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Ms. Keston Ruxton
Manager, Market Assessment and Dairy
Regulation Branch
Commerce Commission
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Dear Keston,

Please regard this letter as our cross-submission to the Commerce Commission ("the Commission") on the "Invitation to contribute to problem definition" for the Input Methodologies Review. In this letter we will use the terms "MDL", "we", "us" or "our" to refer to the Gas Transmission Business (GTB) of Maui Development Limited.

Our main recommendation to the Commission, after reviewing all the submissions, is to allow more separation between the topics and the timing of the IM review for each sector.

Other issues that became more apparent for us include the following.

- We support clarification of the impacts of indexation and inflation
- IRIS seems problematic for other entities too
- Form of control for GTBs should be reviewed
- Extra care may be needed with cost of debt review for GTBs
- CPP roll-over needs to be considered
- CPP scope should be reduced
- CPP applications should be simplified
- Complexity and compliance review should include information disclosure issues

We will expand on all of these below, and close with our views on next steps.

Allow more separation between topics and timing for each sector

One of the observations that stands out for us, after attending the forum on 29 and 30 July and reviewing all the submissions, is the wide range of views on the impact of emerging technologies. This topic is likely to generate a lot of discussion and is of obvious interest to a wide range of stakeholders. In the absence of any current consensus or accepted solutions we expect this topic by itself will absorb a lot of time and attention.

We must point out, however, that emerging technologies will probably have no impact on Part 4 regulation for airports, and little impact on Gas Pipeline Businesses. We expect changes in distributed power generation, battery storage and electric vehicle uptake would have very little impact on Gas Distribution Businesses. Those same changes may have some impact on Gas Transmission Businesses, but we expect this to be relatively marginal.

Gas consumption for power generation will be less than 20% of annual delivered quantities after the closing of the Otahuhu and Southdown power stations later this year. That consumption could decline further, and will almost certainly become “peakier”, as a result of emerging technologies. As a percentage of total gas transmission deliveries, however, the impact should be minor.

Moreover, the impact of trends in power generation can be easily dwarfed for us by trends in industrial use of gas. This already represents more than half of our deliveries. The opening of a new urea plant being considered by Ballance, for example, could lead to material increases in gas transmission deliveries.

As a result, we do not expect emerging technologies to be of material relevance for the next DPP determinations for airports and GPBs. It is expected to be of significant relevance for EDBS but it can be deferred to a later stage in the IM review. Our view is shared by the ENA, which stated:

“We also note the IM review does not need to proceed at the same pace for all sectors. For example, the Airports issues are, in many ways, stand-alone and have a well-developed problem definition. The review of these items could be concluded earlier than electricity-specific topics such as the impact of emerging technologies, where more time to assess the impact would be helpful.”

We also note PwC’s comment:

“The Commission’s reasoning for concluding the review one year early relates to gas and airport price setting processes and is not relevant to EDBs.”

We support those statements. We recommend that the Commission separate its planning into topics and issues relevant for each of the individual sectors. It should then schedule topics relevant for GPBs in time for their DPP resets. Of course, some topics will remain relevant across multiple (but not necessarily all) sectors; for example, those related to CPPs. In terms of having an efficient and effective IM review process, however, we consider it neither necessary nor advisable to cover all topics at the same time.

Other issues

We support clarification of the impacts of indexation and inflation

We note that the ENA raised questions about the relationships between WACC, indexation of the asset base, CPI forecasting and DPP price setting. PwC also asked the Commission to provide more detail about how forecast and actual inflation are accounted for in the various regulatory mechanisms. Those questions are of interest to us as well. We support a review and clarification of those issues as part of the overall IM review.

IRIS seems problematic for other entities too

In our submission we stated that the concept of a symmetrical IRIS is likely to remain problematic and inappropriate for GTBs. We were interested to note that several parties from other sectors also expressed concerns about the IRIS mechanism introduced for them.

- Powerco stated: “One area that we strongly believe is adding additional complexity to the framework is the [IRIS]. Outstanding elements of the mechanism still need to be resolved ... as the incentive has become complicated and its meaningfulness is now questionable”.
- Unison stated: “The Commission should consider whether there are improvements to be made to the IRIS mechanisms or whether ‘totex’ may be a more appropriate concept to apply in future”.

- “Orion is concerned about the complexity of the IRIS ... The IRIS may also produce undesirable incentives in certain circumstances ... We suggest it would be useful to assess the IRIS to see if a more straightforward method can be developed.”
- PwC stated: “We note the increasing complexity of the IRIS mechanisms, and are concerned that there may be unintended consequences which are detrimental to consumers and/or non-exempt EDBs in future due to the unpredictable nature of the incentive outcomes.”

In light of those comments we are strengthened in our view that an IRIS mechanism should not be adopted for GTBs. It seems to us that the IRIS remedy may be causing more problems than the maladies it was intended to address.

Form of control for GTBs should be reviewed

We are currently subject to a “hybrid” revenue cap, based on notional price quantities with a 2-year time lag. As we pointed out in our submission, this means we can enjoy windfall profits if throughput quantities are increasing and can suffer unintended shortfalls if they are declining. The impact on consumers is the exact opposite. As WELL noted when describing similar impacts from differences between forecast and actual volumes (under a WAPC) in its submission:

“Importantly, these are windfall gains and losses to consumers and suppliers and do not represent efficient outcomes”.

We note that the submission from Major Gas Users Group recognised issues related to this as well. And we noted the statement by ENA:

“It can be helpful to think of the various forms of control on a spectrum, with a WAPC at one end and a ‘pure’ revenue cap at the other end. The form of revenue cap that applies to gas transmission businesses in New Zealand is just one form of hybrid approach that is available. Other hybrids have been applied internationally. There are therefore a range of options available for setting the form of control ...”

The observation by WELL that the AER and Ofgem have recently moved to pure revenue caps for entities under their jurisdiction can also be relevant.

As a result, we are strengthened in our view that the form of control for GTBs needs to be reviewed. We consider that a “pure” revenue cap may be most appropriate for GTBs and note that Transpower has already moved to such a form of control.

A “pure” revenue cap may also be more suitable for us in order to accommodate auction-based revenue we could derive from introduction of a new AQ capacity product on the Maui Pipeline; as well as accompanying price restructuring.

With respect to the linkage between price restructuring and the form of control we note the following submissions.

- Unison: “... recommends that the Commission evaluate the pros and cons of different forms of control to determine an optimal approach to enabling tariff restructuring”.
- WELL stated: “Under a revenue cap, suppliers are revenue neutral with respect to tariff structures ...”.
- Orion stated: “A revenue cap makes it easier for EDBs to restructure prices without either significantly under-recovering revenues or breaching a price path”.

In the last two references above, we expect that WELL and Orion were referring to a “pure” revenue cap. Our current “hybrid” revenue cap, relying on price quantities with a lag of two years, still imposes risks and restrictions on price restructuring.

Extra care may be needed with cost of debt review for GTBs

We refrained from making comments on the WACC in our submission. We note that most other submitters also seem to have little appetite to revisit this topic, with the exception of reviewing the cost of debt. Notable points for us from other submitters include the following.

- Transpower: "... we consider that the Commission should prioritise consideration of [] a trailing average cost of debt methodology ..."
- Orion: "The term credit spread differential allowance (TCSDA) has some theoretical merit although its financial impact has been minimal. The need for a TCSDA may reduce if adjustments are made to the cost of debt."
- ENA: "There is an argument that the cost of debt for the industry should reflect a longer term, to better reflect the average issuance term for the industry ... If a longer debt term was adopted for the industry-wide cost of debt, the TCSD allowance may no longer be necessary."
- NZIER: "The discussion of the problem ... seems to mix the question of what the Commission uses as an estimate of a fair cost of capital over the regulatory period with how suppliers actually manage their debt funding for a funding period that is likely to be considerably longer than the regulatory period. A starting point for the analysis would be a comparison of the WACC estimated by the Commission with the actual funding costs and maturity structure of supplier funding ..."

We are inclined to support those points. In particular, the assumption that the duration of debt for GTBs would be equal to the length of regulatory periods is unrealistic. The attempt to fix this in the current IMs by the addition of a Term Credit Spread Differential (TCSD) could be considered as a poor compromise. Moreover, the potential TCSD allowance does not work for MDL, for reasons we explain below.

An analysis of actual debt structures of the two GTBs in New Zealand would be faced with the following problems.

- Vector is a relatively large, diversified public company. As such, it has a credit rating and issues long-term bonds on international debt markets in multiple currencies. We would not know how to determine an NZD equivalent for that which would be applicable to the relatively small part of Vector's business portfolio represented by its GTB.
- In our case, due to our joint venture structure, we do not have any debt. Our funding is provided by monthly cash calls to our shareholders. We do not know how our shareholders structure their funding. We would be only a tiny part of their business portfolios, and each of them would have different funding structures.

Overall, we agree with other submitters that the current cost of debt assumptions in the IMs are problematic. However, an evidence-based analysis to come up with more realistic assumptions for GTBs will not be easy.

CPP roll-over needs to be considered

We included questions around the renewal, reset or roll-over of a CPP in our submission. We note that similar questions were raised by PwC and ENA.

- PwC stated: "We recommend the IMs include the process and timings for determining whether a supplier transitioning from a CPP remains on the CPP price path or a new price path is set, and how the new price path will be determined, if that is the Commission's decision."

- ENA stated: "There is currently a material uncertainty regarding what happens at the end of the CPP, which could be an unnecessary disincentive to apply for a CPP."

We agree with PwC that it would be useful to find an approach for being able to remain on a CPP. If, for example, a supplier applies for a CPP in order to deal with an assumption in a DPP determination that is unrealistic for its particular circumstances, then it is possible that it would be faced with the same assumption in the DPP for a next regulatory period. Instead of needing to go through a new CPP application from scratch, it would be useful and more efficient for all stakeholders to facilitate a roll-over of a CPP.

We agree with ENA that it is unlikely that all such issues can be resolved as part of the CPP fast-track process. We support their suggestion that the "full review of the CPP IMs could include a working group review stage". We would be willing to participate in such a working group.

CPP scope should be reduced

This issue was also a part of our submission. It was well supported by the submissions from the ENA, PwC and WELL. We particularly appreciated ENA's statement that:

"We support a smaller form of CPP to address one or a few particular items within a DPP that are unsuitable for a supplier. Whether the mechanism to address this would be called a mini-CPP or DPP reopener seems mainly a matter of semantics."

CPP applications should be simplified

As we stated in our own submission, this issue has already been widely acknowledged. We support the following related statements from other submitters.

- ENA: "We suggest the objective of the clauses that set out what a CPP application must contain should be to 'ensure information is relevant to the applicant and stakeholders, including the Commission'. We consider the level of prescription can be significantly reduced."
- PwC: "In order to make the CPP a more viable option we suggest that the CPP IM should be less prescriptive. The IM should allow an applicant to present their case for an alternative price path and quality standards using information which is directly relevant to their application, and is based on information retained by the EDB which supports the EDB's own planning and operating practices."

We note that section 5 of WELL's submission also contains a range of useful observations and recommendations. In relation to the specific issue of Input Methodology variations as part of a CPP application we support the statement from Powerco:

"The opportunity for the Commission and the potential CPP applicant to have the flexibility to discuss and agree the IMs that apply is an important and value adding exercise. As such, we consider that this discussion and agreement should form part of a formal 'pre-submission' process."

Complexity and compliance review should include information disclosure issues

We saw broad support for reducing the complexity of the IMs and making compliance easier. Notable points for us included the following.

- Transpower stated: "We consider that a useful addition to the review process would be for the Commission to establish a working group consisting of regulated suppliers (including Transpower), other interested parties, auditors and Commission staff tasked with identifying unnecessary and undesirable complexity and compliance costs, and developing a set of recommendations for addressing these issues." We too would be happy to participate in such a group.
- We also support the proposal that: "... compliance would be made easier by simply amending the IMs so all definitions are in a single place in a single document ..."
- PwC stated: "errors within the IMs and other Part 4 determinations cause confusion and compliance costs. When errors are identified they should be corrected as soon as possible and updated versions of the IMs should be provided".
- Powerco "... consider it is essential that provision be made during the IM review process, and through the decision making framework, for drafting errors, ambiguity and business as usual improvements to be addressed."
- Alpine Energy: "We appreciate that the commission has finite resource and time and that the temptation is to concentrate on the 'big issues' and put these simple fixes to one side. We urge the commission not to give into this temptation as the simple fixes are also important."

We support those points and would like to add that we consider that simple error corrections should not be subject to materiality constraints.

We also support the observation by PwC that it may be necessary to consider linkages between IM changes and Information Disclosure issues. While it might be preferable to conduct a review of the Information Disclosure requirements separately, the extent to which those are prescribed or constrained by the IMs needs to be taken into account as part of the current review.

Next steps

Orion, Powerco, PwC and Transpower all commented on the potentially big jump between going from a problem review stage to a draft decision stage in one go. We agree that one or more interim steps to explore and develop options and potential solutions would be useful. We are not clear to what extent that was already intended by the conceptual steps set out in the Commission's discussion draft (of 22 July 2015) for a decision-making framework.

Following up on our main recommendation to allow more separation between topics and timing we suggest the Commission plan its next steps with more granularity. In particular, the timings need not be the same for every sector.

Conclusion

We have appreciated the opportunity to provide this cross-submission. For any additional questions or clarifications please do not hesitate to contact us.

Yours sincerely,



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for Maui Development Limited