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Matthew Lewer
Regulation Branch
Commerce Commission
PO Box 2351
Wellington

CC: commercial.operator@mauipipeline.co.nz

Dear Mr. Lewer,

Maui Development Limited (MDL) thanks the Commerce Commission (Commission) for the opportunity to provide a cross-submission for the Discussion Paper on Starting Price Adjustments for Default Price-quality Paths.

We have reviewed all the original submissions on this paper. We are heartened by the high level of many of those responses. Given the large quantity and high quality of responses we will not use this letter to set out everything we agree with. In general, we do agree with much that has been submitted. For example, we agree with several submitters, among which Vector was most eloquent, that the starting price adjustments should be an input methodology. In this cross-submission we will only highlight the issues that we believe are of particular significance. These are set out below.

## The WACC should be set to actually encourage new investment

We agree that the CAPM has many shortcomings as a tool for estimating the cost of equity, as indicated by e-dec and by Orion. We realise that CAPM is used for simplicity, in the absence of anything better. However, this does not make CAPM a good approach or negate any of its errors and "heroic assumptions" (as mentioned by Powerco). We also refer to our own prior submissions and those of KPMG. As a result we believe that its use will incline the Commission to underestimate the actual cost of equity and the actual WACC for New Zealand gas industry firms.

We realise the Commission is partly trying to compensate for this by proposing ROI bands around the 75th percentile WACC estimate. As was pointed out by several parties, this still implies a 25% probability that returns at this level would actually represent an economic loss. The problem becomes worse if the WACC estimate is biased or skewed too low, as is also believed by many parties. Therefore, we are glad to see support for our submission that the WACC estimate should be set at a higher percentile.

Most important, however, even if the Commission's estimate for the WACC were perfect it would still do nothing to incentivise new investment unless the Commission allowed an economic profit too. The most explicit example of this is WEL Networks' statement: "Our board has set a target for some years of WACC plus 1.5% as the appropriate setting for investing". Our owners too, regulatory wishes notwithstanding, are extremely unlikely to approve any new investment with an NPV of zero.

As a result, if the Commission wants to promote new investment over and above required maintenance and replacement, it will need to allow a return on such investment that exceeds the actual WACC. We realise this is problematic in light of the Commission's desire to target zero NPV for the industry's investments. In order to find solutions to this conundrum we suggest the exploration of further options. For example, the Commission may allow for a higher return on new investments in comparison to the targeted return on existing investments.

In any case we share the concern, expressed by many parties, that the Commission's currently proposed approach will fail to provide "incentives to innovate and to invest".

**ROI Bands should be designed to avoid negative return on investment**

This issue is related to the previous one, but with two sides to it. On the downside we agree with many submitters that the Commission should allow firms to at least cover their cost of capital. We agree in particular with the submission by PricewaterhouseCoopers on this matter. This means the lower bound of the ROI band should indeed not be lower than the Commission's WACC estimate, and arguably should be even higher.

On the upside the issue is tangled with our comments above. Many submitters have provided many good reasons why the ROI band should not be too narrow. Included among those reasons is the need to have an upside that, after taking account of uncertainty and variability, will actually provide an incentive for new investment and innovation.

In light of those compelling reasons we see no justification for having symmetrical ROI bands. The risks are not symmetrical, so the returns do not need to be symmetrical either.

Finally, we need to comment on Vector's suggestion to set a separate ROI band for each industry participant. We do not have an opinion in this regard for Gas Distribution Businesses. However, our submission did include the observation that Gas Transmission Businesses are more volatile than GDBs. We proposed to reflect this in the form of an asset beta premium or alpha adjustment to the WACC, but we agree it could also be reflected in an uplift to the ROI band for GTBs. We also submitted that our business, with a common carriage regime, is different from Vector's GTB with a contract carriage regime. We agree with Vector that using the average from our two GTBs "may produce an outcome of no statistical validity and limited applicability to either company". Therefore, subject to all the points we have made previously, we are willing to support Vector's suggestion.

## Major capital investments should not require a CPP

We particularly endorse Vector's submission in this regard. We too anticipate a need for expansion investment within the next five years, while noting that current demand for such expansion is uncertain. Even though GTB investments are lumpy by nature, i.e. large and infrequent, they are not abnormal or unusual and should be able to be accommodated within a DPP framework.

We note that several Electricity Distribution Businesses have made similar observations in their submissions. Capital expenditure in excess of regulatory depreciation is apparently a normal feature in that industry too. Therefore, we expect the Commission will find a way for dealing with that within a DPP.

## Conclusion

If required, we will be happy to discuss these points in more detail with the Commission.

Yours sincerely,

Don Gray.

General Manager, Commercial Operator Maui Pipeline

**for Maui Development Limited**