

**IN THE HIGH COURT OF NEW ZEALAND
WELLINGTON REGISTRY**

**I TE KŌTI MATUA O AOTEAROA
TE WHANGANUI-A-TARA ROHE**

**CIV-2022-485-348
CIV-2022-485-352
[2024] NZHC 959**

UNDER Sections 91 and 52Z of the Commerce Act
1986

IN THE MATTER of an appeal against the Gas Transmission
Services Input Methodologies Amendment
Determination (No. 2) 2022 and Gas
Distribution Services Input Methodologies
Amendment Determination (No. 2) 2022

AND an appeal against the Gas Transmission
Services Default Price-quality Path
Determination 2022 and the Gas Distribution
Services Default Price-quality Path
Determination 2022

BETWEEN MAJOR GAS USERS' GROUP
INCORPORATED
Appellant

AND COMMERCE COMMISSION
First Respondent

continued ...

Hearing: 16–20 October 2023

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Judgment: 29 April 2024

**JUDGMENT OF RADICH J AND
LAY MEMBERS PROFESSOR A VAN ZIJL AND DR J WALKER**

... continued

FIRST GAS LIMITED
Second Respondent

POWERCO LIMITED
Third Respondent

VECTOR LIMITED
Fourth Respondent

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Introduction

[1] There are a number of markets in which there is little or no competition and little or no likelihood of a substantial increase in competition. The gas pipeline services, provided by the second, third and fourth respondents are markets of that kind.¹

¹ Gas pipeline services are regulated through s 55B of the Commerce Act 1986. First Gas, Powerco and Vector are all suppliers of gas pipeline services. First Gas has both transmission and distribution pipelines, while Vector and Powerco are gas distribution businesses.

[2] Part 4 of the Commerce Act 1986 regulates those markets for the long-term benefit of consumers by promoting outcomes that are consistent with outcomes that are produced in workably competitive markets. It does so by regulating the price and quality of goods or services in the markets to which it relates.

[3] Prices and quality in those markets are regulated through the Commerce Commission setting “default price-quality paths” for regulated suppliers.²

[4] In order to set prices under default price-quality paths, the Commission prepares sets of regulatory rules and processes, known as “input methodologies”.³ The input methodologies include an allowance for the depreciation of assets.

[5] In response to Government signalling on the phase-out of fossil fuels such as natural gas, the Commission has amended input methodologies for gas pipeline businesses to enable adjustments to be made to the asset lives of gas pipeline assets.⁴ That, in turn, enables depreciation on them to be brought forward, which would increase the calculated costs of gas pipeline operators and, therefore, their regulated prices.

[6] Major Gas Users Group Inc (MGUG) – an association of businesses that are major users of natural gas – say that the Commission’s decision is premature, that it is contrary to the purpose of pt 4 of the Act (prescribed in s 52A) and that it is contrary to the purpose and nature of input methodologies under ss 52R and 52T of the Act. It says that the change overcompensates suppliers at the expense of consumers.

[7] The Commission, First Gas Ltd, Powerco Ltd and Vector Ltd say that the decision does no more than to enable the Commission to adjust an asset life and depreciation calculation in the input methodologies that is known to be wrong and that, in doing so, it is consistent with the purpose of the pt 4 scheme and of the mechanisms used to give effect to it.

² Under pt 4, sub-pt 6 of the Commerce Act. The Commerce Commission may set customised price-quality paths for individual suppliers as a replacement for a default price-quality path through s 53Q of the Act.

³ Commerce Act, s 52S(b)(ii).

⁴ Its decision makes amendments to input methodologies that apply during the regulatory period from 1 October 2022 to 30 September 2026.

[8] There are two overarching issues for the Court. The first relates to the input methodologies determination of the Commission in which it enabled the asset life reduction to be used. The Court is to consider whether an item of relief sought by MGUG – revoking the changes, restricting them or sending them back for reconsideration – is “materially better” than the amendment the Commission has made, in meeting the purpose of pt 4.⁵

[9] The second relates to the Commission’s subsequent determination in which it used the revised input methodologies to accelerate gas pipeline depreciation in the 2022 default price-quality path for gas pipeline businesses. The Court is to consider whether the Commission erred in law in the ways it applied those changes to First Gas, Powerco and Vector in its default price-path determination.⁶

The legislative scheme

[10] The factual background and the issues arising from it would normally be explained before turning to the relevant legislative scheme. However, in this case an understanding of the scheme is needed before the Commission’s decision under it, and what the parties say about the decision, can properly be addressed.

[11] The case is grounded in pt 4 of the Commerce Act. Part 4 provides for the regulation of the price and quality of goods or services in markets in which there is little or no competition and little or no likelihood of a substantial increase in competition. First Gas, Powerco and Vector provide services in markets of that kind.

The purpose of Part 4

[12] Much of the case turns upon whether the decisions the Commission has made are consistent with the purpose of pt 4. The purpose of pt 4 is given in s 52A which is in the following terms:

52A Purpose of Part

- (1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting

⁵ Commerce Act, s 52Z(4).

⁶ Section 91.

outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
 - (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
 - (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
 - (d) are limited in their ability to extract excessive profits.
- (2) In this Part, the purpose set out in subsection (1) applies in place of the purpose set out in section 1A.

[13] Through the application of s 3(1) of the Act, the term “competitive markets” means “workably competitive markets”. A workably competitive market is one that provides outcomes that are reasonably close to those found in strongly competitive markets; a market in which prices reflect efficient costs (including the costs of capital and, accordingly, a reasonable level of profit).⁷

[14] An essential feature of s 52A is that it does not seek to mimic features of or behaviours in workably competitive markets. The markets that are regulated under pt 4 are not workably competitive. Rather, pt 4 introduces machinery of a type that does not feature in a workably competitive market in order to produce outcomes of a kind that are produced in workably competitive markets. Those kinds of outcomes promote the long-term benefit of consumers in those markets; benefits that would not otherwise be available to those consumers as a result of the level of market power that could, absent regulation, be exercised by the few firms within them.

[15] The “consumers” whose long-term benefit is to be promoted are consumers of all services regulated under pt 4 of the Act. In *Wellington International Airport Ltd v Commerce Commission*, the Court said that the purpose of pt 4 is to promote the long-term benefit of consumers of regulated goods and services as acquirers of those goods and services, rather than the broader interests of those consumers as participants in New Zealand’s wider economy, or the interests of consumers of unregulated services.⁸

⁷ *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289 [*Wellington International Airport*] at [14].

⁸ At [222] and [686].

The Court noted also that, while the interests of consumers of goods and services that might *potentially* be regulated under pt 4 were not *required* to be considered under s 52A(1), dynamic efficiency considerations suggest that it would nevertheless be appropriate for the Commission to consider their interests.⁹

[16] Workable competition and prices under pt 4 were the subject of careful analysis by the Court in *Wellington International Airport*. We draw upon that analysis throughout this decision.¹⁰

Default price-quality paths

[17] As s 53K of the Act provides, the purpose of default/customised price-quality regulation¹¹ is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.

[18] Under s 53L, the Commission is to set default price-quality paths that apply for a regulatory period and all regulated suppliers must apply those default price-quality paths, unless they make a proposal to the Commission for a customised price-quality path.

[19] Every price-quality path must, under s 53M, specify:

- (a) in relation to prices, either or both of the following for a specified regulatory period:
 - (i) the maximum price or prices that maybe charged by a regulated supplier;

⁹ At n 442.

¹⁰ Generally at [6]–[29]. The Court in that case considered appeals from multiple aspects of the first set of input methodology determinations made by the Commission under pt 4 brought by a number of firms in different markets regulated under pt 4 of the Act.

¹¹ Customised price-quality paths for individual suppliers are set through ss 53Q to 53ZB of the Commerce Act but are not in question in this case.

- (ii) the maximum revenues that may be recovered by a regulated supplier; and
- (b) the quality standards that must be met by the regulated supplier; and
- (c) the regulatory period.

[20] Default price-quality paths are to be set out in a determination made by the Commission under s 52P. Determinations under that provision must:

- (a) set out the requirements that apply to each regulated supplier;
- (b) set out any timeframes that must be met or that apply;
- (c) specify the input methodologies that apply;
- (d) be consistent with pt 4.

[21] Under s 53P, the starting prices must be either:

- (a) the prices that applied at the end of the preceding regulatory period; or
- (b) prices, determined by the Commission, that are based on the current and projected profitability of each supplier.

[22] In this case, we are dealing with the second of those approaches: prices determined by the Commission, based upon projected profitability of suppliers and set by applying the gas pipeline input methodologies.

Input methodologies

[23] Before default price-quality paths can be set under sub-pt 6, the Commission must, under sub-pt 3, determine the input methodologies to be used in calculating them. Section 52R provides that the purpose of input methodologies is to promote certainty for suppliers and consumers in relation to the rules, requirements and

processes applying to the regulation, or proposed regulation, of goods or services under pt 4.

[24] Input methodologies must be applied to determine the prices or quality standards applying to the goods or services in question.¹² Section 52T(1)(a) of the Act is in the following terms:

52T Matters covered by input methodologies

- (1) The input methodologies relating to particular goods or services must include, to the extent applicable to the type of regulation under consideration,—
 - (a) methodologies for evaluating or determining the following matters in respect of the supply of the goods or services:
 - (i) cost of capital;
 - (ii) valuation of assets, including depreciation, and treatment of revaluations;
 - (iii) allocation of common costs, including between activities, businesses, consumer classes, and geographic areas;
 - (iv) treatment of taxation;
 - ...

[25] In determining input methodologies, the Commission is to follow a prescribed process including through publishing a draft methodology and giving interested people a reasonable opportunity to give their views which may include holding conferences.¹³ When completed, an input methodology is secondary legislation.¹⁴

The building blocks method

[26] As the Court put it in *Wellington International Airport*, implicit in pt 4 price regulation is the use by the Commission of what is known as the “building blocks” method to determine or assess the revenues of suppliers of regulated services and control or influence the prices charged by those suppliers for those services.¹⁵ It is in the context of the building block method that input methodologies are determined which, in turn, are applied in setting default price-quality paths.

¹² Commerce Act, s 52S.

¹³ Section 52V.

¹⁴ Section 52W.

¹⁵ *Wellington International Airport*, above n 7, at [43].

[27] The building blocks method seeks to give effect to the s 52A purpose of promoting outcomes that are consistent with those produced in workably competitive markets. To that end, the method is based upon the notion that workably competitive markets produce prices based on costs. An entity's costs are inputs to application of the building blocks method and revenue is the output. This in turn determines prices. And prices reflect costs. The method is used in regulatory systems throughout the world.

[28] More particularly, the building blocks method enables the Commission to set, in advance of a particular regulatory period, regulated revenue that will enable a supplier to recover its costs and to earn a normal rate of return on its capital.

[29] The building block method calculates regulated revenue on the following basis:

$$\begin{aligned} & \text{regulatory asset base} \times \text{cost of capital} \\ & + \text{depreciation} + \text{operating expenditure} + \text{tax} \\ & - \text{revaluation gains (or} + \text{revaluation losses)} \\ & - \text{other income} \end{aligned}$$

[30] In this equation:

- (a) The regulatory asset base comprises the assets of suppliers that are used to supply services subject to regulation. Major components of the asset bases here are the pipelines of First Gas, Powerco and Vector.
- (b) Cost of capital is the cost of all types of capital – debt and equity – a supplier uses to fund its operations.
- (c) Depreciation is the allocation of the net cost (or other amount that substitutes for cost) of an asset over its expected life.

[31] The building block method gives effect to one of the fundamental principles of economic regulation: financial capital maintenance, including the *ex ante* expectation (or forecast) of normal returns. The Commission put it this way in its first input

methodologies decision for electricity distribution and gas pipeline services in December 2010 (2010 Input Methodologies Decision):¹⁶

Over the lifetime of its assets, a typically efficient firm in a workably competitive market would expect *ex ante* to earn at least a normal rate of return (i.e. its risk-adjusted cost of capital). Because allowing a firm the expectation of being able to earn normal returns over the lifetime of an investment provides it with the chance to preserve its ‘financial capital’ in real (not nominal) terms, such an outcome is often referred to as ‘financial capital maintenance’ or ‘FCM’. In a regulatory context, FCM is achieved, on an *ex ante* basis. This is comparable to expectations in competitive markets that are conducive to promoting investment.

[32] In *Wellington International Airport*, the Court recognised the financial capital maintenance concept as “central to the Commission’s approach” and endorsed its approach as “non-controversial”.¹⁷ The Court approved the Commission’s view that, in defining the cost of depreciation and allowed return, regulators should adopt rules that meet the financial capital maintenance accounting principle.¹⁸ The principle is sometimes referred to, also, as net present value equals zero (or NPV=0), meaning that, in net present value terms, suppliers will receive no more than the cost of their capital.

[33] Financial capital maintenance cannot be sustained if assets are stranded; that is to say, if assets are no longer able to earn enough revenue to enable investors to recoup the balance of their investment. Much of this case turns on who should bear the cost of asset stranding. Should it be borne by suppliers, through not being able to recover the cost of their asset through depreciation, or by consumers through higher prices?

[34] A point raised by MGUG, which we come on to address, is whether the fundamental justification for the role of financial capital maintenance simply ceases to exist given the unprecedented asset stranding issues that arise. And, aligned with that is the issue of whether the weighted average cost of capital (WACC), a component part of the building block method, already compensates gas pipeline businesses for the risk of asset stranding in any event or whether, as the Commission says, the equity

¹⁶ Commerce Commission *Input Methodologies (Electricity Distribution and Gas Pipeline Services) – Reasons Paper* (22 December 2010) [2010 Input Methodologies Decision – Reasons Paper] at [2.6.28] (footnotes omitted).

¹⁷ *Wellington International Airport*, above n 7, at [256].

¹⁸ At [256].

component of the WACC covers only systematic risks – i.e., those risks that affect the whole of the economy – and not the non-systematic risks that affect an individual supplier.¹⁹

The decisions on appeal

[35] The two decisions of the Commerce Commission in issue on this appeal are these:

- (a) The 2022 Input Methodologies Decision. This decision comprises the Gas Distribution Services Input Methodologies Amendment Determination (No. 2) 2022,²⁰ made on 30 May 2022, the Gas Transmission Services Input Methodologies Amendment Determination (No. 2) 2022, made on the same date,²¹ and a reasons paper, released also on 30 May, entitled *Amendments to input methodologies for gas pipeline businesses related to the 2022 default price-quality paths*.²² This decision allows the Commission to reduce, or increase, asset lives (and to bring forward or extend depreciation accordingly) in resetting the price path.
- (b) The 2022 Default Price-quality Path Decision. This decision comprises the Gas Distribution Services Default Price-quality Path Determination 2022,²³ made on 31 May 2022, the Gas Transmission Services Default Price-quality Path Determination 2022, made on the same date,²⁴ and a

¹⁹ As is discussed in further detail below, the “equity beta” component of the weighted average cost of capital for gas pipeline businesses is more generous than is the case for electricity distribution businesses but this is, the Commission says, only intended to address the level of systematic risk that gas pipeline businesses face; not non-systematic network stranding issues.

²⁰ Commerce Commission *Gas Distribution Services Input Methodologies Amendment Determination (No.2) 2022* ([2022] NZCC 15, 30 May 2022) [2022 Input Methodologies Decision – Determination].

²¹ Commerce Commission *Gas Transmission Services Input Methodologies Amendment Determination (No.2) 2022* ([2022] NZCC 16, 30 May 2022).

²² Commerce Commission *Amendments to input methodologies for gas pipeline businesses related to the 2022 default price-quality paths – Reasons Paper* (15.01/45340, 30 May 2022) [2022 Input Methodologies Decision – Reasons Paper].

²³ Commerce Commission *Gas Distribution Services Default Price-quality Path Determination 2022* ([2022] NZCC 19, 31 May 2022) [2022 Default Price-quality Path Decision – Determination].

²⁴ Commerce Commission *Gas Transmission Services Default Price-quality Path Determination 2022* ([2022] NZCC 20, 31 May 2022).

reasons paper, released also on 31 May, entitled *Default price-quality paths for gas pipeline businesses from 1 October 2022*.²⁵ This decision, using the 2022 Input Methodologies Decision, adjusted the asset lives for the default price-quality path for gas pipeline businesses for the third regulatory period – 1 October 2022 to 30 September 2026.

[36] Each decision is the subject of a different right of appeal.

Rights of Appeal

Right of appeal for the 2022 Input Methodologies Decision

[37] The 2022 Input Methodologies Decision is subject to appeal under s 52Z of the Act.²⁶ Under that provision, the Court may only exercise its powers to allow the appeal “if it is satisfied that the amended or substituted input methodology is (or will be, in the case of subsection (3)(b)(iii)) materially better in meeting the purpose of this Part, the purpose in section 52R, or both.”

[38] The “materially better” test is unique among statutory appeal tests.²⁷ The Court, in *Wellington International Airport*, considered whether a “two-step” approach to determining appeals under the provision was necessary, that is to say, whether in the first instance the Court was required to determine whether the Commission erred in determining an input methodology and, secondly, if the answer to that question is “yes”, whether the Court would then address the materially better question. It found that a two-step approach was not appropriate:²⁸

In terms of the *Austin, Nichols* principles, we think the effect of s 52Z(4) is that the [input methodology] determination under appeal will be wrong in the

²⁵ Commerce Commission *Default price-quality paths for gas pipeline businesses from 1 October 2022 – Final Reasons Paper* (15.01/45340, 31 May 2022) [2022 Default Price-quality Path Decision – Reasons Paper].

²⁶ Section 52Z(2) of the Commerce Act states that s 52Z applies to the initial determination of an input methodology, any determination by the Commission that amends the input methodology and any determination by the Commission of an input methodology following a review of the input methodology.

²⁷ Section 52Z’s legislative history is explained in *Wellington International Airport*, above n 7, at [141]–[153]. As explained there, as first introduced, the Bill provided only an appeal on points of law from input methodology decisions. The “materially better” threshold test for input methodology decisions was introduced when the Bill was reported back from the Commerce Select Committee.

²⁸ *Wellington International Airport*, above n 7, at [157].

only sense that matters if we conclude that the amended or substituted [input methodology] will be “materially better” as provided in s 52Z(4). There is, in our view, little point in first looking for error and then applying the materially better test. The important point is that we must be satisfied on the materially better ground before we may allow an appeal.

[39] The Court went on to consider the meaning of the phrase “materially better”, in contrast to the word “better” alone. Finding that an exhaustive analysis of the phrase “materially better” is not called for – in the sense that finding a range of synonyms for the phrase is not particularly helpful – the Court went on to say that it is best applied in a practical sense on the facts of a given case. It referred to the inevitable conflict and divergence of views between parties (in that case through expert witnesses) and said the use of the phrase “materially better” requires the Court to look through the inevitable conflict and difference of views and to determine whether the input methodology argued for is indeed materially better:²⁹

... that is, an [input methodology] which, notwithstanding that divergence of views, is sufficiently compelling to be seen by us as being “material better” than that proposed by the Commission.

[40] In undertaking that assessment, a level of deference to the expertise of the members of the Commerce Commission is not strictly needed. While the Commission is a specialist tribunal, so too is this Court, as constituted under s 52ZA, which requires each of its lay members to have relevant experience.³⁰

[41] Having said that, it is only right to have regard to the extensive nature of the decision-making process the Commission has engaged in in reaching its decisions. That process began in April 2021 when the Commission issued an “open letter” which, amongst other things, sought views on potential mechanisms for dealing with stranded assets. The Commission received submissions on that letter, issued a process and issues paper, received submissions and cross-submissions on that paper, prepared draft default price-quality path and input methodologies determinations and reasons, sought and received submissions and cross-submissions on those determinations and then issued its final determinations. The material received and considered (all of which was available to this Court) was extensive.

²⁹ At [164].

³⁰ Commerce Act, s 52ZA(4).

[42] MGUG proposes three alternative changes to the input methodologies provided through the Commission’s decision that are in its view materially better:

- (a) the removal altogether of the provisions inserted by the 2022 Input Methodologies Decision that empower the Commission to adjust asset lives for depreciation purposes;
- (b) the amendment of the terms of the 2022 Input Methodologies Decision to shorten economic asset lives for depreciation purposes for new assets only – on the basis that those new assets would retain the benefit of asset life adjustments for the balance of their asset lives; or
- (c) the referral of the input methodologies back to the Commission with directions on the matters that require amendment. A range of directions are proposed. Central among them is the need for a gas pipeline business to apply to the Commission to shorten asset lives through a customised price-quality path process for new assets while ensuring that network asset stranding risks for sunk assets remain with gas pipeline businesses.

Right of appeal for the 2022 Default Price-quality Path Decision

[43] The appeal right for the 2022 Default Price-quality Path Decision is found in s 91(1B) of the Act. The right of appeal is on a question of law only.³¹

[44] The intended separation of the appeal rights for the two decisions in question here is emphasised by s 91(1A) which provides that “an appeal against a section 52P determination may not include an appeal against all or part of an input methodology, whether on a point of law or on any other ground”.

³¹ A general (merits-based) right of appeal against determinations of the Commission is provided in s 91 also but the provision excludes, expressly, default price-quality path determinations and input methodologies determinations.

[45] Accordingly, it is important for the Court to ensure that the appeal of the 2022 Default Price-quality Path Decision is limited to questions of law and does not encompass any challenge to the 2022 Input Methodologies Decision.

[46] An appeal on a question of law is limited to a consideration of whether or not the Commission misconstrued any relevant provision or legal principle or whether the decision is so misconceived or unsupportable that it is unlawful. As the Supreme Court in *Bryson v Three Foot Six Limited* put it, if the decision under appeal is a permissible option, then there can be no error of law.³²

[47] Deference considerations do not enter into the equation. The Court is not looking to any extent at merits. It matters not that the members of this Court might have reached a different conclusion. If the 2022 Default Price-quality Path Decision was, in the light of the 2022 Input Methodologies Decision, a decision that was open to it in any way, then this Court cannot interfere.

[48] In its notice of appeal for the 2022 Default Price-quality Path Decision, MGUG says that:

- (a) The Commission was premature to apply adjustment factors in the decision given the uncertainties associated with the future of the gas industry; and
- (b) Applying adjustment factors through the decision was contrary to s 52A as it does not promote outcomes consistent with outcomes produced in competitive markets for the long-term benefit of consumers.

[49] As the Commission says, MGUG is not arguing that the Commission erred in law in selecting particular adjustment factors to apply to particular gas pipeline businesses. The challenge is to the Commission's application of adjustment factors at all in its 2022 Default Price-quality Path Decision.

³² *Bryson v Three Foot Six Ltd* [2005] NZSC 34, [2005] 3 NZLR 721 at [27].

The application of the Part 4 scheme to date

[50] Before turning to the decisions under appeal, it is important to understand the prior decisions under pt 4 of the Act as they relate to the issues in these appeals. They build incrementally towards the decisions under appeal.

The 2010 Input Methodologies Decision

[51] The Commission first set input methodologies for electricity distribution and gas pipeline services in its 2010 Input Methodologies Decision. As far as depreciation was concerned, under the asset valuation input methodology, gas pipeline businesses were required to depreciate assets in their regulatory asset base throughout their physical asset lives using straight-line depreciation. Suppliers could, however, apply to use an alternative depreciation approach under a customised price-quality path. Capital additions were to be included in the regulatory asset base at cost and regulatory asset base values were to be linked to the Consumer Price Index.³³

[52] In the 2010 decision, the Commission addressed stranding of individual assets. It said that, where demand for an asset falls away, regulated suppliers may retain the asset in the regulatory asset base and continue to depreciate the asset over its remaining life. In this way, although the asset is stranded, at least a supplier can include the value of the asset, and depreciation on it, when the prices it may charge across the broader network are calculated. Alternatively, a supplier could apply to implement accelerated depreciation through a customised price-quality path if it considers that accelerated depreciation is more consistent with the pt 4 purpose than the alternative option of retaining the asset in the regulatory asset base and seeking to recover its residual value under a default price-quality pathway.³⁴

[53] This approach, however, would not cover a situation where an entire network became stranded, such that it would not be possible to raise sufficient revenue from the regulated services to cover depreciation costs.

³³ 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [4.3.13].

³⁴ At [E11.2].

[54] The Commission considered possible adjustments to its approach to the cost of capital input methodologies in the case of asymmetric risk, which could have addressed the potential for network stranding. Asymmetric risks are unbalanced. They come with a greater downside (potential loss) than upside (potential gain) for suppliers.

[55] The Commission considered providing uplifts to the weighted average cost of capital (WACC) to cover the cost to suppliers of bearing various asymmetric risks and the creation of a reserve fund (to provide insurance against infrequent adverse events such as earthquakes). After giving extensive and detailed consideration to various options, the Commission determined not to provide any *ex ante* uplift to the WACC to cover asymmetric risk. It made this decision for several reasons, including the difficulty of determining an appropriate uplift and the administrative complexity of operating a reserve fund.

[56] Nevertheless, the Commission recognised that it may be necessary to address asymmetric risk at a later point. It put it this way:³⁵

The input methodologies do not make any adjustments to the cost of capital for asymmetric risk. However, the Commission does consider that it may be appropriate to deal with asymmetric risks through some other forms of adjustment or mechanisms, such as adjustments to regulatory cash flows with the use of flexible depreciation (e.g. a front-loaded depreciation profile in the event that asset [stranding] becomes apparent).

[57] It emphasised that “suppliers of a regulated service are exposed to different levels of asymmetric risks and at possibly different time periods”.³⁶ Accordingly, an adjustment to the service wide cost of capital could result in some suppliers being over compensated and others under compensated. That is, “[this] type of cost is specific to the individual supplier and is not compensated for in the standard cost of capital estimations”.³⁷ It included within its assessment of asymmetric risks the prospect of stranding risk. It gave as examples technical obsolescence, unfavourable demand shocks and catastrophic events such as natural disasters.

³⁵ At [H12.1].

³⁶ At [H12.2]

³⁷ At [H12.3].

[58] On the other hand, systematic risk – market-wide risks affecting all investments – was built in by the Commission to the input methodology for cost of capital. It described the size of the premium for risk within the cost of capital as increasing in line with increases in a firm’s exposure to systematic risk – with the measure of this risk referred to as beta.³⁸ The Commission calculated an average asset beta of 0.34 for electricity distribution businesses, gas pipeline businesses and Transpower.³⁹ However, it applied a 0.10 uplift to the asset beta of gas pipeline businesses to reflect their greater exposure to systematic risk. It applied an adjusted asset beta for gas pipeline businesses of 0.44 as a consequence.⁴⁰

[59] The Commission calculated the WACC as an input into the setting of default and customised price-quality paths for gas pipeline businesses (and others). As the Commission said, an error in estimating the WACC could result in a WACC that is above or below the true cost of capital which could, in turn, cause prices to be set incorrectly relative to actual costs and affect incentives to invest and its ability to assess if excessive profits are being earned.

[60] In balancing the risk between setting the WACC too high or too low, the Commission assessed the consequences of possible errors. The consequences were seen to depend upon the regulatory context in which the estimate of the cost of capital is being used. For gas pipeline businesses, the Commission adopted a 75th percentile estimate of the cost of capital for price-quality regulation. The choice of the 75th percentile gave greater weight to the importance of preserving incentives for investment and innovation than to limiting the ability of suppliers to extract excess profits.⁴¹

The Wellington International Airport decision

[61] The Court considered these settings in *Wellington International Airport*. It began its analysis by considering the purpose of pt 4 regulation within the overall purpose of the Act and the purpose of the input methodologies within pt 4. After

³⁸ At [6.4.7].

³⁹ At [6.5.22].

⁴⁰ At [6.5.29].

⁴¹ At [6.7.12].

noting that the general purpose of the Act is to promote competition for the long-term benefit of consumers, the Court went on to say:⁴²

There are, however, a number of markets in which there is little or no competition and little or no likelihood of a substantial increase in competition. In such markets promoting competition cannot, therefore, protect the long-term interests of consumers of goods or services supplied in such markets. Part 4 provides for the regulation of the price and quality of goods and services supplied in such markets.

[62] In considering whether proposed amendments to the input methodologies were “materially better” than those determined by the Commission, the Court considered that the s 52R purpose of the input methodologies to promote certainty is conceptually subordinate to the s 52A purpose of the long-term benefit of consumers because “... promoting the long-term benefit of consumers in accordance with s 52A is the central purpose of Part 4 as a whole”.⁴³

[63] The Court made it clear that the outcomes (a)–(d) in s 52A(1) are a means to the end of promoting that central purpose:⁴⁴

The overall purpose of Part 4 is clear: the promotion of the long-term benefit of consumers in markets where there is little or no competition and little or no likelihood of a substantial increase in competition ... The way that purpose is to be achieved is by the promotion of outcomes in Part 4 markets that are consistent with outcomes in workably competitive markets, such that the subparas (a) to (d) outcomes are achieved.

[64] With these principles in mind, when the Court came on to consider WACC, it did not question the point estimate; rather, it considered the use of the 75th percentile on the basis the commission had correctly estimated the point estimate. The Court saw the use of the 75th percentile⁴⁵ as involving a likelihood that suppliers would earn excess returns at odds with the s 52A(1)(d) purpose, especially in the absence of

⁴² *Wellington International Airport*, above n 7, at [7].

⁴³ At [165].

⁴⁴ At [222].

⁴⁵ Assuming that the estimator of WACC has a normal probability distribution, choice of a percentile greater than 50 percent indicates more concern for under-estimation of WACC than over-estimation. Choice of the 75th percentile reduces the probability of under-estimation from 50 percent to 25 percent.

supporting analysis from the Commission.⁴⁶ It said, “Providing a revenue cushion is not the right way to create the right incentives”.⁴⁷

[65] However, the Court found that proponents on this issue had not persuaded it that simply applying the point estimate of WACC would lead to a materially better input methodology and so did not overturn the Commission’s decision on this point.⁴⁸

[66] Of particular relevance to the matters before us is the Court’s endorsement of the Commission’s decision not to provide compensation for asymmetric risks through the cost of capital input methodology. It said:⁴⁹

... the basic point is that regulated suppliers do not face the same risks as firms in workably competitive markets. They are protected to a high degree from the vagaries of demand and the pressures of competition. Their risk of not receiving a return on assets that get stranded is obviated by the regulatory regime. They can be compensated after the event for catastrophic events. There is no likelihood that they would be allowed to fold and cease providing services.

The decision on a customised price-quality path for Orion following the Christchurch earthquakes

[67] Orion Ltd applied for a customised price-quality path for its electricity distribution network in 2013, prompted by the Canterbury earthquakes in 2010 and 2011. It was seeking to recover the higher expenses and lower revenues incurred post-earthquake but also to implement its long-term network development plans. The Commission allowed Orion to increase its maximum average prices by the consumer price index plus 8.4 per cent at the beginning of the customised price-quality path period with annual increases of consumer price index plus 1.0 per cent until the end of the regulatory period (Orion Decision).⁵⁰

⁴⁶ *Wellington International Airport*, above n 7, at [1457] – [1462].

⁴⁷ At [1473].

⁴⁸ At [1483].

⁴⁹ At [1739].

⁵⁰ Commerce Commission *Setting the Customised Price-Quality Path for Orion New Zealand Limited – Final Reasons Paper* ([2013] NZCC 21, 14.07/14050, 29 November 2013) [Orion Decision – Reasons Paper] at [X2].

[68] The Commission summarised its position on the increased expenditure and reduced revenues post-earthquake that Orion was seeking to recover in the following way:⁵¹

In our view, a sharing of the impact of past additional costs and lower-than-forecast revenues between Orion and consumers is more consistent with the Part 4 regulatory regime. Specifically we allow Orion to recover the net additional costs of responding to the earthquakes, but not the reduction in revenue caused by a reduction in demand from the time of the earthquakes until the new price-quality path takes effect (April 2014).

[69] The Commission emphasised that the central purpose of pt 4 was to promote the long-term benefit of consumers. With this purpose in mind, it made the point that while it was clear that specific repair and replacement expenditure benefits consumers, it is less clear that compensating for a reduction in demand benefits consumers.⁵²

[70] In considering the regulatory framework, in the course of determining Orion's customised price-quality path, the Commission made the point that the scheme does not guarantee full cost recovery for past and planned expenditure,⁵³ and agreed with the view expressed to it by Professor Yarrow to the effect that suppliers are best placed to bear demand risk.⁵⁴

[71] In not approving the full extent of the *ex post* cash flow allowance that Orion had sought, the Commission said that it was clear that it had never committed to what would essentially be mandatory claw-back.⁵⁵ It considered that it was consistent with the purpose of pt 4 for the risks of catastrophic events such as earthquakes to be shared between suppliers and consumers. Suppliers are able to diversify their investments and should also be incentivised to manage these risks efficiently. A guarantee of complete claw-back would not provide suppliers with these incentives.⁵⁶

⁵¹ At [X18].

⁵² At [A91].

⁵³ At [A40].

⁵⁴ At [A40] and [A90].

⁵⁵ At [A110].

⁵⁶ At [B23] and Attachment B generally.

The Commission's 2014 decision amending the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services

[72] In light of the High Court's concerns about the WACC percentile, the Commission acted proactively to review it in its 2014 WACC Adjustment Decision.⁵⁷ The Commission decided to use the 67th percentile of the assumed WACC distribution for price-quality path regulation, rather than the 75th percentile.⁵⁸ The Commission adjusted the cost of capital input methodology accordingly.

[73] The Commission reiterated the reason the cost of capital input methodologies currently specify a WACC above the point estimate for price-quality paths; because the Commission expected the costs to consumers of underestimating WACC to be greater than the costs to consumers of overestimating it, given the uncertainty in estimating WACC.⁵⁹ That is what it designed the uplift to address.

[74] The adjustment was intended to strike the right balance between s 52A(1)(a) (incentives to innovate and invest) and (d) (limiting the ability to extract excessive profits).⁶⁰

[75] The Commission said:⁶¹

It is our view that catastrophic events and other asymmetric risks are best dealt with through cash flows (eg, by resetting price paths), rather than as an addition to WACC.

[76] In the intervening years, the Commission revisited the topic on several occasions, in the decisions that follow.

⁵⁷ Commerce Commission *Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services – Reasons Paper* (15.01/14566, 30 October 2014) [2014 WACC Adjustment Decision – Reasons Paper] at 7. The Commission made the point that the High Court judgment itself would have impacted on the very incentives the WACC percentile uplift was meant to create. That is to say, the High Court's comments created asymmetric expectations of a probable outcome of the next review of the WACC percentile – that it was likely to be reduced and therefore prompt action would create certainty.

⁵⁸ At [X2]; the effect of the Commission's decision was to increase the probability of underestimation of WACC from 25 percent to 33 percent.

⁵⁹ At [X4].

⁶⁰ At [3.18].

⁶¹ At [4.36].

The 2016 input methodologies review decisions

[77] Under s 52Y of the Act, the Commission must review each input methodology at intervals of no more than seven years. In December 2016, it released its input methodologies review decisions (2016 Input Methodologies Review Decisions).⁶²

[78] One of the topic papers forming part of the decisions, Topic Paper 3, addressed the future impact of the emerging technologies in the energy sector. In it, the Commission found that the risk of partial capital recovery for electricity distribution businesses may have increased because of the pace of emerging developments in the electricity sector. Therefore, as a precautionary measure, the Commission decided to allow electricity distribution businesses the option to recover the cost of their assets more quickly. For electricity distribution businesses, the Commission provided an option for suppliers to apply for a “net present value neutral” shortening of their remaining asset lives, capped at a 15 per cent reduction in remaining average asset lives. If suppliers gained the Commission’s approval to exercise the option, then prices to consumers would rise moderately in the short term and fall in the longer term, compared to the status quo.

[79] New technologies enable greater use of distributed generation or greater distributed electricity storage. They may in turn enable:

- (a) more consumers to generate and store their own electricity; and/or
- (b) new competitors to enter the market and bypass distributors’ networks.

[80] Accordingly, the risk to electricity distribution businesses in not being able to fully recover their invested capital, under the existing physical asset lives assumptions in the input methodologies, was seen by the Commission as being asymmetric.⁶³ As the Commission said:⁶⁴

⁶² For a high level summary, see Commerce Commission *Input methodologies review decisions – Summary paper* (17.01/15081, 20 December 2016). The decisions were comprised of three general papers and six topic papers.

⁶³ The downside risk was not seen as having an equivalent upside.

⁶⁴ Commerce Commission *Input methodologies review decisions – Topic paper 3: The future impact of emerging technologies in the energy sector* (17.01/15081, 20 December 2016) [2016 Input Methodologies Review Decisions – Topic Paper 3] at [88].

By allowing [electricity distribution businesses] the option of a more rapid time profile of capital recovery, should the risk of widespread disconnections eventuate, the amount of remaining capital to recover at that time will be less than what otherwise would be the case. Not permitting asset life adjustments now would risk increasing the materiality of any potential future adjustment to asset lives, if the risk becomes more likely. The resulting price shock would be larger, and we therefore consider that acting now is a prudent way for the [input methodologies] to reflect the changed environment.

[81] The Commission did not see similar adjustments for gas distribution businesses as necessary at that point in time. It was thought that gas distribution businesses would maintain the ability and incentive to grow connections such that they had an “upside that is greater than for [electricity distribution businesses]”.⁶⁵

[82] But it went on to say:⁶⁶

However, as mentioned earlier in the paper, should it become clearer in the future that emerging technology developments risk impacting gas networks, we have the ability to revisit the [input methodologies] in response.

[83] In its Topic Paper 4 dealing with the cost of capital issues, the Commission decided (amongst many other things) that the upwards beta adjustment for gas pipeline businesses should be limited to 0.05, rather than the previous uplift of 0.10.⁶⁷ It considered that an uplift of 0.10 to asset beta, combined with the 67th percentile would overestimate WACC by more than could be justified in terms of net benefit to consumers.⁶⁸ It emphasised the point that:⁶⁹

... in estimating asset beta, we are only concerned about exposure to systematic risk, rather than non-systematic risk. Systematic risk affects all investments in a market (to a greater or lesser extent) not just a particular firm or industry.

[84] It added that “competitive stranding risk is generally non-systematic in nature, and so is not relevant to WACC”.⁷⁰

⁶⁵ At [99].

⁶⁶ At [104].

⁶⁷ Commerce Commission *Input methodologies review decisions – Topic paper 4: Cost of capital issues* (17.01/15081, 20 December 2016) [2016 Input Methodologies Review Decisions – Topic Paper 4] at 5.

⁶⁸ At [362].

⁶⁹ At [365].

⁷⁰ At [424].

The fibre input methodologies decision

[85] From 1 January 2022, providers of fibre services became subject to new forms of regulation under pt 6 of the Telecommunications Act 2001. Part 6 introduces a form of regulation that is similar to the regime in pt 4 of the Commerce Act.

[86] The Commission noted that *ex ante* compensation for Type I asymmetric risks is likely to result in over-compensation as a result of difficulty in estimation and the potential for gaming.⁷¹

[87] It addressed the asymmetric risk faced by Chorus Ltd in relation to the threat of technological change, in part, through an *ex ante* cash flow allowance in its 2020 Fibre Decision. It said that:⁷²

Compensation for Type II asymmetric risk associated with asset stranding will be provided by a combination of the following: retaining assets in the [regulatory asset base] in regulated markets, allowing for the possible shortening of asset lives (or alternative depreciation profiles) and a modest *ex-ante* allowance.

[88] The Commission made the point that the *ex ante* allowance would not be implemented through the WACC but, rather, through cash flows at the time of the Commission setting a price-quality path.⁷³ It explained that additional compensation is only required for a risk when it is both asymmetric and material. In that case, there is a need, the Commission said, to address the asymmetric risk; otherwise the approach would be contrary to the economic principle of *ex ante* real financial capital maintenance and would be to the detriment of the outcome in the equivalent of s 52A(1)(a) of regulated providers having incentives to invest.⁷⁴ The Commission considered that asset stranding risk is not compensated through the cost of capital given that stranding risk is normally non-systematic being linked, as it is, to technological development.⁷⁵

⁷¹ Commerce Commission *Fibre input methodologies: Main final decisions – reasons paper* (22.02/16531, 13 October 2020) [2020 Fibre Decision – Reasons Paper] at [6.1017] and [6.1017.1].

⁷² At [6.984.2].

⁷³ At [6.984.3.2].

⁷⁴ At [6.1033].

⁷⁵ At [6.1040].

[89] In addition to providing an *ex ante* allowance equal to 10 basis points applied to the value of the regulatory asset base, the Commission provided for its process to allow for the shortening of asset lives and alternative depreciation profiles.⁷⁶

The net position on asset stranding risks under Part 4

[90] The position that emerges from the application of pt 4 to this point is that the Commission has addressed asset stranding risks in several ways. To the extent that the risk is of a systematic kind, the Commission has addressed it through the WACC and, in particular, provided a beta uplift to gas pipeline businesses. However, for the most part the Commission has considered asset stranding risks to be largely non-systematic. It has addressed the stranding of individual assets by keeping those assets in the regulatory asset base and allowing suppliers to recover depreciation across the broader network.

[91] Historically, the Commission has not provided a cash flow uplift to compensate suppliers of regulated energy services for the cost of bearing a broader network stranding risk because it considered determining an appropriate uplift was too complex. It also considered, as set out more explicitly by the Court in *Wellington International Airport*, that those suppliers were not seen to face the same risk as that faced by firms in workably competitive markets. The Commission has provided a small uplift for fibre services where the stranding risk was considered to be material.

[92] The Commission has assessed any increases in stranding risks and, if material, has provided for them separately in such a way as to maintain – to the extent seen by the Commission as being appropriate – financial capital maintenance for the suppliers concerned.

[93] The Commission has only seen separate provision for asset life adjustments as being appropriate where stranding risks are established and where provision for it is needed in order to maintain financial capital maintenance and decrease the price shocks from otherwise larger future adjustments.

⁷⁶ At [6.1235].

Climate change and the new policy landscape

[94] Concern for the projected effects of climate change led to the New Zealand Parliament passing the Climate Change Response (Zero Carbon) Amendment Act 2019 (Zero Carbon Amendment Act). The Zero Carbon Amendment Act amended the Climate Change Response Act 2002 and the regulations passed under that Act. The Amendment Act established the Climate Change Commission, set a target of net zero emissions of greenhouse gases, other than biogenic methane, by 1 January 2050 and a process to be followed to meet this target.

[95] The Climate Change Commission provides independent advice to Government on mitigating climate change and on adapting to the effects of climate change. In addition, it monitors and reviews the Government's progress on the emissions reduction and adaptation goals. In February 2021, the Climate Change Commission issued for consultation a draft of advice to Government which included prohibiting new gas building connections by 2025 and phasing out existing natural gas connections in buildings by 2050.⁷⁷

[96] In May 2021, the Climate Change Commission's final recommendations to the Government included "[c]reating a plan for managing the diminishing role of fossil gas across the energy system" and "[d]etermining how to eliminate fossil gas use in residential, commercial and public buildings".⁷⁸

[97] The Climate Change Commission also confirmed its recommendation that the Government should set a date (no later than 2025 and earlier if possible) from which no fossil fuel gas connections would be permitted and all new or replacement heating systems installed would need to be electrical or bioenergy.⁷⁹

⁷⁷ Climate Change Commission *2021 Draft Advice for Consultation* (31 January 2021) at 60.

⁷⁸ Climate Change Commission *Ināia tonu nei: a low emissions future for Aotearoa* (31 May 2021) at 286 and 287.

⁷⁹ At 29, 69, 111, 284–228 and 292–294.

[98] In May 2022, the Minister for the Environment released the Emissions Reduction Plan which sets New Zealand on a pathway to meeting the 2050 target and provides that the Government would:⁸⁰

Reduce our reliance on fossil fuels and exposure to volatile global fuel markets, and support the switch to low-emissions fuels by:

- setting a pathway to reduce reliance on fossil gas through a gas transition plan [to be developed] by the end of 2023; and
- increasing access to low-emissions fuels, including developing a hydrogen roadmap.

[99] When the Commission issued the 2022 Input Methodologies Decision and the 2022 Default Price-quality Path Decision, the terms of reference for the transition plan had been issued and publication of the Energy Strategy had been scheduled for the end of 2024.

[100] The Commission's reading of these developments was that, while there remained significant uncertainties on the path to phasing out natural gas and the possibility of repurposing assets, the decline in demand would likely lead to significant stranding of gas pipeline business assets as the asset lives (physical lives) that had been assumed for regulation were significantly longer than the, now evident, remaining economic lives.

The 2022 Input Methodologies Decision

The reasons paper

[101] The seven-yearly review of input methodologies required by s 52Y of the Commerce Act was due to be completed by December 2023. However, the Commission saw it as appropriate to consider, through s 52X, certain amendments outside that review cycle and ahead of a 31 May 2022 default price-quality path reset for gas pipeline businesses.

⁸⁰ Ministry for the Environment *Te hau mārohi ki anamata – Towards a productive, sustainable and inclusive economy* (ME1639, May 2022) at 202.

[102] The amendments to the input methodologies for gas pipeline businesses with which this appeal is concerned are described in the Commission's reasons paper in the following way:⁸¹

We have introduced a mechanism to allow us to adjust asset lives when calculating depreciation for a [default price-quality path] if we are satisfied that doing so would better reflect the economic asset lives and better promote the purpose of Part 4 of the Commerce Act 1986 (**Part 4**). For [default price-quality path] 3, this will allow us to shorten asset lives so that assumed asset lives better reflect the expected economic asset lives considering the expected decline in the use of gas networks. There are flow-on amendments for how depreciation is calculated for information disclosure.

[103] As the Commission observed in its 2010 Input Methodologies Decision, asset lives had been set to match the physical life of assets. Physical lives of gas pipeline assets have tended to be long – up to 80 years for some assets. The Commission had used a straight-line depreciation method for calculating regulatory depreciation allowances, with no mechanism for it to be adjusted on the basis of any new information about remaining economic asset lives. As the Commission explained, when demand for gas pipeline services was expected to remain stable or to grow (as has been the case historically), the straight-line depreciation over physical asset life approach provided gas pipeline businesses with an opportunity to recover their invested capital and to receive a normal return on that capital over the assumed lives of the assets. This gave gas pipeline businesses an *ex ante* expectation of financial capital maintenance which promoted incentives to invest consistent with the pt 4 purpose.⁸²

[104] However, the Commission noted that the risk now faced is not from new technology but from declining demand from consumers and a material risk of phase-out of the regulated service to meet the 2050 emissions target and related emission reduction policies. Steps were needed, the Commission considered, to mitigate the risk of stranding.⁸³

[105] Therefore, the Commission considered there to be a compelling and urgent case to act now and to include a mechanism which could be used to adjust assumed

⁸¹ 2022 Input Methodologies Decision – Reasons Paper, above n 22, at 4.

⁸² At [3.19].

⁸³ At [3.24].

asset lives in time for the third default price-quality path regulatory period (DPP3), rather than through the scheduled input methodologies review which would only enable changes to be made to asset lives for default price-quality paths for the fourth regulatory period, beginning on 1 October 2026.⁸⁴ The Commission summarised its reasons in the following way:

3.47 Full reasons for shortening the asset lives of [gas pipeline business] assets in DPP3 are included in Chapter 6 of the [2022 Default Price-quality Path Decision] reasons paper. The reasons why remaining asset lives need to be shortened in DPP3 can be stated shortly as follows.

- 3.47.1 Because of declining demand and the Government's proposed phasing out of the use of fossil fuels like natural gas, asset lives in the current [input methodology] (which match physical lives) no longer reflect the expected economic life of the assets.
- 3.47.2 This gives rise to an asset stranding problem, as the maximum amount of revenue which [gas pipeline businesses] can earn will not recover their [regulatory asset base] and expected future investment to meet consumer demand for services.
- 3.47.3 This in turn gives rise to an investment incentives problem since [gas pipeline businesses] may be unwilling to invest if they do not have an expectation of recovering their investment.
- 3.47.4 To better promote the Part 4 purpose, and in particular to maintain incentives to invest, we need to shorten asset lives to match the remaining economic life of the networks.
- 3.47.5 To achieve shortening, we need to amend the [input methodologies] to introduce an asset lives adjustment mechanism. In DPP3 this will be used to shorten lives, but it is possible it could be used to lengthen lives in subsequent [default price-quality paths], depending on the circumstances.
- 3.47.6 Our framework indicates we will make changes to fundamental [input methodologies]s only where there are compelling reasons for doing so. There are such reasons in this case because if asset lives are not shortened, then incentives to invest are undermined which threatens investment over DPP3. Similarly, if asset [lives] are not shortened the building block [method] no longer ensures that prices in this period reflect the long-term costs of providing the service.

[106] The adjustment factors apply to both the weighted average remaining asset life calculated for each gas pipeline business's existing assets in the DPP3 financial model,

⁸⁴ At [3.46].

and the 45-year asset life assumption applying to new assets for gas pipeline businesses.

[107] Other options which could have been used to mitigate stranding risk, and identified in the Commission's draft decision, were not favoured by the Commission. One of those options was through *ex ante* compensation. The Commission saw significant difficulty in calculating the extent of any *ex ante* compensation required. That could, it said, lead to over or under compensation to the supplier.⁸⁵

[108] Another option was to apply the asset life adjustment factor to new assets only. The Commission rejected this approach on the basis that new investments will become sunk investments in the next regulatory period and failing to provide an expectation of financial capital maintenance on those assets could undermine current investment incentives.⁸⁶

[109] A further option was removing regulatory asset base indexation to address stranding risk. The Commission said that this would involve practical difficulties and that stranding risk could be managed independently of inflation risk.⁸⁷

[110] In its reasons paper for the 2022 Input Methodologies Decision, the Commission cross-referenced its reasons in Chapters 3 and 6 of the final reasons paper for the 2022 Default Price-quality Path Decision. Chapter 3 described in some detail the context for the Commission's decisions and Chapter 6 addressed the Commission's decision to recognise shorter asset lives given the expected decline in demand for, and phase-out of the use of, natural gas. The chapters are mentioned briefly in the discussion of the 2022 Default Price-quality Path Decision below.

Gas Distribution Services Input Methodologies Amendment Determination

[111] The 2022 Input Methodologies Decision amends the Gas Distribution Services Input Methodologies Determination 2012. The amendments to the 2012

⁸⁵ At [3.129.1].

⁸⁶ 2022 Default Price-quality Path Decision – Reasons Paper, above n 2525, at [C58]–[C59].

⁸⁷ 2022 Input Methodologies Decision – Reasons Paper, above n 22, at [3.129.2].

determination are in the form of the deletions, substitutions and additions to clauses in the 2012 determination that are tracked in red in attachment A to the determinations.

[112] By way of summary, cl 4.2.2(4) provides, in both of the 2022 determinations,⁸⁸ that:

The **Commission** may apply an adjustment factor in respect of a **[default price-quality path] regulatory period** for the purpose of determining the **remaining asset life for existing assets** and the **remaining asset life for additional assets**, provided the **Commission** is satisfied that applying an adjustment factor would better reflect economic asset lives and doing so would better promote the purpose of Part 4 of the **Act**.

[113] In order to give effect to that discretion, the decision makes additions to the definition of “depreciation” in cls 4.2.2(2) and (3) such that remaining asset lives for existing assets can be adjusted, upwards or downwards, by the application by the Commission of an adjustment factor for the relevant default price-quality path regulatory period.

[114] Under cl 2.2.8, which defines the term “physical asset life”,⁸⁹ a new sub-cl (5) applies if the Commission has applied an adjustment factor under cls 4.2.2(3) and (4). If sub-cl (5) applies, a gas distribution business must apply a percentage reduction or extension (as the case may be) for existing assets and for assets commissioned during the default price-quality path regulatory period on the basis described in cls 4.2.2(3) and (4).

The 2022 Default Price-quality Path Decision

[115] The Commission’s 2022 Default Price-quality Path Decision for gas pipeline businesses set new default price-quality paths for the third regulatory period (1 October 2022 to 30 September 2026) on the basis of the amendments to input methodologies that had been published the day before.⁹⁰

⁸⁸ See para [35(a)] above.

⁸⁹ Which forms part of the asset valuation input methodologies.

⁹⁰ 2022 Default Price-quality Path Decision – Reasons Paper, above n 25.

[116] The reasons paper expressed the decision relating to an increase in the depreciation allowance⁹¹ in the following terms:⁹²

The expected average asset lives for new and existing assets has reduced. The effect of this is to increase the depreciation allowance in DPP3.

[117] It described the “benefit delivered” from that decision in the following way:⁹³

We have shortened the average lives of new and existing assets to better reflect the remaining economic lives of the networks. This mitigates the risk of economic stranding by increasing the depreciation allowance for DPP3, bringing revenues forward to maintain incentives to invest (Chapter 6)

[Gas pipeline businesses] will record higher depreciation in [information disclosure] for each year of DPP3, and this will reduce the [regulatory asset base] we will use to set prices in DPP4.

Consumers of gas pipeline services will benefit from continuing investment in the network and [gas pipeline businesses] have a reasonable opportunity to recover their investment together with a normal rate of return within a timeframe which reflects the best information we have on how long the [gas pipeline businesses] may continue to convey natural gas.

In making our decision on remaining economic lives we have had regard to a range of scenarios for how long it may take to phase out the use of natural gas as well as the potential for the pipelines to have a residual value if they can be used to convey other gases (eg, hydrogen).

[118] The Commission explained that past assumptions about the relatively stable long-term demand for gas pipeline business services no longer hold, and, accordingly, physical lives of network assets being an acceptable proxy for economic lives is no longer appropriate for many pipeline assets.⁹⁴ It said that the risk of a significant decline in demand and Government phase-out of natural gas was not anticipated when the input methodologies for gas pipeline businesses were established or last reviewed. It said, in addition, the decline in demand is not currently compensated for in the inputs to the building block method such as in the parameters that inform the cost of capital or through an *ex ante* stranding allowance.

⁹¹ Decisions were made on a number of other inputs to the default price-quality paths applicable to gas pipeline businesses including on resetting starting prices, adjusting operating expenditure allowances and capital expenditure allowances, shortening the regulatory period to four years and forecasting demand using gas distribution business data.

⁹² 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at 58.

⁹³ At 58–59.

⁹⁴ At [6.11].

[119] The Commission explained, also, that by allowing recovery of asset-related costs under the building block method over a shorter timeframe – seen by the Commission as being more realistic – the consumers of gas pipeline services should avoid larger price increases in future resets. It said that, to minimise price shocks to consumers, it has smoothed the price increases occurring in DPP3 and deferred some of the increase in prices to the fourth default price-quality path regulatory period (DPP4).

[120] The adjustment factors to be applied to asset lives for DPP3 were as follows:⁹⁵

Gas Pipeline Business	Adjustment Factor
GasNet	0.81
Powerco	0.84
Vector	0.66
First Gas Distribution	0.69
First Gas Transmission	0.75

[121] An adjustment factor of less than 1 results in a reduction in assumed asset lives.

[122] The Commission said that its decisions (collectively) will result in a nominal increase in household gas bills of about 3.8 per cent per year on average for each of the four years of DPP3. This increase includes the effect of several other adjustments as well as the acceleration of asset depreciation. It said that, for a median annual household gas bill of about \$1,246, this will be an increase of around \$48 per year for each of the four years.⁹⁶

[123] In making the decision, the Commission explained its approach to real financial capital maintenance, which provides regulated suppliers with the *ex ante* expectation of earning their risk-adjusted cost of capital.⁹⁷ It explained that this provides regulated suppliers with the opportunity to maintain their financial capital in real terms over timeframes that are longer than a single regulatory period. However, it said that price-quality regulation does not guarantee a normal return over the lifetime

⁹⁵ At [4.28].

⁹⁶ These impacts are not the same as those for business customers, which will be proportionately less.

⁹⁷ 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at [2.50].

of a regulated supplier's assets. The decarbonisation of the energy sector provides additional challenges and uncertainty to businesses conveying natural gas by pipeline and the returns on and of capital from doing so.

[124] The Commission described New Zealand's transition to a net zero carbon emissions economy in Chapter 3 and it described its reasons for wishing to recognise shorter asset lives to address resulting stranding risks in Chapter 6.

[125] In Chapter 6, the Commission explained the reasons for its view that the physical asset lives of network assets are no longer an appropriate proxy of economic lives for many pipeline assets. As network stranding risk had not been compensated for through inputs to the building block method, a shortened average asset life mechanism was warranted.

[126] The Commission explained the adjustment factors it had applied in the following way:⁹⁸

- (a) The average remaining asset life for each gas pipeline business's asset is derived by dividing its total regulatory asset base by its total amount of depreciation disclosed in the base year.
- (b) A different approach is taken in the default price-quality path for new assets (being those commissioned during the DPP3 period), which are prescribed as having a 45-year remaining life in the year of commissioning for default price-quality path purposes.
- (c) The sum of the forecast depreciation amounts calculated for new and existing assets for each year of the default price-quality path regulatory period becomes the value of the depreciation components of the building block method for setting prices under the default price-quality path.

⁹⁸ At [6.32]–[6.56].

- (d) The asset adjustment factors (set out in [120]) alters the applicable asset lives used to calculate forecast depreciation and so changes the depreciation allowance in DPP3. In particular, the Commission multiplies the adjustment factor by:
- (i) the implied average useful life remaining for each gas pipeline business's assets in the base year, for existing assets; and
 - (ii) the 45-year assumed life, for new assets.
- (e) Shorter asset lives in conjunction with straight-line depreciation increases depreciation for the new and existing asset lives such as to increase its costs and, therefore, its regulated prices fixed through revenue increases.

[127] The Commission described the annual real revenue rises for gas pipeline businesses from the Commission's decision to shorten asset lives – along with revenue increases (or decreases) due to other factors:⁹⁹

Gas Pipeline Business	Revenue increase from shortening asset lives	Revenue increase due to other factors	Total revenue increase (Capped at 10% real and rounded to nearest 0.5%)
GasNet	2.19%	3.31%	5.50%
Powerco	2.84%	2.16%	5.00%
Vector	6.18%	-3.18%	3.00%
First Gas Distribution	5.26%	4.74%	10.00%
First Gas Transmission	5.25%	3.25%	8.50%

[128] It is important to observe that, while shortening asset lives supports what market participants have described as a reasonable expectation of recovering the cost of past and future network investments, it does not guarantee a full capital recovery for gas pipeline businesses over the economic lifetime of the assets. It provides for an *ex ante*

⁹⁹ At [6.53] (footnotes omitted).

expectation of recovery over the shortened asset lives. But the businesses are exposed to further forecasting risks. In addition, rather than reflecting immediately the shorter expected asset lives in the building block method, the Commission used modelling that assumes a transition to expected economic lives over a six-year period. Gas pipeline businesses bear the risk associated with the transition. In the event that demand drops more quickly, or there is an earlier than expected phase-out of natural gas use, a gas pipeline business may be exposed to unmitigated stranding risks.

[129] In this way, gas pipeline businesses bear risk over time. As the Commission put it, its decision-making framework seeks to preserve an *ex ante* expectation of financial capital maintenance only to the extent that it promotes the pt 4 purpose.¹⁰⁰

[130] This approach is consistent with the approach that was signalled by the Commission in its 2010 Input Methodologies Decision. There, it had made the point that, in a regulatory context, financial capital maintenance is achieved on an *ex ante* basis – comparable with expectations in competitive markets that are conducive to promoting investment. For example, a commercial competitor would not come into an industry if it did not expect to be able to recover the decline in real values of their assets as well as earn a normal profit (the opportunity cost of capital).¹⁰¹ It is not, as the Commission said, possible to guarantee that regulated suppliers earn a normal return over the life of assets because any analysis used to set prices will typically be conducted part way through the lifetimes of the assets. The Commission went on to say that “the allocation of risks between suppliers and consumers will usually mean that, although suppliers might have expected to earn a normal return *ex ante*, such a return is not earned *ex post*”.¹⁰²

The appellant’s position

[131] The positions of the parties are embedded within our discussion of the issues in the next sections of our decision. However, for the purpose of framing that analysis, we identify here the primary points that have been advanced for the appellant.

¹⁰⁰ At [6.57].

¹⁰¹ 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [2.6.28].

¹⁰² At [2.6.28].

[132] As a preliminary point, we observe that the appellant speaks broadly about “the 2022 determinations” which combine the 2022 Input Methodologies Decision and the 2022 Default Price-quality Path Decision. However, as has been explained, the decisions need to be assessed separately as, although the 2022 Input Methodologies Decision cross-references reasons in the 2022 Default Price-quality Path Decision, they are separate decisions, subject to very different approaches on appeal.¹⁰³ We are to consider whether the approach proposed by the appellant in relation to the input methodology for depreciation of assets (asset lives) is materially better than the Commission’s input methodology. But, in relation to the application of the input methodology through the 2022 Default Price-quality Path Decision, we may only intervene if the Commission’s decision is affected by an error of law.

[133] That said, MGUG challenges the 2022 Input Methodologies Decision on three bases. The first basis is that it is premature. It is said that the relevant domestic decisions to transition New Zealand to a net zero carbon emissions economy are uncertain, tentative and exploratory, with no targets or timetables. An out-of-cycle input methodology is not required, it is said, in those circumstances. It is said that there is no consensus that natural gas will be phased out by 2050 and, in fact, projections show growth through to 2030. Accordingly, it is said, it is not necessary to take action now to prevent a smaller pool of consumers covering higher costs in the future and that there is minimal economic cost to gas pipeline businesses in waiting for more certainty on threats to asset lives.

[134] The second basis for MGUG’s challenge is that the Commission’s 2022 Input Methodologies Decision does not serve the purposes of s 52A of the Act. There are several component parts to this submission:

- (a) It is said that the Commission’s approach allows excess profit and pricing that is inconsistent with pricing in competitive markets.
- (b) It is said that the Commission’s approach doubly compensates gas pipeline businesses for asset stranding risks by enabling recovery when full or anticipatory compensation is already built into the WACC –

¹⁰³ See paras [37]–[49] above.

including compensation for stranding from technological, regulatory or other changes.

- (c) It is said that the decision enables the Commission to provide suppliers with an *ex post* assurance of financial capital maintenance in relation to existing assets that is not consistent with outcomes in competitive markets and not, therefore, lawful.
- (d) It is said that inappropriate weight is given to incentives for supplier investment. It is said that inadequate account is taken of whether supplier investment behaviour will be actually affected by the incentive, that there is a potential waste of investment if asset stranding risks are near term, that there is a potential lack of benefit for both current generation consumers who pay in advance of an established need and for consumers who may cease to consume, and that the Commission has not taken into account the effect of incentives and penalties that already exist under price-quality path standards, the Gas Act 1992 and health and safety regulations. It is said that, if the time horizon for the regulated service is short, then natural gas consumers cannot derive any benefit from incentives to innovate such that the fundamental justification for the role of financial capital maintenance ceases to exist. Accordingly, if as the Commission says it is concerning itself only with the interests of consumers of natural gas, little or no benefit will be received.
- (e) It is said that a revenue cushion is inconsistent with competitive market outcomes in the case of impending stranding, such as to create an environment for inefficiency.

[135] The third basis for MGUG's challenge to the 2022 Input Methodologies Decision is that it is at odds with s 52R of the Commerce Act (which provides that the purpose of input methodologies is to promote certainty) and s 52T of the Act (which provides the particular matters that input methodologies must include). It is said that these provisions provide detailed requirements for the purpose of achieving certainty

and predictability for suppliers and consumers while the 2022 Input Methodologies Decision involves improper discretions. The discretions provided, it is said, are simply not methodologies.

[136] The applicant proposes three “materially better” options. The first is to revoke the acceleration provisions inserted by the amendments gazetted on 30 May 2022.

[137] The second is to provide for the shortening of economic asset lives for regulatory-based depreciation purposes only for new assets with physical lives that are likely to extend beyond a forecast stranding date. It is proposed that those assets would remain subject to a set of accelerated depreciation provisions in subsequent regulatory periods.

[138] The third is for the Court to refer the input methodologies back to the Commission with directions on the matters that require amendment. Draft directions are proposed.

Approach to discussion of the grounds of appeal

[139] We begin by looking at the second basis advanced by MGUG – that the 2022 Input Methodologies Decision is inconsistent with the s 52A purpose of the Act. That, as we see it, is the most fundamental issue.

[140] We address the points that MGUG raises under this head through two primary questions. The first is essentially a threshold question. It is whether stranding risk is already built into the WACC or otherwise compensated for in the building block method, such that it ought not to have been dealt with separately by the Commission.

[141] If it is built into the WACC or elsewhere in the building block method, then it is already part and parcel of the way in which the s 52A purpose is met through the input methodologies that were in place before the Commission made its decision.

[142] The second question under this head asks whether, if the stranding risk is not built into the WACC or elsewhere in the building block method, the Commission’s decision is consistent with the s 52A purpose.

[143] We then turn to consider MGUG’s first head of claim – whether the input methodology amendments are premature. And finally – before considering the appeal of the 2022 Default Price-quality Path Decision under s 91 of the Act – we consider MGUG’s claim that the amendments made in the 2022 Input Methodologies Decision are contrary to ss 52T and 52R of the Act.

Is the 2022 Input Methodologies Decision inconsistent with the s 52A purpose?

Is stranding risk already addressed through the weighted average cost of capital component of the input methodologies – or otherwise provided for in the input methodologies?

[144] We begin by explaining in a little further detail the ways in which, previously, the Commission had or had not (as the case may be) made provision for risk, whether systematic or non-systematic, within component parts of existing input methodologies. While we have introduced this topic in discussing the Commission’s earlier decisions, we look at it more closely here in the context of MGUG’s argument that the Commission’s approach doubly compensates gas pipeline businesses for asset stranding risks because anticipatory compensation is already built into the WACC.

Systematic risk is compensated through the equity beta in the WACC

[145] As mentioned in looking at the Commission’s earlier decisions, WACC is the average cost of all types of capital a firm uses to fund its operations – both debt and equity. The Commission estimates the cost of the equity component of a firm’s WACC by using the capital asset pricing model (CAPM). There are a number of different versions of the model but the version used by the Commission is the “post-tax model”.¹⁰⁴ The model gives the cost of equity as the sum of the post-tax cost of risk-free debt plus a risk premium which is the product of the firm’s equity beta and the post-tax market risk premium. Variation in the cost of equity across different firms is explained by the variation in equity beta.

¹⁰⁴ Also known as and described by the Commission as the Simplified Brennan-Lally CAPM (SB-L CAPM) or just as the Brennan-Lally CAPM.

[146] The equity beta is a measure of the systematic risk of the firm, that is, the extent to which returns on investment in the firm moves with returns on the market portfolio. The technical definition of equity beta is that it is the ratio of:

- (a) the covariance between return on investment in the firm and return on investment in the market portfolio of all possible investments; and
- (b) the variance of the return on investment in the same market portfolio.

[147] The total risk of a firm comprises systematic risk and non-systematic risk. If an investment in the equity of a firm is of average systematic risk, the equity beta is one; if it has less than average risk it will have an equity beta less than one, and conversely. Non-systematic risk (or specific risk) reflects returns that do not move with the market portfolio and so the beta is zero.

[148] Return on investment in a firm increases with increasing leverage of the firm. The equity beta incorporates the effect of leverage. If this effect is removed, the beta is referred to as asset beta. For listed firms, the equity beta can be estimated from market data on returns of the firm and the market. However, regulated firms are, in most cases, not listed and therefore, for regulatory purposes, the equity beta is estimated from the equity betas of a sample of comparator firms that are listed. This process involves estimation of the equity betas of the comparator firms, de-levering these estimated betas to provide an estimate of the asset beta of the firm(s) in focus, and then re-levering to form an estimate of the equity beta of the firm(s) in focus.

Provision for asymmetric risk in the WACC

[149] The common type of asymmetric risk¹⁰⁵ relevant to regulated suppliers has negative expected payoff and is non-systematic. Therefore, it has zero beta. Asymmetric risks can be divided into two categories: Type I and Type II.¹⁰⁶ Type I risks are generally unrelated to the day-to-day operations of a firm and arise through

¹⁰⁵ As mentioned in para [54] above, asymmetric risks are unbalanced. They come with a greater downside (potential loss) than upside (potential gain) for suppliers,

¹⁰⁶ 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [H12.3]–[H12.4], as quoted in *Wellington International Airport*, above n 7, at [1715].

infrequent events that could produce large losses. Examples include natural disasters, pandemics, terrorist threats, or significant unexpected government policy shifts that could force the shutdown of operating plant before the end of its economic life. Type II risks derive from events such as the threat of competitive entry, technological change, or other negative demand shocks.

[150] The reasons for the Commission not offering an uplift to WACC to make provision for asymmetric risk, or an *ex ante* increment to regulatory cash flows, are that it would be difficult to estimate the size of the uplift or increment required and they are subject to gaming.¹⁰⁷ Further, the WACC is set as a sector-wide measure but the need for an adjustment would vary across the sector.

[151] However, the Commission considered that it may be appropriate to deal with asymmetric risks associated with asset stranding through some other form of adjustment mechanisms, such as *ex post* adjustments to compensate for Type I catastrophic risks or front loading depreciation in the event that Type II asset stranding risks become apparent.¹⁰⁸

[152] Consistent with this, as we have seen, the Commission has provided for asymmetric risk in several ways:

- (a) It permits suppliers to retain stranded assets in the regulatory asset base until they have been fully depreciated, regardless of whether they are still in use.
- (b) It agreed to an *ex post* cash flow allowance for Orion in the customised price-quality path developed in response to the impact of the Christchurch earthquakes.
- (c) In the 2016 Input Methodologies Review Decisions, it introduced a provision in the asset valuation input methodologies for electricity distribution businesses to reduce asset lives to their economic life in

¹⁰⁷ See para [86], above.

¹⁰⁸ 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [H12.7] and [H12.28].

response to the potential impact of technological change. It considered whether a similar provision was required for gas pipeline businesses but concluded that the businesses were not subject to the same level of threat from technological change at that time.

- (d) It provided an *ex ante* cash flow allowance for Chorus in relation to the threat of technological change.

[153] In the Commission’s February 2022 draft default price-quality pathway reasons paper, it confirmed that WACC compensates suppliers for ‘systematic’ risks only.¹⁰⁹ It went on to say:¹¹⁰

While some economic stranding is systematic, ‘non-systematic’ factors are likely to pose a more material stranding risk for DPP3. Non-systematic risk refers to risks which affect an individual company or sector of the economy. In particular there is a risk of government policy changes and shifts in consumer demand for natural gas that specifically lead to economic network stranding for [gas pipeline businesses]. We consider that the current Gas [input methodologies] do not currently provide adequate compensation for these types of risk.

[154] As the Commission said in its 2022 Default Price-quality Path Decision, “[r]egardless of wider economic conditions, the impact of decarbonisation efforts on [gas pipeline businesses] is likely to be negative and material.”¹¹¹

Double counting

[155] MGUG argues that, if the amendments made by the Commission are not revoked, they should be amended to prevent double counting by gas pipeline businesses through receiving compensation for stranding risk when they already receive compensation by:

- (a) estimation of the WACC at the 67th percentile; and
- (b) stranding risk being provided for in the regulated WACC.

¹⁰⁹ Commerce Commission *Default price-quality paths for gas pipeline businesses from 1 October 2022 – Draft reasons paper* (15.01/45340, 10 February 2022) [2022 Default Price-quality Path Decision – Draft Reasons Paper] at [6.17].

¹¹⁰ At [6.20].

¹¹¹ 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at [C38].

[156] The Commission's practice of setting the estimate of WACC at the 67th percentile (originally at the 75th percentile) was introduced to limit the consequences of possible error in estimation of WACC.¹¹² There are asymmetric consequences to investment from under-estimation versus overestimation of WACC. The Commission's view is that consumers paying higher prices because of an over-estimate of WACC is preferable to the negative impact on investment from adopting an underestimate of WACC.¹¹³ As a result, it is possible that the WACC adopted may exceed the true WACC. However, this result reflects only on uncertainty in estimation of WACC and so has no relevance to compensation for stranding risk.

[157] The Commission's position on including an allowance for stranding risk in estimating the WACC for gas pipeline businesses is as follows:

(a) The 2010 Input Methodologies Decision

As noted earlier, the Commission rejected the option of adding an uplift to WACC to compensate suppliers for carrying the risk of stranding. It noted that, while an option of that sort would be consistent with outcomes in a competitive market, there were practical difficulties in estimating the allowance in a regulatory setting.¹¹⁴

The Commission estimated a sector-wide (electricity distribution businesses, gas pipeline businesses and Transpower Ltd) asset beta of 0.34 and continued the practice applied in prior decisions of adding an increment of 0.1 for gas pipeline businesses to allow for the higher level of systematic risk of gas pipeline businesses.¹¹⁵ The theoretical reasons for the increment were discussed in detail and summarised as relating to growth options, operating leverage, the nature of the product and the composition of customers. However, there was no mention of stranding risk in relation to the increment.

(b) The 2016 Input Methodologies Review Decisions

¹¹² As discussed above while considering the 2010 Input Methodologies Decision – Reasons Paper, above n 16; *Wellington International Airport*, above n 7; and the 2014 WACC Adjustment Decision – Reasons Paper, above n 57.

¹¹³ 2016 Input Methodologies Review Decisions – Topic Paper 4, above n 67.

¹¹⁴ 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [E11.4] and [E11.6].

¹¹⁵ At [6.5.29], [H8.172] and [H8.179].

The Commission reduced the increment applied to the asset beta for gas pipeline businesses from 0.1 to 0.05. It considered that there were two factors, neither of which in isolation supported an uplift but which did so in combination. The factors were, first, the higher income elasticity of demand for gas and, secondly, the relatively low proportion of NZ households connected to gas, which has the potential to increase the risk of economic network stranding (which the Commission considered to be partly systematic in nature) and which suggests that greater growth options will exist for gas.¹¹⁶

The Commission confirmed that the estimate of asset beta should only include an allowance for stranding risk to the extent that it is systematic but noted that it is difficult to distinguish between systematic and non-systematic stranding risk.¹¹⁷

(c) The 2022 decisions

In its draft default price-quality path reasons paper, the Commission stated that “[t]he WACC compensate[s] suppliers for ‘systematic’ risks only and stranding risk may be partly systematic for [gas pipeline businesses]”.¹¹⁸ Furthermore, in its final reasons paper, it said that “[r]isks relating to climate change policies which affect the natural gas industry are likely to be non-systematic risk and so are not compensated through the parameters that determine the WACC in the Gas [input methodologies]”.¹¹⁹

[158] On this basis, it is clear that the Commission has, since 2016, regarded stranding risk as being in part systematic. The uplift of 0.05 determined in 2016 to the asset beta of gas pipeline businesses reflects two factors, neither of which the Commission viewed as supporting an uplift but which did so in combination; and stranding risk is one of two drivers contributing to just one of those factors. Accordingly, the Commission’s assessment of the significance of the impact of systematic stranding risk appears to be that it is minimal. Furthermore, it has regarded

¹¹⁶ 2016 Input Methodologies Review Decisions – Topic Paper 4, above n 67, at [344].

¹¹⁷ At [430].

¹¹⁸ 2022 Default Price-quality Path Decision – Draft Reasons Paper, above n 109, at [6.17].

¹¹⁹ 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at [C38].

network stranding risk relating to climate change as non-systematic and so has not compensated for it through the WACC.

[159] Accordingly, there is no double counting.

Otherwise, is the Commission's decision consistent with the s 52A purpose?

[160] For the reasons we come on to give, the Commission's decision is in our view consistent with the s 52A purpose. Promoting the outcomes in sub-ss (a)–(d) of s 52A(1) that are associated with workably competitive markets is a means to the end of pursuing the ultimate purpose of s 52A; that ultimate purpose being the long term benefit of consumers of services regulated under pt 4. However, regulation remains a “second best” means of pursuing the long-term benefit of consumers where competition is lacking and it cannot replicate the *process* of competition itself. In workably competitive markets, firms would be compensated *ex ante* for the cost of carrying stranding risk. The margin required to compensate for this cost and incentivise necessary investment would be determined by the process of competition itself.

[161] In the absence of that competitive process, given the difficulty of determining an appropriate margin, gas pipeline businesses have not been provided with any *ex ante* compensation to cover the cost of carrying non-systematic stranding risk. Consumers benefited from lower prices as a result.

[162] Gas pipelines now face a very real risk of network stranding as demand falls away as a result of the government's policy response to climate change. In a workably competitive market, a falling away of demand in this way would result in lower prices, all else equal, and firms would not expect to recover all their sunk costs. However, these same firms would have been compensated *ex ante* for carrying this risk, which regulated gas pipelines have not been. The long-term benefit of consumers of regulated services will not be served if suppliers of those services receive no *ex ante* compensation for bearing stranding risk and cannot be confident that stranding risk will be addressed as the need arises. Investment incentives for both gas pipeline services and other services regulated (and potentially regulated) under pt 4 would be

undermined in a scenario of this sort, to the detriment of consumers. We explain in more detail in the following sections how we arrive at this conclusion.

Workably competitive markets, regulation and the long-term benefit of consumers

[163] As this Court said in *Wellington International Airport*, the overriding purpose of pt 4 is to promote the long-term benefit of consumers in markets which are regulated, or which may be regulated, under pt 4.¹²⁰ This is to be done by promoting the outcomes in sub-ss (a)–(d) of s 52A(1), which are consistent with outcomes that would be expected in (workably) competitive markets. However, it is the long-term benefit of consumers which is the overriding purpose of pt 4 regulation and promoting the outcomes in sub-ss (a)–(d) is a means to that end.¹²¹ None of these outcomes is to be prioritised over the others but, rather, they are to be balanced in pursuit of the overriding objective.¹²² As George Yarrow noted in advice he gave to the Commission in the context of the Commission’s Orion Decision,¹²³ the sub-ss (a)–(d) outcomes are not exhaustive of outcomes associated with workably competitive markets and – of particular relevance in this appeal – they make no mention of risk sharing between suppliers and consumers.¹²⁴

[164] Absent market failure,¹²⁵ competition has the benefit of aligning the profit maximising incentives of firms with promoting efficiency and the long-term benefit of consumers. Competition operates both within and between markets to drive the efficient allocation of resources, to reduce costs and to drive innovation to promote consumer welfare. Firms are incentivised by competition to ‘beat the market’ and win customers by increasing their cost efficiency, keeping consumer prices down and innovating to attract consumers to buy their products rather than those of rivals.

¹²⁰ *Wellington International Airport*, above n 7, at n 442. At n 442, the court said that the latter group of consumers are not a mandatory consideration but may be taken into account.

¹²¹ At [165], [222] and [761].

¹²² At [684].

¹²³ Discussed in para [70] above.

¹²⁴ George Yarrow “Further advice on claw-back” (paper presented to the Commerce Commission to aid it in its Orion Decision, August 2013) at 10.

¹²⁵ “Market failure” occurs where the conditions for market success, which align competition with the promotion of efficiency, are not met. Market failure can arise from the absence of competition, economies of scale or ‘externalities’ – costs and benefits that bypass markets.

[165] When consumer preferences change, resulting changes in demand create price and profit signals to redirect resources away from markets where demand is falling and towards markets where demand is rising, in line with consumer preferences. When demand falls, prices and profits tend to fall, and where demand rises, prices and profits tend to rise, all else being equal. Resources will be redirected from the former to the latter markets.

[166] Section 3(1) of the Act defines competition to be workable or effective competition. As explained in *Wellington International Airport*, the term “workable competition”, first coined by J M Clarke, is not a precise concept but, rather, refers to markets where no firm has significant market power and there is sufficient rivalry to produce a tendency towards efficiency and cost reflective prices.¹²⁶ The Australian Trade Practices Tribunal said in *Re Queensland Co-operative Milling Association Ltd*:¹²⁷

In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.

[167] This set of requirements reflects the process of rivalry that drives efficiency and benefits consumers in workably or effectively competitive markets. When considering the relevance of workable or effective competition as a standard in the context of pt 4 regulation – where, by definition, competition is lacking – this Court said in *Wellington International Airport*:¹²⁸

In our view, what matters is that workably competitive markets have a tendency towards generating certain outcomes. These outcomes include the earning by firms of normal rates of return, and the existence of prices that reflect such normal rates of return, after covering the firms’ efficient costs.

[168] In applying the standards of workable or effective competition to the regulation of markets which are not in fact competitive, the focus is on the *outcomes* rather than the *process* of competition, to the extent that those outcomes promote the long term benefit of consumers. Markets which are regulated, or which may be regulated, under

¹²⁶ *Wellington International Airport*, above n 7, at [11]–[29].

¹²⁷ *Re Queensland Co-operative Milling Association Ltd* (1976) 8 ALR 481 (Trade Practices Tribunal) at 17246.

¹²⁸ *Wellington International Airport*, above n 7, at [18].

pt 4 are not workably competitive. They face no competition and no real prospect of competition. That is why they are regulated. Part 4 regulation cannot mimic the *process* of rivalry and price-quality signals which characterise workably competitive markets. Instead, it uses the regulation of price and quality to promote the long term benefit of consumers by promoting the *outcomes* in sub-ss (a)–(d), which are generally associated with workable or effective competition.¹²⁹

[169] In workably competitive markets, firms expect to earn a normal rate of return on their investments, but actual returns may turn out to be higher or lower, sometimes for extended periods, as prices and profits provide the signals for resources to be reallocated to reflect demand for goods and services. While workably competitive markets tend towards long-run equilibrium outcomes, they may never actually reach such an equilibrium.¹³⁰ Of particular relevance to this appeal is the fact that a reduction of demand will generally tend to put downward pressure on prices and revenues, as suppliers compete for the smaller pool of customers (although suppliers may be protected to some extent by long-term “take or pay” contracts).¹³¹

Input methodologies in times of stable demand

[170] To date, pt 4 regulation has operated in the context of services which were expected to have a long-term future and where demand was relatively stable – not necessarily static, but not anticipating any radical decline (or expansion). In this context, input methodologies have been determined and price paths have been set on the basis of forward-looking cost building blocks, including providing a return of, and on, the investment (both past and new) required to deliver services in accordance with forecast demand, over periods of four to five years.

[171] Suppliers are incentivised to invest through an expected return of (through a depreciation allowance) and on (through the WACC) those investments. Recoupment occurs over multiple pricing periods, with financial capital maintenance essentially

¹²⁹ At [29].

¹³⁰ At [524]–[529].

¹³¹ See, for example, George Yarrow “The Orion CPP determination” (paper presented to the Commerce Commission to aid it in its Orion Decision, May 2013) at 9–10.

being “re-set” at the start of each new default price-quality path regulatory period.¹³² Suppliers are also incentivised to improve cost efficiency because they will retain the “in period” benefits of any cost reductions by “beating the cap”, rather than by “beating the market” as is the objective in a competitive market. Because there is no competition to drive quality outcomes and suppliers could be incentivised to “beat the cap” through quality degradation, quality standards are also determined when price paths are set.¹³³

[172] This approach to regulation has served us well during a period in which gas pipelines were expected to have a long term future. Promoting the outcomes in s 52A(a)–(d) is consistent with the “within market” tendencies associated with workable competition and with promoting the long-term benefit of consumers. Relevantly for the issues now before the Court, the regulatory settings, and in particular the asset valuation input methodologies and the cost of capital input methodologies, have supported a return of and on gas pipeline investments over their physical lives, across multiple pricing periods.

[173] The approach has promoted the long-term benefit of consumers by facilitating the provision of those services at prices which reflect the long-run costs of supplying them. Gas pipeline services require substantial ongoing investments in long-lived sunk assets in order to provide an ongoing safe and reliable service. While straight-line depreciation of assets will not necessarily reflect their economic depreciation or allocative efficiency, it provides a reasonable proxy under steady state conditions.¹³⁴

¹³² Commerce Commission *Input Methodologies Discussion Paper* (19 June 2009) at [2.71]; quoted in *Wellington International Airport*, above n 7, at [265]; Commerce Commission *Input methodologies review decisions – Framework for the IM review* (17.01/15081, 20 December 2016) [2016 Input Methodologies Review Decisions – Framework Paper] at [121]–[122].

¹³³ Under sub-pt 6 of pt 4 of the Commerce Act.

¹³⁴ John Small “Expert Review of the New Zealand Commerce Commission’s Draft Decisions and Reasons for Electricity Distribution Services and Gas Pipeline Services” (paper presented to the Commerce Commission to aid it in its 2010 Input Methodologies Review Decisions, July 2010) at [28]; George Yarrow “Questions relating to the regulation of fibre fixed line access services (FFLAS) in New Zealand” (paper for Chorus to aid it in its submissions on the 2020 Fibre Decision, 2019) at 19.

Responding to the risk of network stranding

[174] It is a more challenging regulatory task to promote outcomes associated with workable competition *between* markets or, more broadly, to incentivise a reallocation of resources in response to substantial shifts in demand, as is currently anticipated for gas pipeline services. Whether gas pipelines have a long-term future, either for supplying natural gas and/or “clean” gas, is now highly uncertain. Assets, including entire networks, may become “stranded” before the cost of those assets have been fully depreciated under the “steady state” regulatory settings.

[175] Investments are made in long-lived assets in advance of revenues being received from their use to supply the market with goods or services. A rational investor will only make investments if they expect to recover those investments, including both a return on and of those investments.

[176] In a workably competitive market, suppliers bear the risk of asset stranding and will require *ex ante* compensation for doing so.¹³⁵ It can be thought of as a “self insurance premium” or the cost of bearing the risk of stranding, which suppliers require to be priced into the product before they are willing to make investments. That premium will be determined by the process of competition itself.¹³⁶

[177] If and when (full or partial) asset stranding occurs, suppliers in a workably competitive market would be expected to compete for the diminishing pool of customers by lowering prices, all else equal. The result of this competition will tend to be less than full recoupment of prior investments. While reduced demand will put downward pressure on prices, there may be offsetting effects if operating costs rise due to a loss of economies of scale and/or higher input costs. Competitive suppliers

¹³⁵ 2010 Input Methodologies Decision – Reasons Paper, above n 1616, at [E11.4]; *Wellington International Airport*, above n 7, at [1717] and [1720]; and Frontier Economics “Memo – Response to key submissions made by stakeholders on the Commerce Commission’s approach to addressing stranding risks in the Gas Draft DPP3 Decision” (paper submitted on behalf of First Gas, Powerco and Vector to the Commerce Commission as a cross-submission on the Commission’s 2022 Default Price-quality Path – Draft Reasons Paper (above n 109), 28 March 2022) [Frontier Economics Cross-submission on Commission’s 2022 Draft Reasons Paper] at [60(a)(i)].

¹³⁶ At [E11.4]; and Competition Economists Group “Stranding risk – depreciation vs uplift” (report submitted on behalf of Vector as a submission on the Commission’s 2021 Process and Issues Paper (below n 144), August 2021) [Competition Economics Group – report in response to the Commission’s 2021 Process and Issues Paper] at n 1.

will be willing to continue to supply as long as prices and revenues are sufficient to cover their “staying in business” costs, including an expected return of and on any new investments required to maintain supply.¹³⁷

[178] Fixed and sunk costs associated with prior investments will continue to be incurred regardless of whether services are supplied and any contribution that revenues can make towards them after covering “staying in business costs” will be a bonus.¹³⁸ Suppliers who resist the pressure of competition are likely to lose customers, and any associated contribution to cover their fixed and sunk costs, to rivals who lower their prices in response to falling demand.

[179] It is not consistent with rivalry in a workably competitive market for prices to be increased to recoup the costs of *past* investments in the face of (expected) falling demand. Such an outcome would require coordination, whether explicit or implicit.¹³⁹ George Yarrow put it this way in the context of the Orion Decision:¹⁴⁰

In the context of supply of a reasonably homogeneous product/service, using long-lived specialised assets, demand reduction in a competitive market can be expected to put downward pressure on prices, more or less immediately in spot markets and potentially more gradually in contract markets (depending upon the form of the contracts used: a long term contract for specified volumes at a price determined by a spot price index would likely show a price response almost [as] quick as the spot price response itself). It would, I think, be surprising if, having lost some customers, competitive firms with excess capacity and short-run marginal costs well below the prevailing price level, then increased prices to remaining customers to restore their profitability. Cartelisation might do the trick, but the market could not then be said to be workably competitive.

¹³⁷ Competition Economics Group – report in response to the Commission’s 2021 Process and Issues Paper, above n 136, at [32]; and *Wellington International Airport*, above n 7, at [597].

¹³⁸ Unless the supplier could do better by shutting down and selling the assets for an alternative use, taking into account the exit costs.

¹³⁹ *Wellington International Airport*, above n 7, at [1740].

¹⁴⁰ George Yarrow, above n 131, at 13.

Initial consideration given to stranding risks under pt 4

[180] When the Commission made its original 2010 Input Methodologies Decision, it gave extensive consideration to the question of how to address the risk of asset stranding in regulatory settings.¹⁴¹

[181] Compensation for bearing stranding risks must necessarily be provided *ex ante* in a workably competitive market, where the size of the risk premium will be determined by the process of competition itself. Determining what is an appropriate *ex ante* premium to cover the cost to suppliers of bearing asset stranding risk is fraught with difficulty in the absence of competition, particularly when the size of the risk is highly uncertain and perhaps very low. By contrast, as the Commission discussed, regulators are in the unique position of being able to accelerate depreciation or make other *ex post* adjustments as stranding becomes apparent and with the benefit of hindsight.¹⁴²

[182] Systematic stranding risk should be covered by the WACC and the asset beta for gas pipeline businesses has to date been higher than for electricity lines based on higher income elasticity of demand and particularly the relatively “thin” market for gas in New Zealand, which was thought to put gas pipelines closer to the “death spiral tipping point”.¹⁴³

[183] However, as discussed in the preceding section, network stranding risk was viewed as largely non-systematic and, as a result, not regarded as being covered by the WACC.¹⁴⁴ As discussed earlier, after considering various options to address non-systematic asset stranding risks, the Commission decided not to provide suppliers with any *ex ante* compensation for bearing non-systematic asset stranding risks. It was

¹⁴¹ The Commission considered the provision of an ex-ante allowance in the context of the cost of capital input methodologies, rather than the asset valuation input methodologies; see the discussion at *Wellington International Airport*, above n 7, at [1714]–[1722].

¹⁴² 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [H12.1], [H12.7], [H12.25], [H12.28], [H12.35] and Appendix H more generally; *Wellington International Airport*, above n 7, at [1741].

¹⁴³ At [H8.179]; 2016 Input Methodologies Review Decisions – Topic Paper 4, above n 67, at [343]–[344], [371], [416], [426] and [433].

¹⁴⁴ Commerce Commission *Resetting default price-quality paths for gas pipeline businesses from 1 October 2022 – Process and Issues paper* (15.01/45138, 4 August 2021) [2021 Process and Issues Paper] at [D9.3] and [D25]–[D26]; 2022 Default Price-quality Path Decision – Draft Reasons Paper, above n 109, at [6.16]–[6.20].

considered too difficult to determine an appropriate *ex ante* revenue allowance, and the reserve fund proposal was also considered too administratively complex.¹⁴⁵

[184] As outlined earlier, in *Wellington International Airport* the Court agreed with the Commission that providing *ex ante* compensation for stranding risk was inappropriate because of the difficulties in determining an appropriate uplift to cover the cost of carrying these risks and because regulated firms did not face the same risks as firms in workably competitive markets. Of particular relevance for the issues before us, the Court agreed with the Commission that these risks are better dealt with through front loading the depreciation profile or cash flows and/or allowing individual stranded assets to remain in the regulatory asset base.¹⁴⁶

[185] The regulatory choice not to provide *ex ante* compensation to cover the cost of bearing stranding risk was made having regard to the overriding purpose of pt 4, being the long-term benefit of consumers, notwithstanding that it was inconsistent with what would be expected in a workably competitive market.¹⁴⁷

[186] As a result of this choice, consumers rather than suppliers were explicitly or implicitly left to bear most of the risk of asset stranding which would otherwise have required higher upfront prices to be charged to consumers, when the necessary risk premium for suppliers to bear the risk would be difficult to determine in the absence of competition.¹⁴⁸

[187] The Commission has distinguished between what was referred to as “physical asset stranding” and “economic asset stranding”.¹⁴⁹ The former refers to the stranding of individual assets, where the remaining assets in the network can continue to generate sufficient revenues to cover total depreciation, while the latter refers to a

¹⁴⁵ See discussion in *Wellington International Airport* above n 7, at [1714]–[1722] and [1739]–[1741]; and 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [E11.1]–[E11.16] and [H12.1]–[H12.36].

¹⁴⁶ At [1722] and [1742].

¹⁴⁷ 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [E11.6].

¹⁴⁸ By contrast, when determining the 2020 Fibre Decision the Commission considered asset stranding to be a higher risk and included a modest ex-ante allowance, along with provisions for alternative depreciation profiles and keeping individual assets in the regulatory asset base, effectively splitting the risk between suppliers and consumers. See 2020 Fibre Decision – Reasons Paper, above n 71, at [6.984.2] and [6.1022].

¹⁴⁹ 2016 Input Methodologies Review Decisions – Topic Paper 3, above n 64, at [72].

situation where the network as a whole cannot generate sufficient revenue. However, both types of asset stranding are economic in the sense that the assets no longer generate sufficient revenue to recoup the capital invested in them.

[188] In the case of individual (physical) assets that become redundant, the stranding risk has been addressed by allowing the assets to remain in the regulatory asset base until they have been fully depreciated, regardless of whether they were still in use. The historic cost of the investments could be recouped by revenues generated from other assets. As a result, the risk of individual asset stranding has been carried by consumers of services under pt 4 regulation. Consumers benefit from lower prices while assets remain in use but, in the event that individual assets do become stranded, prices will be higher to allow their historic costs to be recouped.

[189] In the case of (economic) network stranding, the collective willingness to pay of consumers is insufficient to cover remaining depreciation allowances for the total regulatory asset base and an alternative solution would be required if suppliers were to have an expectation of financial capital maintenance. Unless suppliers can take action to mitigate risk and/or have an expectation that the risk will be otherwise addressed if and when required, and so effectively be borne by consumers to some extent, investment incentives will be undermined unless the risk of stranding is close to zero.

[190] When determining the initial 2010 Input Methodologies Decision, the Commission drew insights from markets characterised by long-term contracts.¹⁵⁰ Long-term contracting is often associated with markets involving long-lived sunk assets, especially where investments are customer-specific. Contracts of this type protect investors from *ex post* appropriation of quasi-rents by customers, such that investors would not receive a return of and on their investments. The terms of the contract are determined in advance of investments being made and the returns that accrue over time will reflect the market circumstances at the time the contract was made, rather than when the services are subsequently provided.

¹⁵⁰ 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [2.6.22]–[2.6.26], [H1.17]–[H1.18] and [H12.25]–[H12.26].

[191] Part 4 regulation has some parallels with a series of incomplete long-term bilateral contracts between suppliers, who invest in long-lived sunk assets, and the regulator, acting on behalf of consumers.¹⁵¹ Suppliers do not “agree” to the regulatory settings, while the Commission has always been clear that there was no “regulatory compact” and its adherence to key economic principles was contingent on those principles continuing to assist in promotion of the pt 4 purpose.¹⁵² Nevertheless, a consistent application of regulatory principles over time promotes confidence in the regulatory system and, all else equal, will tend to promote efficient investment.¹⁵³ The Commission has recognised that abandoning the economic principles that have underpinned pt 4 regulation could affect investor certainty.¹⁵⁴

[192] In relation to stranding risks, the application of those principles has suggested previously that asymmetric network stranding risk would be addressed if and when required, including through front loading the depreciation profile as stranding becomes apparent.¹⁵⁵ Suppliers were willing to invest in gas pipelines despite receiving no *ex ante* compensation to carry the risk of network stranding because they had a reasonable expectation that this (low) risk would be addressed if and when it became a reality (or a high probability); just as the risk of individual asset stranding was to be addressed by allowing assets to remain in the regulatory asset base if and when they became redundant until they were fully depreciated. Accordingly, network stranding risks were implicitly left with consumers, who would benefit from lower prices unless and until the risk became a reality.

Consideration given by the Commission to stranding risks in 2016

[193] As discussed earlier, network stranding risk was considered again during the 2016 Input Methodologies Review Decisions. At that time, stranding was considered to be an increased risk for electricity distribution networks, due to technological innovations associated with dispersed generation potentially making electricity lines redundant.¹⁵⁶ Making good on supplier expectations that stranding risk would be

¹⁵¹ At n 221; and John Small, above n 134, at [10]

¹⁵² 2016 Input Methodologies Review Decisions – Framework Paper, above n 132, at [143]–[153].

¹⁵³ John Small, above n 134, at [10].

¹⁵⁴ 2016 Input Methodologies Review Decisions – Framework Paper, above n 132, at [151].

¹⁵⁵ 2010 Input Methodologies Decision – Reasons Paper, above n 16, at [H12.28] and [H12.35].

¹⁵⁶ 2016 Input Methodologies Review Decisions – Topic Paper 3, above n 64.

addressed if and when the need arose, the Commission made provision for accelerated depreciation of up to 15 per cent, where an electricity distribution business could satisfy the Commission that it met certain criteria.¹⁵⁷ This provision was not extended to gas pipelines, which were not considered to be facing significant stranding risk at that time.¹⁵⁸

The current situation

[194] The situation now facing gas pipelines is very different. While climate change has been a general concern for many years, it is only now that the policy responses are crystallising. Gas pipelines face a very uncertain future following the Government’s commitment to net zero by 2050 and a phasing out of fossil fuels. While demand is not expected to fall during DPP3, the future risk of network stranding is now a substantial one.¹⁵⁹ While there may be some ongoing future use of natural gas in a net zero world, it will necessarily be much reduced from the current level of demand. There is also a potential for gas pipelines to be used to carry “clean gas”, such as hydrogen, in the future. However, it is far from certain whether this demand will be sufficient to prevent economic network stranding.

[195] Faced with a significantly elevated risk of network stranding of gas pipelines, the Commission considered several potential solutions to the problem that would make good on the expectations that had been created in 2010. Its preferred solution is the amendment to the asset valuation input methodologies subject to this review. Essentially, the amendment provides the Commission with a discretion to accelerate and decelerate depreciation of gas pipeline assets at each pricing period reset based on evolving information on the expected economic life of those assets, ameliorating but not eliminating the asset stranding risk faced by gas pipeline businesses. Should asset stranding be realised more rapidly than expected in setting the adjustment factors, gas pipeline businesses would still fail to fully recoup their investments.

[196] The amendments within the 2022 Input Methodologies Decision were made ahead of the price path for DPP3 being set in order to allow depreciation to be

¹⁵⁷ At [84]–[87].

¹⁵⁸ At [104].

¹⁵⁹ 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at [3.38].

accelerated over that period, despite no expectation of falling demand until later pricing periods. The context and timing of the changes were clearly significant and they are described as being “[a]mendments to input methodologies for gas pipeline businesses *related to the 2022 default price-quality paths*”.¹⁶⁰ In considering whether the Commission’s input methodologies amendments are consistent with the purpose of pt 4, as set out in s 52A, we consider the changes in the context in which they were made. While on their face the amendments simply provide the Commission with the discretion to accelerate or decelerate depreciation, the amendments were clearly made with the intention of accelerating depreciation during DPP3.¹⁶¹ However, the specific details of that acceleration, the specific adjustment factors that were set for DPP3 and the smoothing and capping of price increases are matters for the Commission’s exercise of its regulatory discretion in determining the price path for DPP3 and are not relevant to the merits of the input methodologies amendments.

[197] Accelerating depreciation in DPP3 would allow gas pipeline businesses to increase recoupment while demand for gas pipeline services remains robust, providing an expectation (but not a guarantee) that past and future capital investments required to supply the services can be fully recouped over the assets’ economic life. If forecasts of declining demand in later periods turn out to be too pessimistic, depreciation can be decelerated. It does not provide a guarantee of recoupment, since future demand paths may not turn out as expected but, absent provision for accelerated depreciation (or some other means of increasing the maximum allowable revenue) during DPP3, it seems likely that investors may no longer expect to be able to fully recoup their investments from a dwindling customer base in future pricing periods. Acting now takes advantage of a “window of opportunity” for recoupment before the risk of asset stranding potentially becomes a near certainty.¹⁶²

[198] MGUG argues that providing for accelerated depreciation and elevated prices in the face of an expected falling away of demand is inconsistent with what would happen in a workably competitive market. This much is true. As discussed earlier, in a competitive market a falling away of demand would be expected to put downward

¹⁶⁰ 2022 Input Methodologies Decision – Reasons Paper, above n 22 (emphasis added).

¹⁶¹ By way of example, at [3.37]–[3.39].

¹⁶² Competition Economics Group report in response to the Commission’s 2021 Process and Issues Paper, above n 136, at [4(g)], [67]–[70] and [87]–[92].

pressure on prices as suppliers compete for a dwindling customer base in order to recoup what they can of their fixed and sunk costs. They would be expected to be willing to continue to supply the market as long as they can at least cover their “staying in business costs”, including any new investment required.¹⁶³

[199] Only coordination, whether explicit or implicit, would enable otherwise competing suppliers to increase their margins over “staying in business costs” sufficiently to accelerate recoupment of their past sunk investments. By contrast, a regulated monopoly has head room to increase prices and revenues closer towards total willingness to pay, if the regulatory settings are changed to permit it.

[200] However, in a workably competitive market, suppliers would have been compensated *ex ante* for bearing the risk of demand falling away and assets being stranded, through a competitively determined price premium. Gas pipeline services are not supplied in a workably competitive market and the Commission previously determined that it would not provide an *ex ante* allowance to cover network stranding risk. With the new reality of a policy commitment to 2050 net zero and the phasing out of fossil fuels, gas pipeline businesses face a heightened asymmetric non-systematic network stranding risk.

[201] It should be noted also that leaving the input methodologies unchanged would be inconsistent with what would be expected in a workably competitive market as demand falls away. Suppliers competing for a dwindling pool of customers would shave prices to attract a greater share of customers and, accordingly, to recover a greater contribution towards recouping their sunk investments. It is unlikely that they would be able to continue recoupment at historic levels of revenue over “staying in business costs”.

[202] All of this leads to the question that is central to this appeal: is the overriding purpose of pt 4 – namely, the long-term benefit of consumers – best promoted through adopting the Commission’s input methodologies as determined in its 2022 decision or

¹⁶³ *Wellington International Airport*, above n 7, at [597]; and Competition Economics Group – report in response to the Commission’s 2021 Process and Issues Paper, above n 136, at [32].

are the alternative proposals put forward by MGUG materially better for promoting the long term benefit of consumers?

Are MGUG's proposals materially better?

[203] Demand for gas pipeline services is expected to be sustained throughout DPP3 but to start falling away in subsequent pricing periods.¹⁶⁴ The Commission's amendment to the asset valuation input methodologies, through its application in DPP3, allows gas pipeline businesses to accelerate the recoupment of investment costs while demand remains more robust.¹⁶⁵ If demand turns out to be more sustained than currently expected, the Commission can decelerate depreciation over subsequent periods. Clearly gas pipeline businesses will benefit from this change because it increases the likelihood that both past and new investments will be recouped. The change is only "net present value neutral" compared to the existing input methodologies if asset stranding would not in fact become a reality under current regulatory settings.¹⁶⁶ The very purpose of the change is to provide gas pipeline businesses with an expectation (but not a certainty) of fully recouping their investments, where they would not expect to do so absent the change. The question is whether this is also consistent with the purpose of pt 4 to promote the long-term benefit of consumers?

[204] The appellant's first option is to leave the asset valuation input methodologies unchanged. Consumers would pay lower prices, at least in DPP3, if the input methodologies remained unchanged and assets were depreciated over their physical lives. If asset stranding was realised, by definition, total revenues over the life of those assets will also be lower. However, the interests of consumers extend beyond prices. Consumers also benefit from the provision of a safe and reliable service for as long as there is demand to sustain that supply, which will require significant ongoing investment over DPP3 and beyond.¹⁶⁷ For DPP3 alone, capital expenditure

¹⁶⁴ See 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at 3.36–3.40 and [C44].

¹⁶⁵ At [6.12].

¹⁶⁶ 2021 Process and Issues Paper, above n 144, at [D30].

¹⁶⁷ HoustonKemp "Consequences of declining gas pipeline utilisation" (report prepared for Vector, Firstgas and Powerco in response to the Commission's 2021 Process and Issues Paper (above n 144), 30 August 2021) [HoustonKemp – report in response to the Commission's 2021 Process and Issues Paper] at 6 and 10; Frontier Economics "The case for a nominal returns framework for

allowances total almost \$284 million and gas pipeline business capital expenditure estimated requirements over 10 years were nearly \$900 million.¹⁶⁸ The Competition Economists Group (CEG) modelling provided to the Commission was based on an assumption that \$25 million per annum “stay-in-business [capital expenditure]” was required by gas pipeline businesses.¹⁶⁹

[205] Gas pipeline businesses would not rationally make those investments, beyond what was required to meet their minimum legal obligations, unless they could expect to receive a return of and on the capital invested. With the expected economic lives of these new investments being less than their physical life, the unamended input methodologies would not provide that expectation. For example, Frontier Economics estimated that around \$600 million of undepreciated new investment – allowing only for minimum investment required to operate the network reliably and safely through to 2031 – would remain in the regulatory asset base at 2050.¹⁷⁰

[206] The appellant has not demonstrated that the long-term benefit of consumers would be better served by those investments not being made. Accordingly, we are not satisfied that MGUG’s first option, to leave the asset valuation input methodology unamended would be materially better than the Commission’s 2022 Input Methodology Decision.

[207] The appellant’s second option is to only apply the amended input methodologies to new investments and to fix the depreciation profile (factor) at the time investments are made. The depreciation profile for new investments in each default price-quality path would be determined once and for all when the price path was set, but a different profile (factor) could be set for new investments in each subsequent pricing period. Prior investments would continue to be recouped in part

regulated gas networks in New Zealand” (paper prepared for Vector, Firstgas and Powerco in response to the Commission’s 2021 Process and Issues Paper (above n 144144), 27 August 2021) [Frontier Economics – paper in response to the Commission’s 2021 Process and Issues Paper] at [17(g)].

¹⁶⁸ 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at [6.27.2], Table [5.1], at [5.3], 71, Table C1 at [C33] and 178.

¹⁶⁹ Competition Economists Group – report in response to the Commission’s 2021 Process and Issues Paper, above n 136, at [83] and Appendix A.

¹⁷⁰ Frontier Economics – paper in response to the Commission’s 2021 Process and Issues Paper, above n 167, at [43]–[50] (calculated as the approximate difference between the no new investment and minimum new investment scenarios).

but, if demand falls away as currently expected and alternative uses are insufficient to replace that demand, investors would no longer expect to fully recoup them. This is closer to what would be expected to happen in a workably competitive market, except that the extent of under-recoupment would be determined by competition for dwindling demand in a workably competitive market, rather than by straight-line depreciation.

[208] Pricing closer to “staying in business costs” would also encourage greater utilisation of the gas pipelines, potentially improving allocative efficiency and benefiting consumers.¹⁷¹ We say “potentially” improving allocative efficiency because this is only true to the extent that the negative externalities associated with the use of natural gas have been fully captured by the emissions trading system. The Commission suggested that accelerating depreciation would encourage consumers to make more efficient use of gas pipeline businesses’ services because they would otherwise face prices that did not reflect the underlying cost of supply.¹⁷² When there is excess capacity and an uncertain future for the service, pricing below long-run costs would be the likely outcome in a workably competitive market to encourage greater utilisation of assets. However, to the extent that lower prices encouraged more consumers to connect to the network and make investments in gas appliances, this may not be efficient and could even leave consumers worse off overall.

[209] The second option is preferable to the first option, since it would provide investors with an expectation of receiving a return of and on new investments required to maintain safe and effective service delivery, provided the time profile of demand turned out to be consistent with expectations. However, as discussed earlier, in a workably competitive market suppliers would be compensated *ex ante* for bearing stranding risk; historically for sunk investments and in the current price path for new investments. Neither occurs under the existing regulatory settings, with or without the amended input methodologies, and the risk of network stranding is now significant and affects both existing and new assets, even allowing for the accelerated depreciation of new assets.

¹⁷¹ *Wellington International Airport*, above n 7, at [601]–[602] (in the context of setting the initial regulatory asset base value).

¹⁷² 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at [6.27.3], [6.55] and [C63.3].

[210] With a fixed depreciation profile, suppliers would bear the remaining network stranding risk. With no compensation to cover the cost of bearing this risk on new assets, the risk is asymmetric and a rational investor would likely be wary of making those investments unless they were very confident of demand forecasts. While this option is preferable to leaving the input methodologies settings unchanged, it still puts at risk the substantial ongoing investments required to maintain gas pipeline services as required in the years ahead. Accordingly, we are not satisfied that this option would be materially better than the Commission’s 2022 Input Methodologies Decision.

[211] Finally, the appellant’s third option is to refer the input methodologies amendment back to the Commission, with direction as to the particular matters that require amendment, under s 52Z(3)(b)(iii). Given the limitations of these provisions, the reference back would need to be relatively prescribed.¹⁷³ The necessary changes would need to be clear and not require any further consultation, such that we could be satisfied that the outcome of a reference back would be “materially better” than the Commission’s 2022 Input Methodologies Decision.

[212] One such option suggested by MGUG was the need for a gas pipeline business to apply to the Commission to shorten asset lives for new investments through a customised price-quality path process while ensuring that network asset stranding risks for sunk assets remain with gas pipeline businesses. This option has the potential to provide more flexibility over the life of new investments in the future. However, the requirement to apply for a customised price-quality path adds to compliance costs and creates further delay.

[213] Another option for a reference back to the Commission might be to vary the appellant’s second option so that the depreciation schedules for new investments could be further adjusted by the Commission in subsequent pricing periods. This would align with the Commission’s amendments but would apply only to new investments. We do not consider this option would be technically unworkable and it should provide investors with greater confidence that they would be able to fully recoup necessary investments in the years ahead.

¹⁷³ *Wellington International Airport*, above n 7, at [182] and [189]–[191].

[214] However, both of these options for referral back fail to make good on suppliers' prior expectations relating to the treatment of asset stranding risk – on investments that are now sunk – when suppliers were not compensated *ex ante* to cover the cost of carrying that stranding risk. That failure could be regarded as a form of *ex post* capital expropriation that has the potential to undermine investor confidence in the regulatory system. Investors could lack confidence as a result of concerns as to whether depreciation schedules for new investments would be adjusted sufficiently if needed once these investments also become sunk. While the extent of this impact on investor confidence is uncertain, it could be significant and we cannot be confident that either of these amendments would be materially better in meeting the pt 4 purpose than the Commission's amendments.

[215] More broadly, the failure to make good on regulatory expectations could undermine confidence in the regulatory system and investment incentives for suppliers of other services regulated and potentially regulated under pt 4.¹⁷⁴ As discussed earlier, the relevant group of consumers is consumers of all services regulated under pt 4. Furthermore, as the Court found in *Wellington International Airport*, it is open to us, but we are not required, to consider the interests of consumers of services potentially regulated under pt 4.¹⁷⁵ Electricity lines services have not received any *ex ante* compensation to carry network stranding risk and have made investments to date based on an expectation that network stranding risk would be addressed if and when required.

[216] This expectation was consistent with the 2016 Input Methodologies Review Decisions which allowed limited acceleration of depreciation for electricity distribution businesses. However, in the future, electricity distribution businesses may not be confident that the Commission would adjust regulatory settings as required to ameliorate asymmetric network stranding risks if and when they become more pressing. This, in turn, may make regulated suppliers reticent to make necessary investments, which would not be consistent with promoting the long-term benefit of consumers of those services. This concern arises in relation to all three of MGUG's proposed alternatives to the Commission's 2022 Input Methodologies Decision.

¹⁷⁴ At [600], [605] and [759].

¹⁷⁵ At n 442.

[217] In addition, we are not convinced by MGUG’s suggestion that the Commission’s 2022 Input Methodologies Decision, by providing an expectation, but not a certainty, of recoupment on past investments, could incentivise “gold plating” and excessive investment. Incentives for excessive investment would depend on the returns expected on those new investments, not on whether past investments will be recouped.¹⁷⁶ Excessive new investment could be a consequence of providing an excessive “cushion” in the WACC,¹⁷⁷ but the cost of capital input methodologies is not the subject of this appeal. As long as investors only expect to receive a normal return on capital invested, and with no *ex ante* compensation to cover the very real remaining risk of network stranding, we would expect investors to remain prudent. In the particular context of DPP3, this state of affairs has been encouraged further by the Commission not increasing capital expenditure allowances above historic levels.¹⁷⁸

[218] Accordingly, we are not satisfied that any of the appellant’s alternatives to the Commission’s 2022 Input Methodologies Decision would be materially better. All three of the options risk undermining the incentives for gas pipeline businesses to continue making the investments that would be required to maintain a safe and reliable service, for which there will be an ongoing demand, and in order to provide for an orderly cessation of operations if and when required.

[219] For these reasons, this ground of appeal does not succeed.

Is the 2022 Input Methodologies Decision premature?

[220] MGUG submits that the Commission acted prematurely in making the 2022 Input Methodologies Decision on the basis of what it refers to as uncertainty over future policy affecting long-term gas demand.

[221] It says that possible future decisions will require a complex balancing of economic and social considerations, including the consideration of technologies that

¹⁷⁶ At [1462] and [1479]–[1480].

¹⁷⁷ At [1472]–[1474].

¹⁷⁸ 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at [X20], [4.20.2] and Figure 4.4.

are presently unknown. It is said that the current relevant decisions are expressly uncertain, tentative and exploratory with no specific targets or timetables.

[222] The first point to be made is material. As we have discussed, the merits-based appeal requires us to consider whether MGUG's options are materially better than those of the Commission. However, the 2022 Input Methodologies Decision only gives the Commission the *option* to adjust asset lives where doing so would be consistent with the purposes of pt 4, in light of the best information available at the time.

[223] MGUG's prematurity arguments are in effect arguments that the Commission erred in deciding to exercise the power provided by the amended input methodologies when it set price paths in the 2022 Default Price-quality Path Decision. That is the subject of the separate error of law appeal on the 2022 Default Price-quality Path Decision, addressed below. Given that the 2022 Input Methodologies Decision only gives an *option* to adjust asset lives, any issue of prematurity cannot, logically, arise.

[224] Moreover, in the preceding section, we discussed the Commission's response to the new reality of a policy commitment to 2050 net zero and to the phasing out of fossil fuels. We considered that MGUG's proposals were not materially better. In many ways, that addresses MGUG's prematurity argument in the sense that we were, in comparison with MGUG's proposals, satisfied that what the Commission was doing, and the time at which it is doing it, is to be preferred.

[225] Underlying those conclusions, it can be said that there was a sound evidential basis for the Commission to be concerned about the risk of assets stranding and a clear basis for its decision, as a result, to act now.

[226] In an April 2021 open letter, following publication of the Climate Change Commission's January 2021 draft advice on the first emissions budgets,¹⁷⁹ the Commission made the point that, whether or not the Climate Change Commission's draft advice is adopted by the Government, gas use is likely to come under increasing

¹⁷⁹ Which recommended setting a date by which no new natural gas connections are permitted – being no later than 2025 if possible.

pressure as decarbonisation efforts progress. Submissions on the open letter expressed concerns about the disruption that the Climate Change Commission’s approach would cause to the government’s “regulatory business-as-usual framework”.¹⁸⁰

[227] Following the Climate Change Commission’s final advice to the government in May 2021, the Commission in its August 2021 DPP3 Process and Issues paper explained that economic stranding risks for gas pipeline business assets had increased since the 2016 Input Methodologies Review Decisions. It observed that, in light of the responses it had received to its open letter, it would be considering potential options to address the increased asset stranding risks, including a mechanism to shorten asset lives (similar to that introduced for electricity distribution businesses in 2016) or providing an *ex ante* allowance to compensate for an increased risk of assets stranding (similar to that provided in the 2020 Fibre Decision).

[228] In response to the Commission’s Process and Issues paper, Powerco, Vector and First Gas provided expert reports from Frontier Economics and HoustonKemp which analysed stranding risk using economic modelling. In addition, Vector engaged Competition Economics Group (CEG) to quantify the stranding risk and to suggest possible remedies to address it.¹⁸¹

[229] Frontier Economics estimated that existing regulatory settings would leave more than \$600 million in unrecovered capital, even without further (necessary) investment. Its calculations showed \$1.2 billion in unrecovered regulatory asset base, assuming stranding in 2050 and only strictly necessary asset investments in the meantime.

[230] HoustonKemp’s calculations showed that, even with full recovery of the maximum allowable revenue up to 2050, the unrecovered regulatory asset base across the gas pipeline industry would be in the order of \$890 million.

¹⁸⁰ As First Gas put it in its response to the open letter.

¹⁸¹ Frontier Economics – paper in response to the Commission’s 2021 Process and Issues Paper, above n 167167; Competition Economics Group – report in response to the Commission’s 2021 Process and Issues Paper, above n 136; HoustonKemp – report in response to the Commission’s 2021 Process and Issues Paper, above n 167.

[231] CEG modelling found that customer willingness to pay would fall below building block costs in 2037, at which point suppliers would start to experience stranding and that the network would cease to operate in 2043. Accordingly, it concluded, suppliers would need additional compensation before 2037 if there was to be any expectation of recovering their full costs. A 2.88 per cent uplift – as a percentage of the regulatory asset base – would be needed.

[232] While we have not set about to test the substance of these expert views, they demonstrate that the Commission had received evidence from suppliers which explained the significance of the stranding risks they faced.

[233] Furthermore, in its February 2022 draft reasons papers for draft amendments to the input methodologies and default price-quality path, the Commission explained that its own modelling demonstrated that “current regulatory settings imply that even with no new investment there will likely be significant unrecovered [regulatory asset base] across depreciable assets for all suppliers in 2040, 2050, 2060 and 2070”.¹⁸²

[234] In May 2021, the government had established the Gas Infrastructure Future Working Group to consider potential impacts of government action to address climate change from a gas infrastructure perspective. The Working Group in an analysis paper in response to the Commission’s draft decision, provided an analysis which showed that, if gas infrastructure was wound down by 2050, in the absence of changes to regulatory or policy settings, infrastructure owners would be exposed to \$644 million of unrecovered regulatory asset base, which was more than 30 per cent of the value of the current regulatory asset base across the networks.

[235] Given the extent of the stranding risk, the Commission decided that it was appropriate to address most of that risk within DPP3.¹⁸³ It was of the view that, in taking action in 2022 – during DPP3 – it would better promote the pt 4 purpose, including by giving a more credible expectation of financial capital maintenance for

¹⁸² 2022 Default Price-quality Path Decision – Draft Reasons Paper, above n 109, at [6.40].

¹⁸³ At [6.112].

suppliers which would, in turn, support and provide incentives for prudent and efficient investment for the long-term benefit of consumers.¹⁸⁴

[236] It canvassed different options for assessing stranding risks in DPP3 but ultimately settled, in its draft decision, on what it called, with reference to a submission by Vector, the “least regrets approach” of accelerated depreciation through shortening asset lives.¹⁸⁵

[237] In a review of submissions on the Commission’s draft decision, Frontier Economics considered, amongst other things, MGUG’s submission that any adjustment of asset lives should be delayed until the next regulatory period.¹⁸⁶ It used the Commission’s model to assess the outcomes of delaying the decision to accelerate depreciation until DPP4. It concluded on the issue that, if the Commission waited until DPP4 to accelerate depreciation, then: ¹⁸⁷

... the future gas price increases that would, in expectation, be required in order for the [gas pipeline businesses] to recoup their full [regulatory asset bases] by 2050 would be materially and persistently higher from approximately 2031 onwards than if the Commission were to begin accelerating depreciation in DPP3.

[238] In its final decisions the Commission maintained its position that it was appropriate to act in DPP3.¹⁸⁸ It saw there to be “compelling and urgent reasons for doing so”.¹⁸⁹ Moreover, it saw that acting in 2022 enabled it to give better effect to the pt 4 purpose, to support an expectation of financial capital maintenance and to preserve options of value to consumers.¹⁹⁰

[239] Its own financial modelling demonstrated that, if wind down occurred, gas pipeline businesses would face particularly high stranding risks, expected to total \$573 million against all gas pipeline businesses by 2050.¹⁹¹

¹⁸⁴ At [6.55], [6.60], [6.63], [6.65] and [6.112].

¹⁸⁵ At [6.96].

¹⁸⁶ Frontier Economics Cross-submission on Commission’s 2022 Draft Reasons Paper, above n 135.

¹⁸⁷ At [19].

¹⁸⁸ See, by way of example, 2022 Default Price-quality Path Decision – Reasons Paper, above n 25, at [X13.3].

¹⁸⁹ 2022 Input Methodologies Decision – Reasons Paper, above n 22, at [2.20], [3.46] and [3.47].

¹⁹⁰ 2022 Default Price-quality Path Decision – Draft Reasons Paper, above n 109, at [C63.1] – [C63.5].

¹⁹¹ At Table [C2] at [C48].

[240] We agree that the Commission’s conclusions were justified by the evidence. Given the prospect that declining demand will materially impact revenue as a known credible risk, an input methodology that gives a regulator an ability to address that known risk is better than one that does not.

[241] The changes do not facilitate any ‘over recoupment’ of investment. At best, investors will fully recoup their investments, but there remains a risk of under recoupment. However, the ‘window of opportunity’ argument suggests that, if network stranding is not addressed now, it may be too late to address it later because collective willingness to pay for services over the remaining life of the assets will be insufficient to fully recoup investments over a shorter remaining period.

[242] A failure to shorten asset lives now, when the expected economic life of new investments is shorter than their physical lives, may itself undermine investor expectations of financial capital maintenance and, accordingly, their confidence to make those investments.¹⁹² If things turn out differently, the Commission can change adjustment factors for subsequent pricing periods to extend (or further reduce) the remaining period for depreciation.

[243] In addition, acting now will be likely to allow the cost to be spread across a larger group of consumers (unless some technological breakthrough results in no drop off in demand) than would otherwise be the case. If change is delayed, it is more likely that the cost of stranded assets will not be recouped and/or that the cost will fall on a smaller group of customers with less elastic demand. This could include both residential customers, particularly renters, but also some industrial and commercial users for whom there is currently no close substitute for gas (for example, feedstock and high temperature energy).¹⁹³

[244] Furthermore, taking advantage of the window of opportunity to incentivise continued operation of the pipelines while there is sufficient demand is more likely to preserve the option value of gas pipelines being repurposed to carry clean gas in future, if and when technology enables that to occur. Shutting down the network prematurely

¹⁹² At [C63.2].

¹⁹³ At [3.39].

because investors are not confident that the new investment required to maintain pipeline operations will be recovered could extinguish the option of repurposing.¹⁹⁴

[245] On the other side of the equation, there is no detailed evidence on the record to suggest that, if network shutdown occurred in 2050 or 2060, the current regulatory settings would not result in gas pipeline businesses having significant unrecovered regulatory bases.

[246] Accordingly, we are not satisfied that it would be materially better to wait and reconsider the asset valuation input methodology at a later time (likely during DPP4) when demand is expected to fall away. We agree with the Commission's conclusion that there were compelling and urgent reasons to act.

[247] Accordingly, this ground of appeal does not succeed.

Is the 2022 Input Methodologies Decision contrary to s 52T and/or s 52R?

[248] MGUG says, in this further ground of appeal, that the 2022 Input Methodologies Decision is in fact a grant by the Commission of a power to itself to exercise wide discretions. That, it is said, misinterprets and misapplies ss 52R and 52T which prescribe detailed requirements for input methodologies in order to achieve certainty and predictability for suppliers and consumers. The improper discretions are, it is said, a reflection of the point that, in MGUG's view, not enough is known about the risks that accelerated depreciation is designed to address to enable the clear specification that is required for input methodologies.

[249] Clause 4.2 of the methodologies (referred to in paras [112]–[114], above) in fact provides a carefully prescribed methodology for determining total depreciation for gas distribution and gas transmission services. It includes detail, through the provision of a formula, on how any adjustment factor selected by the Commission should be applied to determine depreciation in the case of any asset valuation.

¹⁹⁴ Frontier Economics – paper in response to the Commission's 2021 Process and Issues Paper, above n 167, at [61].

[250] A level of discretion is applied through cl 4.2.2(4) over whether to apply an adjustment factor. But that does not mean that a methodology is not provided.

[251] The purpose of input methodologies, given in s 52R, is to “promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part”. As the Court of Appeal said in *Commerce Commission v Vector Ltd*, that does not require the Commission to achieve “absolute certainty”.¹⁹⁵ And, as the Supreme Court said in those proceedings, the fixing of price-quality paths necessarily involves regulatory judgment and “not just the largely mechanical application of published methodologies”.¹⁹⁶

[252] We are satisfied that the 2022 Input Methodologies Decision provides the level of certainty that is needed to satisfy the terms of s 52R.

[253] Section 52T prescribes the matters that are to be covered by input methodologies. It requires, amongst other things, that the input methodologies include methodologies for determining the valuation of assets, including depreciation. The methodology does that. Under s 52T(2), the methodology must set out the matters listed in subs (1) in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on them.

[254] The methodology prescribed and the limited grounds on which an adjustment factor may be applied are such that, in our view, suppliers can reasonably estimate material effects of the methodology on them.

[255] For these reasons, no issues arise with the input methodologies proposed by the Commission in terms of ss 52R and 52T that would lead us to a view that MGUG’s proposals are materially better. In fact, we observe that MGUG’s proposed amendment to exclude sunk assets from acceleration (its second alternative claim for relief) includes higher levels of discretion and flexibility for the Commission. It would require, amongst other things, the Commission to be “satisfied” on a number of

¹⁹⁵ *Commerce Commission v Vector Ltd* [2012] NZCA 220, [2012] 2 NZLR 525 at [60].

¹⁹⁶ *Vector Ltd v Commerce Commission* [2012] NZSC 99, [2013] 2 NZLR 445 at [74].

matters, within which further judgement would be required on the Commission’s part about “likely” physical asset lives, its “best estimate” on economic asset lives, taking account of circumstances “the Commission reasonably considers relevant” and the perceived of the use of “reasonably informed consumers” about the benefits to them of particular new investments.

[256] Accordingly, we do not see MGUG’s approach under this head as being materially better either. This ground of appeal does not succeed.

Did the Commission err in law in making the 2022 Default Price-quality Path Decision?

[257] As discussed in [43]–[47] above, s 91(1B) provides a right of appeal to the High Court on a question of law against any determination of the Commission under the Act.

[258] The right of appeal under s 91 excludes input methodologies determinations and provides, in subs (1A), that:

An appeal against a section 52P determination may not include an appeal against all or part of an input methodology, whether on a point of law or on any other ground.

[259] Therefore, the appeal against the Commission’s default price-quality path decision must proceed on the basis that the methodology decision is valid and applies on its terms. The question, then, is limited to asking whether, in applying the input methodologies that were adjusted by the 2022 Input Methodologies Decision, the Commission erred in law.

[260] The Commission will have erred in law if:¹⁹⁷

- (a) it has failed to apply the right legal test or misconstrued or misunderstood the law; or

¹⁹⁷ *Edwards v Bairstow* [1956] AC 14 at 36; *Vodafone New Zealand Ltd v Telecom New Zealand Ltd* [2011] NZSC 138, [2012] 3 NZLR 153 at [50]; *Bryson v Three Foot Six Ltd*, above n 32, at [24]–[27].

- (b) it has made a decision that is so clearly untenable – in the sense that the available evidence just cannot support it – that the proper application of the law requires a different answer.

[261] The appellate court’s views on what the substantive outcome of a case should be are not relevant. The question under the second head is whether the decision under appeal was permissible.¹⁹⁸

[262] As mentioned previously, MGUG has not addressed the 2022 Default Price-quality Path Decision appeal in its submissions separately. It has assessed both of the Commission’s decisions together, referring to them collectively as “the 2022 determinations”. In that sense, it has applied the “materially better” appeal standard to both of them. However, while in places the Commission’s reasoning in its reasons for the 2022 Input Methodologies Decision cross-references reasoning in its reasons for the 2022 Default Price-quality Path Decision such that the latter can be drawn into an assessment of the former, the 2022 Default Price-quality Path Decision must, in setting and applying adjustment factors for each of the gas pipeline businesses, be considered separately.

[263] In the absence of submissions on the point from MGUG, we must turn to its notice of appeal. It is a long and discursive document but two errors of law are alleged. They are in the following terms:

- (a) The Commission’s decision to make the adjustments was premature and based on no (or no sufficient) evidence, and it was inconsistent with or misapplied or misconstrued the prevailing purpose of s 52A of the Act; and
- (b) The determinations overlay the principle of financial capital maintenance on the application of Part 4 input methodologies with the result that they do not promote outcomes consistent with outcomes produced in competitive markets, for the long-term benefit of gas

¹⁹⁸ *Piggott Brothers & Co Ltd v Jackson* [1990] ICR 85, [1991] IRLR 309 (CA) at 92.

consumers and in doing so the Commission erred in law by misinterpreting/misapplying s 52A of the Act.

[264] In our view, the Commission understood correctly the statutory criterion contained in the input methodologies and it proceeded to apply that understanding to the facts before it to reach the 2022 Default Price-quality Path Decision in which it set adjustment factors to be applied to asset lives for the regulatory period. In these circumstances, the conclusion that is reached – that is to say, the adjustments that are made – “is a matter for the Commission weighing up the relevant facts”.¹⁹⁹

[265] The Commission had significant evidence before it, was proceeding appropriately under s 52A and formed a view, weighted to take into account price implications on consumers, that was open to it to take. No error of law arises.

Outcome

[266] In the appeal against the Commission’s 2022 Input Methodologies Decision, assessed under s 52Z of the Act, we are not satisfied that any of the applicant’s alternatives to the input methodology amendments made by the Commission would be materially better in meeting the purpose of pt 4 of the act having regard to:

- (a) the terms of s 52A of the Act;
- (b) the timing of the 2022 Input Methodologies Decision;
- (c) the terms of ss 52R and 52T of the Act.

[267] Accordingly, the appeal against the 2022 Input Methodologies Decision is dismissed.

[268] In the appeal against the Commissions 2022 Default Price-quality Path Decision, assessed under s 91 of the Act, we have found that the Commission did not err in law.

¹⁹⁹ *Vodafone New Zealand Ltd v Telecom New Zealand Ltd*, above n 197, at [51]–[58].

[269] Accordingly, the appeal against the 2022 Default Price-quality Path Decision is dismissed.

[270] Costs were not addressed at the hearing. They should in the Court's view be determined on a 3C basis. In the event that costs cannot be resolved between the parties, the respondents may file memoranda within 15 working days of the date of this decision and the appellant may file a memorandum in reply within a further 15 working days. Cost memoranda, including schedules, should be limited to six pages in length.

For the Court

Radich J

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