenue cap;
    - A volume wash-up; or, at a minimum,
    - Re-opener mechanisms to re-open the price-path where volumes are significantly different from forecast.

15. In our view, a revenue cap remains the best option to address short term demand risk. The weighted average price cap currently implemented in the IMs is designed to incentivise new connections. This is not an appropriate incentive in the current environment. We note in the UK, Ofgem has maintained a revenue cap for gas networks since 2007.

16. Frontier's report for Vector, submitted during the 2023 IM review, described Ofgem's approach:[1]

    "*Ofgem's decision to set price controls for GDBs using revenue caps rather than price caps followed a recognition by Ofgem that nearly all of the costs incurred by GDBs in delivering regulated services are fixed. Therefore, exposing GDBs to volume risk did not improve incentives to match available network capacity to peak demand. Instead, allowing GDBs' volumes to vary with volumes simply introduced unnecessary (and unmanageable) volatility into the recovery of efficient costs, since GDBs typically have little control over the factors that might cause demand to fluctuate over the regulatory period*."

17. We recognise the Commission maintained the weighted average price cap in the 2023 IM review. However, we consider there is now more evidence about ongoing gas price volatility and its impact (e.g. gas supply uncertainty and large industrials disconnecting or reducing operations in 2024) which makes it appropriate for the Commission to revisit this decision.

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[1] Frontier Economics, *The merits of introducing a revenue cap for gas distribution businesses: a report prepared for Vector* (April 2023) at para 17, available: https://comcom.govt.nz/__data/assets/pdf_file/0024/323169/Vector-Frontier-Economics-The-merits-of-introduced-a-revenue-cap-for-gas-distribution-businesses-6-April-2023.pdf

18. However, if the Commission maintains a weighted average price cap, it is critical other mechanisms to wash-up volumes are introduced to address volume risk. Recent regulatory precedent in Australia supports this approach.

19. Jemena Gas Networks (NSW) proposed a 'hybrid tariff variation' mechanism for its 2025-2030 price control period. This involves a +/-5% threshold and sharing volume risk 50:50 with customers. If actual gas volumes in a regulatory year are more than 5% lower/higher than forecast, then revenue under/over recovery will be split with customers (via higher or lower tariffs in future years). The AER accepted this proposal in its draft decision (the final decision will be published by May 2025).[2]

20. We consider introducing a similar mechanism to wash-up volumes would support the long-term benefit of consumers, although we consider lower thresholds would be needed in the NZ context.

21. In addition, we recommend the Commission consider introducing a volume re-opener. This is also supported by Australian regulatory precedent, where gas networks can apply to re-open their price path where volumes are materially different from the forecast used to set the price path.

22. There is inherent uncertainty and administrative burden involved in the re-opener process so this option would be less effective than implementing a revenue cap or volume wash-up. However, we consider it would be better than the status quo.

23. If short term demand risk is left unaddressed, we consider a risk premium in the WACC would be justified to account for this risk.

Managing asset stranding risk

24. Managing asset stranding risk in the context of declining demand remains a key task for this DPP reset.

25. The Commission's decision to reduce asset lives in DPP3 was an appropriate response, although we consider the Commission took a conservative approach.

26. In our view, recent market developments suggest a more aggressive approach to managing stranding is risk is needed in DPP4 to preserve incentives to invest and ensure remaining consumers are not burdened with exponential price rises in later years.

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[2] AER, *Draft Decision: Jemena Gas Networks (NSW) access arrangement 2025 to 2030, Attachment 10 – Reference tariff variation mechanism* (Nov 2024), available: https://www.aer.gov.au/system/files/2024-11/AER%20-%20Draft%20decision%20-%20JGN%20access%20arrangement%202025%E2%80%9330%20-%20Attachment%2010%20-%20Reference%20tarff%20variation%20mechanism%20-%20November%202024.pdf

27. As identified in the Commission's open letter, MBIE forecasts that gas production will not meet demand for at least the next three years based on the most recent (July 2024) reserves data; and the existing gas shortage has impacted all areas of the supply chain (e.g. fewer retailers accepting new gas customers and reductions in business operations).

28. This is consistent with recent experience on Vector's network. Gas price volatility has moved the business case for electrification forward and has resulted in business closures and reductions in production (resulting in reduced gas consumption).

29. We do not consider any recent policy decisions (e.g. the reversal of the oil and gas ban) will reverse this overall trend, particularly given the potential for policy to change with different governments approaches.

30. Accordingly, the risk of asset stranding is now materially higher than when the Commission made its decisions on DPP3 and the 2023 IM review.

31. For DPP4, we recommend the Commission:
    - **Apply a larger adjustment factor:** shorter asset lives are needed in DPP4 to reflect increased standing risk.

    - **Un-index the RAB from inflation**: We remain concerned that indexing the RAB to inflation serves to inflate the scale of the stranding risk and undermine the intent behind accelerating depreciation (i.e. the need to bring cashflows forward). In our view, recent market developments (such as large industrial disconnections in 2024) provide a reason for the Commission to revisit its decisions from the 2023 IM review; and

    - **Implement a tilted accelerated depreciation profile rather than straight line accelerated depreciation**: In the face of heightened stranding risk, we consider it would be appropriate for the accelerated depreciation profile to be more front-loaded so greater recovery can be spread over the current larger customer base. For example, the following approaches could be considered to support accelerated depreciation:

        - A 'diminishing value' approach: where the rate of depreciation is a fixed percentage of the remaining asset value. This results in larger depreciation in early years with less in later years. This method has been applied in the Netherlands.[3]

[3] Oxera, *Regulatory tools applied to gas networks to accommodate energy transition: note prepared for Vector, First Gas and Powerco* (August 2021) available: https://comcom.govt.nz/__data/assets/pdf_file/0016/264400/Powerco-Vector-and-Firstgas-Oxera-Energy-transition-regulation-report-Submission-on-Gas-DPP-2022-process-and-issues-paper-30-August-2021.pdf

- A 'tilted annuity' approach: where the rate of depreciation declines annually depending on the tilt. The tilt can be designed to match future gas volume declines to mitigate price increases on consumers. This method was applied to Chorus' financial loss asset.
- A 'sum of digits' approach: Where the rate of depreciation declines linearly, by the same amount each year, from the year it is commissioned down to zero when it reaches the end of asset life. This approach has been implemented in the UK since 2013 by Ofgem.[4]

- **Amend the WACC determination to provide a higher risk premium**: The higher stranding risk should be reflected in the WACC, otherwise investors will look to assets with similar return but less risk.

Approach to expenditure

32. We do not consider historic expenditure an appropriate starting point to determine DPP4 expenditure. In the context of declining demand, GPBs are likely to spend less on capex and more on opex going forward.

33. This additional expenditure will not be captured in the base year of a step and trend opex forecast. Furthermore, there is no offsetting benefit where a GPB makes a capex saving by increasing opex, as there would be under the regulatory framework for EDBs. This could undermine incentives for efficient expenditure.

34. In determining DPP4, we consider the key issues related to expenditure are:

- Managing the opex/capex trade-off in an environment where opex is likely to increase relative to capex;
- Determining appropriate step changes for opex. We consider the Commission's approach to step changes in EDB DPP4 (i.e. providing a template for EDBs to submit their step changes, along with guidance on how to meet the Commission's assessment criteria) delivered a good outcome and could be applied for GPB DPP4.
- We consider step changes are likely to be needed for:
  - Accelerated disconnections;
  - Step changes to cover increased costs such as insurance, SaaS and traffic management; and
  - Step changes for projects that help transition gas networks towards net-zero emissions (for example increased gas leak detection surveys). We recommend the AER methodology for valuing emissions be adopted by the Commission to assess

[4] Ibid

GPB emission reduction spending.[5] Alternatively, the Commission could benchmark using the emissions trading scheme price.

35. We also note, in EDB DPP4, the Commission applied an inflation adjustment to "to reflect historical higher inflation in the electricity, gas, water, and waste sector that we consider is likely to persist in the medium-term."[6] This should also be applied in GDB DPP4 if a base step and trend approach is used.

Decommissioning costs

36. The Open Letter did not discuss decommissioning costs. We consider this is another topic that should be canvassed as part of the DPP4 reset.

37. GPBs will have obligations to decommission assets when their networks are at the end of life. GAAP allows for decommission costs to be part of an asset commissioned value. We would consider it is appropriate that the GAAP treatment is followed for legitimate decommissioning costs. This will ensure that suppliers are compensated for those decommissioning costs before they are required to be incurred. This would be appropriate as at the end a networks life there is likely to be insufficient consumers to recover those costs from. If suppliers are not appropriately compensated for decommissioning costs this is likely to bring forward significantly the ceasing of the pipeline services. This is due to the businesses being in a negative cashflow position a lot earlier than if decommissioning costs were compensated. We would like to understand the Commission's view on how it considers decommissioning costs should be treated under the regulatory framework.

38. We recognise there is a broader conversation involving the role of government in decommissioning. However, if GPBs are to have certainty on decommissioning cost recovery, it is necessary to get a clear view from the Commission on how these costs should be treated under the current regulatory framework.

Innovation

39. As noted in the Open Letter, the second emissions reduction plan sees a potential role for landfill gas capture; carbon capture, utilisation and storage; and hydrogen and biogas as fuel substitutes.

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[5] AER, *Valuing Emission's Reduction: AER guidance and explanatory statement* (May 2024) available: https://www.aer.gov.au/system/files/2024-05/AER%20-%20Valuing%20emissions%20reduction%20-%20Final%20guidance%20and%20explanatory%20statement%20-%20May%202024.pdf

[6] Commerce Commission, *EDB DPP4 Final Reasons Paper: Attachment C operating expenditure* (Nov 2024) at C428

40. We recommend the Commission introduce innovation funding for GPBs to trial these processes to support emissions reductions. This would support the long-term benefit of consumers by potentially preserving optionality on the network along with supporting the net zero target.

41. We note the decline in gas volumes could provide an opportunity for a greater blending component across the network suggesting a role for appropriate innovation funding.

Quality standards

42. We consider the current quality standards are fit for purpose and the Commission should not consider any new quality standards in DPP4. This would be a distraction from the key issues in the current environment.

Yours sincerely

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