MDL Commerce Commission Submission: Default Price-Quality Path Starting Price Adjustments For Gas Pipeline Businesses

September 2010

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1. BACKGROUND

1.1 Maui Development Limited (**MDL**) welcomes the opportunity to make a submission on the "Starting Price Adjustments for Default Price-Quality Paths, Discussion Paper, 5 August 2010 (**Starting Price Paper**)[1].

1.2 The default price-quality path (**DPP**) is a regulatory instrument provided for under Part 4 of the Commerce Act 1986 **(the Act**).

1.3 MDL notes that the Commerce Commission (**Commission**) is looking to implement a standardised DPP for Gas Transmission Businesses (**GTB's**) although an optional Customised Price Path (**CPP**) will be available should MDL have special circumstances that it wishes the Commission to take into account. MDL notes that the Commission is looking to discourage a high number of CPP proposals. MDL in turn has a strong preference for a DPP, which it considers is a less costly and less laborious form of control.

1.4 In the situation that a DPP applies to a supplier of regulated goods and services (**supplier**), the Commission is required to make a determination under section 52P of the Act, which (amongst other things) requires that the Commission set starting prices. MDL's current views on the Commission's Discussion Paper are set out below.

1.5 Please note that MDL's position may change as a result of further information being provided by the Commission.

1.6 The structure of this Submission is as follows:

[1] Commerce Commission, *Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*, 5th August 2010

2. STARTING PRICE FRAMEWORK

2.1 Under section 52P of the Act, starting prices for each supplier will be based on either: (i) the prices that applied at the end of the previous regulatory period, or (ii) those based on an assessment of the current and projected profitability of that supplier[2].

2.2 Given that MDL has not been previously regulated under the Act, it is considered that starting price will be assessed on the basis of (ii) an assessment of MDL's current and projected profitability.

2.3 MDL notes that a two step approach to starting price adjustment framework is under consideration[3]. The two step approach consists firstly of comparing a supplier's Return on Investment (**ROI**) against an ROI band around an industry wide WACC point estimate and secondly undertaking a qualitative assessment which takes into account qualitative factors which are expected to impact on a supplier's projected profitability.

2.4 MDL agrees with the Commission in its current views that inclusion of qualitative analysis in setting starting prices would require considerable levels of judgement. This is particularly true for GTBs where viable qualitative measures have not been provided to date and are still under consideration by the Commission.

2.5 In fact MDL is uncertain as to whether robust qualitative measures can be standardised across the gas transmission industry. Although the industry contains only two businesses, they vary considerably in structure. Reliability is seen as an important qualitative measure and a relevant measurement for reliability would likely be different under the two pipelines. As noted in previous submissions, MDL has a predominantly common carriage regime while Vector's regime is closer to a contract carriage regime. In MDL's view the carriage regime adopted will have a considerable impact on reliability measurement. (For instance a common carriage regime does not generally guarantee that a given pipeline capacity will always be available to a given user while a contract carriage regime starts from the premise that a given amount of capacity is being purchased). MDL will be happy to discuss reliability measures specific to gas transmission with the Commission, should the Commission feel it is appropriate.

[2] Page iv, Para X.2, Commerce Commission, *Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*, 5th August 2010

[3] Page 11, Para 3.2, Commerce Commission, *Starting Price Adjustments for Default Price-Quality Paths Discussion Paper*, 5th August 2010

3. COMPONENTS OF THE FRAMEWORK

3.1 The Commission has proposed the following steps to undertake starting price adjustments:

- Calculate supplier returns through a return on investment (ROI) measure;
- Compare supplier returns against an ROI band;
- If ROI is above or below the ROI band, adjust starting prices

3.2 The Commission's proposed ROI calculation is provided as follows[4]:

ROI = (revenue – depreciation – operating expenditure – regulatory tax allowance + revaluation) / regulatory investment value

3.3 **ROI:** MDL is broadly satisfied with the ROI calculation. The calculation is consistent with MDL's current tariff setting procedures which calculates a required return which is adjusted for revaluation, tax allowance and depreciation.

3.4 Tariff calculation principles are principally set out in Schedule 10 of the Maui Pipeline Operating Code (**MPOC**). MPOC sets out the following requirements in terms of MDL's tariff calculation:

- Provides for a Revenue cap;
- Provides for Operating Expenses to be recovered through a separate tariff (**tariff 2**);
- Where MDL's total revenues are more or less than its required revenues as determined within the tariff calculation, then tariffs may be adjusted in the following years (to achieve required return over time) in a manner that endeavors to reduce pricing volatility for MDL's customers (**Shippers**). This is effectively both a wash up facility and smoothing adjustment.

3.5 It should be noted that the wash up and smoothing adjustment was required by MDL's customers at the time the open access regime on the Maui Pipeline was negotiated. At that time, customers were adamant in requiring a wash up facility to prevent the possibility of over recovering from customers through consistently under estimating demand which would cause upward pressure on tariffs. MDL customers were clearly more willing to accept volatile prices rather than a possibility of over recovery.

3.6 As smoothing and wash up adjustments effectively adjust for under recovery or over recovery in the previous year, MDL requests that these adjustments be recognized in the year previous to the year adjustments are made. This will ensure that MDL is not disadvantaged by the Commission's calculation. For example, under current processes, if MDL under recovered in a year, it would increase tariffs the following year to balance its previous under recovery. If this adjustment where to be recognised in the following year rather than the year under recovery occurred, this might make recovery in the following year appear excessive. This adjustment was a correction to ensure the required return is received over time.

3.7 **Revenue cap:** MDL continues to request a revenue cap for its tariff calculations going forward. As stated in earlier submissions, demand for MDL's transmission service is extremely volatile and MDL has little influence over this volatile demand. A revenue cap

[4] Section 4.3, Formula 1, Page 19, Starting Price Paper

with wash up will allow MDL to continue to earn its regulated return and protect its customers from MDL over recovering over time. While it is acknowledged that the cost of this cap is some volatility in prices, this price volatility is based on MDL customers' preferred approach to tariff setting.

3.8 **Cost of Capital:** ROI bands for the gas transmission industry are to be applied to the Maui Pipeline business in determining current and future profitability. Given that these bands are principally driven by the industry WACC, cost of capital is seen as an important concept in starting price adjustments and is thus addressed in this submission.

3.9 MDL currently calculates of cost of capital, utilising the building blocks principles that are being applied to other New Zealand utilities under section 54 of the Commerce Act 1986. In its calculation of cost of capital for the most recent tariff year, 1 July 2010 to 30 June 2011, MDL followed the Commission's Revised Draft Guidelines[5] and input values into the WACC formula were recommended by KPMG. MDL recently contracted KPMG to prepare an independent report on the cost of capital for GTBs. This has now been uploaded on to the Commission's website[6].

3.10 A key component of the WACC is asset beta. MDL notes that the draft asset beta for the gas transmission industry has been set at 0.44, which is no different to the asset beta for gas distribution businesses (**GDBs**). MDL observes that the Commission is possibly offering a revenue cap in lieu of a price cap in order to compensate GTBs from the additional income volatility that they face as compared to GDBs. As such, the Commission has not provided GTBs with an asset beta premium over the less volatile GDBs. MDL would point out that while the revenue cap does reduce GTB income volatility, it does not succeed in reducing the asymmetrical portion of that risk. As such, while MDL appreciates the Commission's consideration of a revenue cap, it also requests the Commission provide a risk premium over GDB's. This could either be in the form of asset beta premium or alpha adjustment.

3.11 **ROI Bands**: MDL is broadly satisfied with the concept of ROI bands which in effect provides for acceptable deviations from an industry WACC. However, no explanation has been given as to how the size of the bands was set. An explanation or calculation will in MDL's view, promote regulatory certainty. Whereas the Commission is looking into ROI bands of +-1% and +-1.25%, MDL suggests +-1.5%. MDL notes that there may be significant capital expenditure requirements in the gas transmission industry over the next few years and it will become apparent over a relatively short timeframe whether investment is appropriately incentivised. Increasing the size of the band is likely to improve the chance of new investment occurring when it is required.

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[5] Commerce Commission, the Commission's Revised Draft Guidelines – 'The Commerce Commission's Approach to Estimating the Cost of Capital', 19 June 2009

[6] http://www.comcom.govt.nz/assets/Pan-Industry/Input-Methodologies/Costcapital-Sub/KPMGs-Submission-on-EDB-Input-Methodologies-Draft-Determination-and-Reasons-Paper-13-August-2010.pdf

3.12 **Vanilla WACC for determining ROI Band:** MDL supports the Commission's use of the Vanilla WACC for determining the ROI band.

3.13 **Point estimate for ROI Band:** It has been noted by some submitters in previous submissions that if the 75% percentile is utilised to set WACC, that this would effectively suggest that on 25% of occasions, the calculated rate would be below that expected in "workably competitive markets". Given that WACC is fundamental in setting the ROI band, this point needs to be reiterated. MDL suggests utilising the 95th percentile for both the cost of capital calculation and in setting the ROI band for gas transmission.

4. VARIOUS CONSIDERATIONS

4.1 **Timeframes:** MDL's tariff year is 1 July to 30 June, while Vector transmission's tariff year is 1 October to 30 September. The Commission previously requested MDL's views as to whether MDL would be prepared to change its tariff year, and annual assessment period, to reflect that of Vector's, to allow alignment of the gas transmission industry in terms of assessment timing. MDL stated that it preferred to maintain its current tariff timeframe (and assessment period) but was able to adjust its timing to coincide with Vector's if this was required.

4.2 Given a change in assessment timeframe will require significant manual manipulation of data, MDL requests that the Commission communicate a decision to MDL as soon as possible. This would provide MDL with increased regulatory certainty and would allow MDL to account for any additional cost in its upcoming budget for 2011.

4.3 **Information Required:** Most submissions to the Reset DPP Discussion Paper supported the use of several years of historical data in calculating returns. However it is considered that the value of doing this is limited if the Commission seeks only to "estimate the current and future profitability of each supplier"[7]. MDL notes that it has limited access to data further back than 2007.

4.4 It is also important to note that forecasting accuracy is limited for GTBs , and especially so for the Maui Pipeline. It is very difficult to forecast gas demand more than one or two years out with any degree of certainty.

4.5 MDL supports the Commission's view that data for starting price adjustments should not require verification. This approach is likely to promote the Act's Section 53K purpose of minimizing compliance costs.

4.6 **One-Off Events:** MDL agrees with the Commission's view to consider one off events[8] in setting the starting price. The Commission suggests mergers and changes in accounting practices are examples of one off events that might justify special consideration. MDL recommends a wide range of potential events to be considered so not to limit the

[7] Section 4.3, Formula 1, Page 19, Starting Price Paper

[8] Section 4.5, Page 20, Starting Price Paper

Commission's ability to adequately address special circumstances. The definition of catastrophic events as is defined under the Draft Determinations[9] may be useful as a definition. MDL considers that special considerations should be provided for DPPs rather than requiring a full building blocks CPP proposal to address any unique of unforeseen circumstance.

4.7 **Pass through Costs:** Pass through costs and recoverable costs are appropriately not included within the Commission's ROI calculation. The starting price calculation is an assessment as to the extent suppliers have recovered their regulated return. Operating expenses are a separate consideration unless they are deemed unrecoverable costs.

4.8 **CPI-X:** The Commission's approach to DPP regulation is based on a 'CPI minus X' (**CPI-X**) structure. The use of a CPI-X price path provides suppliers with the opportunity to earn greater than normal returns as a reward for improved efficiency. Under traditional CPI-X regulation, suppliers are able to realise their efficiencies as savings for the time the saving is made up until the end of the existing regulatory period. As such, a saving would be realised for between one and five years. However under the Incremental Rolling Incentive Scheme (**IRIS**) that is available under a CPP structure the supplier realises efficiency gains for a five year period. This entails an inherent advantage of the CPP structure over the DPP structure. MDL is of the view that a CPP incentive scheme should not be advantageous of the comparable DPP scheme.

4.9 MDL requests that X factor be set to 0 for the term of regulatory period as was provided to Electricity Distribution Businesses (**EDBs**).

4.10 **Section 53P(4) probation to recover previously realised excessive profits:** The Commission is required to set starting prices on the basis of the current and projected profitability of each supplier[10]. Furthermore, according to section 53P(4), the Commission "must not seek to recover any excessive profits made during any earlier period". Despite this apparent inability to adjust for what is considered to be over recovery in previous periods, provisions within the Act provide for a wide variety of circumstances that justify a claw back. MDL requests that the Commission specify specifically how claw backs will be applied under price setting for a DPP.

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[9] Commerce Commission, DRAFT Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010

[10] Section 4.3, Formula 1, Page 19, Starting Price Paper

5. CONCLUSION

5.1 A fundamental component of a DPP is the procedure in which starting prices are specified for suppliers.

5.2 Robust qualitative measures should be set for the gas transmission industry before it is considered appropriate to utilise qualitative analysis in calculating starting price adjustments.

5.3 MDL agrees that assessment of current and projected profitability is the appropriate framework for calculating starting price adjustments.

5.4 MDL is broadly satisfied with proposed ROI calculation. However, wash up and smoothing adjustments, which are a contractual obligation of MDL, should be given consideration.

5.5 MDL continues to support a revenue cap for GTBs.

5.6 In respect of WACC, MDL is of the view that it is too low and does not compensate GTBs adequately for asymmetrical risk.

5.7 Method for calculating ROI bands of +-1% or +-1.25% are requested.

5.8 MDL supports special consideration of one off events.

5.9 Further information as to how claw backs might be applied under a DPP is requested.

Yours sincerely,

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