MDL Commerce Commission Submission: Input Methodology (Gas Pipeline Services) Draft Reasons Paper, Companion Paper, and Draft Commerce Act Determination 2010

August 2010

9 August 2010

1. BACKGROUND

1.1 Maui Development Limited (**MDL**) welcomes the opportunity to make a submission on the "Input Methodologies Gas Pipeline Services, Draft Reasons Paper 2 July 2010 (**IM Paper**); the Input Methodologies for Electricity Distribution Businesses (**EDBs**) and Gas Pipelines Businesses (**GPBs**), Companion paper (Draft Determinations and Customised Price Quality Path Requirements) 2 July 2010 (**Companion Paper**); and the Draft Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010 (**Draft Determination**).

1.2 MDL notes that the Commerce Commission (**Commission**) is looking to implement a standardised Default Price Path (**DPP**) for Gas Transmission Businesses (**GTB's**) with an optional Customised Price Path (**CPP**) available; should MDL have special circumstances that have to be taken 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, less laborious, form of control. Due to MDL's preference for a DPP, MDL is hopeful that the CPP structure would not be overly advantageous with respect to the DPP structure. If material advantages do exist, MDL would have little choice but to submit a costly and time consuming CPP.

1.3 This submission covers all August 2010 submissions for transmission pipelines with two exceptions. The first exception relates to the Cost of Capital (**WACC**) which will be addressed separately. Second, MDL reserves the right to provide a "Marked up Copy of Draft Determinations" bearing in mind that this submission is due on 25 August 2010.

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

1.5 The structure of this Submission is as follows:

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2. INITIAL VIEWS

2.1 MDL notes that the Commission is required to promote the long term benefit of consumers through ensuring that suppliers of regulated goods or services "have incentives to innovate and to invest, including in replacement, upgraded, and new services"[1]. For gas transmission pipelines capacity upgrades are capital intensive and lumpy in nature, with an uncertain timing of requirement. Despite the difficulties surrounding capacity planning, it is seen as important that capacity increases in line with increasing demand, and also with increasing supply from new oil and gas discoveries. Capacity increases may be necessary to enable gas from new oil and gas discoveries to reach the market.

2.2 While the Draft New Zealand Energy Strategy 2010 provides for a renewable electricity generation target of 90% by 2025, the last few years have shown that renewable generation from wind requires significant gas generation capacity to ensure security of supply. Thus renewable generation is not anticipated to "phase out" thermal generation rather it increases the demand for quick start-up "firming" capacity that will be available when other sources fail. This impacts on gas transmission pipelines by increasing the requirement for delivery of capacity without necessarily increasing the total amount of gas conveyed each year. MDL notes that some electricity generation companies are looking to build new thermal facilities over the next few years. These companies are following the Commission's progress closely in terms of how regulation impacts MDL's incentives to invest. New thermal facilities for electricity supply firming will almost certainly lead to a requirement for additional capacity on the Maui Pipeline.

2.3 Increased capacity on gas transmission pipelines is realised through; new compressors, meters, possibly new pipelines, and accompanying systems (such as daily allocations and nominations regimes). The timing of these is not always accurately known and depends on other parties' investment decisions.

2.4 MDL views "investment incentives" as a paramount objective in terms of a regulatory platform which stimulates economic growth. It remains concerned that constraining cost recovery, through capping operating OPEX and CAPEX over the term of the initial regulatory period, may adversely impact MDL's ability to earn an adequate return on investment. The concern is particularly acute where timing of costs is unpredictable and where costs are not directly under MDL's control.

2.5 Regulatory costs are a good example of unpredictable costs. It is difficult to assess regulatory costs particularly where costs heavily depend on the extent to which industry participants agree on required changes.

2.6 Overall it appears that the Commission has been prepared to compromise in terms of adjusting its policies to meet the specific circumstances of the (to be) regulated suppliers. MDL is encouraged by the Commission's separate treatment of GTBs, and its draft decision

[1] Section 52A(1)(a) Commerce Act 1986

to allow a revenue cap. It is also encouraged by the inclusion of the "contingent project" facility, although it requests that this be available under both DPP and CPP forms of control.

2.7 MDL has commissioned KPMG to review the WACC calculation, and KPMG has in turn sought advice from various independent experts. KPMG's submission on Cost of Capital will be provided separately.

3. PRICING METHODOLOGY

3.1 **Wash Up:** Currently, MDL employs a pricing methodology which is based on Schedule 10 of the Maui Pipeline Operating Code (**MPOC**). MPOC requires that MDL adhere to a revenue cap which is based on earning a required return on a Regulated Asset Base (**RAB**). The final paragraph of MPOC Schedule 10 effectively provides for a wash up mechanism whereby, if the Maui Pipeline makes more or less than its required revenue in a tariff year then this will be balanced through a "wash-up" adjustment in the following tariff year.

3.2 In MDL's view, the Commission does little to address the wash up concept in its IM paper[2]. It is therefore uncertain whether the Commission is supportive of a wash up under a revenue cap. MDL considers that under a revenue cap, a wash up might reasonably be implied. A wash up mechanism is appropriate under a revenue cap as it allows a supplier to earn its Maximum Allowable Revenue (no more, no less). If there were no wash up, there would be a clear incentive on a supplier to habitually underestimate demand to avoid under recovering. With a wash up, any inaccuracy in estimation would simply be reversed out in the following tariff year. Under a revenue cap, prices are estimated to fluctuate regardless of whether the wash up is in effect and thus a wash up is not considered to have a detrimental impact on the status quo under a revenue cap.

3.3 **Revenue Cap under DPP:** In terms of from of control, MDL notes that the Commission has indicated that GTBs will have some flexibility as to a revenue or price cap under a DPP (subject to the Commission's final determination)[3]. As stated in the "Initial Views" section of this report, MDL prefers the less costly DPP but it also has a strong preference for a revenue cap. MDL notes that the Draft Determinations and IM Paper do not provide any update in terms of the Commission's initial views in terms of pricing methodology under a DPP and continues to monitor progress in this area.

3.4 **Pass through Costs:** MDL notes that under the Commission's draft decision, pass through costs mainly relate to local authority rates and levies, including GIC levies[4]. MDL notes that the Commission continues to monitor pipeline balancing arrangements, and still considers that balancing related costs or at least the portion of them that is not assigned to pipeline users should be included within the Commission's definition of pass through costs.

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[2] Clause 6.9.104, page 300, With the exception of a IM

[3] Section 4.27, page 19, Initial Default Price-Quality Path for GPBs

[4] sections 8.4.4, page 340, IM Paper

3.5 Participation in the GIC's pipeline balancing work stream, over the previous two years, has been at a significant cost to MDL. There is a concern that future budgetary constraints on GTBs can effectively prevent suppliers from assisting the GIC on important work streams. MDL is concerned that if it is constrained in its budget to address GIC propositions, that it will not have the ability to address matters concerning its own pipeline. Aside from the balancing work stream, the relatively young work stream of "pipeline capacity" is anticipated to be larger and require more resources that that of balancing.

3.6 The GIC's work is funded from levies and under the definitions put forward by the Commission these can be passed through to the Maui Pipeline's customers. MDL suggests that parts of MDL's regulatory budget required to engage with the GIC also be considered as a pass through cost. MDL has limited control over this cost.

3.7 **Recoverable Costs:** MDL supports the Commission's inclusion of "recoverable costs" which provides for costs that do not meet the Pass-Through-Cost-Criteria but where practical regulatory design precludes these costs from being treated in the same way as costs explicitly provided for in the price-quality path in advance[5]. MDL supports the inclusion of CPP proposal costs, verification costs and external audits costs as recoverable.

3.8 MDL notes that rules and processes provided in the IM paper only address CPP proposals and information disclosure requirements. Given that MDL prefers a DPP in place of a CPP, its overall view on the Commission's draft decisions is highly dependent on whether the DPP structure will contain inherent flexibilities.

3.9 **CPI –X:** In terms of the CPI-X model under a DPP, there has been no indication (as yet) as to the value that the Commission will assign to the X factor in the CPI-X model. However, MDL is encouraged by the DPP for EDB's where X is assigned a value of zero for the period between 2010 and 2015[6]. MDL supports an X value of 0 for GTB's. As stated in earlier submissions, MDL does not expect there to be any noteworthy scope for reducing costs and in fact would point out that some costs which make up a substantial part of its operational budget, such as pipeline maintenance, can actually increase as a pipeline asset ages.

3.10 **Quality Standards:** MDL notes that section 53M (1) (b) of the Commerce Act requires that each price-quality path must specify quality standards. MDL previously submitted on some of the problems associated with GDB related quality standards, such as SAIDI and SAIFI, and commented on limits to their successful application for GTBs. In terms of quality standards, MDL continues to support the Commission's initial view that it is "appropriate for the Initial DPP to consist of separately specified and assessed price path and quality standards[7].

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[5] sections 8.4.21 (b), page 344, IM Paper

[6] http://www.comcom.govt.nz/20102015defaultpricepath/, "be subject to an X-factor of 0% per annum"

[7] para 5, Page 12, Commerce Commission, Initial Default Price-Quality Path for Gas Pipeline Businesses, Issues paper, 12 April 2010

3.11 MDL is of the view that implementation of a set of effective quality standards for New Zealand's GTB's will be difficult to implement, particularly in terms of measuring reliability across the industry. As previously submitted, MDL currently discloses certain "reliability standards" which are effectively based on activities which are beyond MDL's control. For example, most interruptions on the Maui Pipeline are caused by producer outages. Interruptions not due to producers outages are generally caused by non compliant over taking or under taking at MDL's Welded Points. In some cases, a situation can be contained through provision of balancing gas, however, sufficient quantities of balancing gas are not always available.

3.12 The process of measuring reliability on the Maui Pipeline will not be an easy task; thebuilding of a standardised reliability model which effectively assesses both Maui and Vector transmission pipelines will be an even greater challenge. In terms of reliability on the Maui Pipeline, it may be appropriate to measure "capacity curtailment"[8] to assess reliability of the service. However, in terms of Vector's transmission pipelines, given that it sells reserved capacity, it is very difficult to determine whether a physical constraint actually exists or not.

3.13 If a robust model for effectively measuring service quality cannot be developed, MDL would request that the Commission adopt a conservative approach to control, particularly where introduction of a price or revenue constraint may be assessed to have a detrimental impact on the quality of MDL's service. MDL continues to monitor the Commission's progress in terms of developing appropriate quality standards for GTBs, particularly in terms of a measurement for reliability.

4. RULES AND PROCESSES

4.1 **IRIS:** The Commission has indicated that it will operate an Incremental Rolling Incentive Scheme (**IRIS**) under a CPP. The IRIS effectively allows suppliers to keep their efficiency gains for a five year period from the year that an efficiency gain was made. Thus under an IRIS, efficiency gains can be kept by suppliers even after the end of the five year initial regulatory period. The motivation for including this facility is to encourage suppliers to make efficiency gains (where possible), even when the regulatory term is almost at an end.

4.2 Considering that an IRIS applies only to controllable costs, and that the concept of "controllable" is often one of degree, MDL requests that the Commission provide further details as to which of GTBs costs might be considered controllable.

4.3 MDL supports the IRIS concept, however notes that this facility is only available under a CPP. Under a DPP, suppliers will be governed by a CPI-X system which facilitates savings being kept by suppliers for the regulatory period only. Given that there appear to be clear advantages of an IRIS over a CPI-X scheme, the lack of provision for an IRIS under a DPP may be a strong incentive for a supplier to apply for a CPP.

[8] Since beginning of Open Access, there has never been a capcity curtailment on the Maui Pipeline

4.4 **Contingent Projects:** As stated in previous proposals, MDL supports the Commission's draft decision to offer the contingent projects facility to GTBs[9]. Contingent projects are intended to be included in the RAB when a trigger event occurs.

4.5 MDL requests that the contingent project facility be available under the DPP. MDL considers a likely contingent project, for the initial regulatory term, to be a compressor upgrade involving capital expenditure in the vicinity of $25 million. If the trigger is reached, MDL would see this project as being crucial to maintaining security of supply and that it should be a simple matter of the Commission increasing its Regulatory Asset Base (**RAB**) to enable owners to gain a return on this investment. The requirement to undertake a CPP to have this project recognised in the RAB would be seen as a barrier to investment. MDL notes that the Commission will be required to authorise this project for inclusion in the contingent projects facility and would be involved in the design of the trigger event. In MDL's view this project can be seen as an incremental project. Because it would be subject to a revenue cap any increased throughput would not entitle MDL to increased revenues beyond those generated by an increase in RAB.

4.6 An alternative to offering contingent projects in the DPP might be to simply make an assumption that certain projects will occur at certain dates. This would be despite the fact that the exact timing of the requirement is understood to be uncertain. The supplier would simply hold the additional income in a dedicated account, and, at the end of the regulatory period, if the project did not go ahead, the supplier would reimburse customers through reduced tariffs. MDL views an assumption that 'a capacity upgrade project will occur in say year two of the regulatory period' would be more conducive to incentivising investment by other parties, than an assumption that the project would not occur until the end of the regulatory period.

4.7 **Catastrophic/Change Events:** MDL supports the inclusion of catastrophic events and change events which justify reopening of a CPP. MDL also supports a materiality clause which requires that these events be at a value at least equivalent to 5% of maximum allowed revenue after tax but would prefer this to be more along the lines of 2%[10].

4.8 MDL also requests that the Commission consider certain "pre approved" type events which provide for reopening under a DPP. Note: this does not suggest that a CPP application should not involve a full building blocks approach. It is simply a request that the Commission reserve its rights to make an adjustment to the DPP, if it can be established that the event or contingency project has "incremental" impacts on certain parts of the business only and need not, in certain circumstances, be subject to a CPP which is a full building blocks approach.

4.9 **Flexibility under DPP:** MDL would point out that if there is a revenue cap, there is already scope for some volatility in prices to account for changes in demand. It is not considered that stability in customer prices will be adversely impacted by any decision by the Commission to

[9] Section F11 Contingent projects, Draft Determination,
[10] Section 5.5.2 and 5.5.3, Draft Determination,

reopen a DPP. In fact, given the high cost of the CPP, with its associated recoverable costs, it is likely that the consumer will face higher price volatility through a change to CPP, than allowing a certain amount of flexibility under a DPP.

5. COST OF CAPITAL

5.1 Since the commencement of Open Access, MDL has outsourced the calculation of the Cost of Capital.

5.2 MDL considers that the Commission's assessment of Cost of Capital is too low. To this end, MDL has commissioned KPMG to address cost of capital and in particular, Asset Beta. A KPMG submission will be provided separately.

6. ASSET VALUATION

6.1 Assets used in the supply of gas pipeline services that are not subject to Gas Authorisation, such as is the case for MDL, will be established using the financial year-end regulatory asset values disclosed in 2009 in accordance with the Gas (Information Disclosure) Regulations 1997. MDL is not required to disclose its RAB under current disclosures and thus anticipates that in respect of its opening RAB, it will roll forward its 2009 RAB, updated for (such adjustments as), "actual CAPEX (including expenditure on vested assets), depreciation, disposals, and indexation"[11]. MDL notes that the Commission has avoided a revaluation or reset and MDL makes no further comment in this respect. MDL would however point out that the Commission has stated that the IM Paper and Determinations Paper do not address a DPP[12]. MDL is thus interested in how this process might be different under a DPP. At the risk of giving too much attention to areas that are not addressed, MDL views the CPP as a last resort and is looking to demonstrate that the CPP should not have any clear advantages over a DPP which might "effectively force" a supplier to apply for a CPP.

6.2 MDL notes that opening Regulated Asset Base can change as a result of the application of cost allocation rules whereby parts of the RAB are deemed to be part of non regulated activities. This draft decision should not have a material impact on the Maui Pipeline business.

6.3 The concept of adding Commissioned Assets[13] to a suppliers RAB is appreciated by MDL although, given a significant portion of capital expenditure is lumpy, out of MDL's control and difficult to predict in terms of timing, MDL expects this facility to be utilised for small, anticipated and measurable capital expenditure adjustments only. MDL supports inclusion of certain financial leases within the definition of Commissioned Assets[14]. To meet the objective of incentivising investment, it may be appropriate for the Commission to be

[11] Para 2, page xii, IM Paper
[12] Table 1.1, page 5, IM Paper
[13] Section 5.3.12, 5.3.17, RAB roll forward, Draft Determination,
[14] Section 5.3.17 (1)(a), Commissioned Assets, Draft Determination,

receptive in terms of considering a variety of potential funding structures including separate ownership of certain transmission pipeline assets.

6.4 MDL notes that where an asset is stranded, GPB's cannot apply accelerated deprecation but can continue to depreciate the asset over its remaining useful life[15]. While the Commission notes that a supplier can apply for a CPP to have an alternative depreciation method considered, it would appear to be "overkill" if a supplier was required to do so. Withholding of accelerated depreciation in certain circumstances, particularly where capital is required to fund replacement assets, may be considered contrary to incentivising investment.

7. CUSTOMISED PRICE/QUALITY PATHS

7.1 MDL agrees with the Commission's draft decision to utilize a top down, service based and materiality based approach to information requirements for a CPP.

7.2 However MDL remains of the view that information requirements for CPP application are burdensome and that required information is already supplied via other reporting streams such as annual information disclosure, and the Asset Management Plan (**AMP**). Furthermore, as stated in earlier submissions, the requirement to allocate OPEX, CAPEX and Service Categories into a multitude of projects and programs is also burdensome. MDL is of the view that complicated, activity based costing allocation rules will be required in order to create this structure. MDL questions the value of complicated allocation rules that are considered arbitrary in what is essentially viewed as a simple business structure. While, MDL can meet these new requirements, they will arrive at a cost. For example implementation of a new accounting system may be necessary under a CPP.

7.3 As stated in earlier submissions, MDL is hopeful that the DPP will have sufficient inherent flexibility to incentivise investment and that MDL will not be required to undergo the costly and time consuming CPP process in order to respond to uncertainty. This is on the basis that some uncertainty is an inherent part of the gas transmission industry and Maui Pipeline customers, who in turn, experience uncertainty in their demand for gas, wouldn't have it any other way. Where, in the future, MDL is required to have its DPP reconsidered, it will likely be due to an incremental change to its circumstances. By accepting incremental changes and not reviewing all building blocks under a CPP, the Commission is taking an initial "position of trust" with a supplier. It would be possible for a verifier to verify only what it considers "material impacts" caused by a re-opening of a DPP.

7.4 Under the proposed CPP structure, once a CPP has been implemented, a supplier can not apply to have the CPP re-opened except in the case of; a catastrophic event, an error, a change event, or if a contingency project is triggered[16]. MDL supports the contingency project facility as being particularly relevant to gas transmission businesses, where the timeframe for requirement of investment is uncertain and circumstances requiring investment are beyond a GTB's control.

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[15] Section 5.3.15 Depreciation constraint, Draft Determination,

[16] Section 2.6.3, Fixed WACC parameters, Draft Determination

7.5 The gas transmission industry in New Zealand is assessed by MDL to be part way through an important period of transformation and innovation. Some of the changes over the last few years are: implementation of open access arrangements; ratification of the Maui Legacy Gas Contract; implementation of a balancing market and implementation of cost recovery mechanisms. There are a number of initiatives currently under development such as: development of a spot market for gas; improvements to downstream allocations; review of capacity arrangements; and innovations in the balancing gas market/cost recovery systems which will move gas transmission closer to a best practice model.

7.6 While fixed asset capital expenditure programs such as new compressors would typical fall within the Commission's materiality threshold of 10% of maximum allowable revenue[17] (which is around $30,000,000), the various innovation programs which are more intangible in nature will almost certainty not fall within the materiality threshold. However, implementation of these projects is nevertheless material in terms of the way they can impact New Zealand's gas market. In MDL's view, the Commission could have more discretion to decide on what is material in terms of catastrophic events, change events and contingency projects.

8. REGULATORY TAX

8.1 As stated in earlier submissions, MDL is an unincorporated joint venture. Tax is paid by each of the joint venture partners separately and MDL is not privy to specific information regarding the respective tax structures of each of the joint venture partners. MDL currently models financial accounts for information disclosure and tariff calculation purposes only.

8.2 The Commission's draft decision has been to utilize a tax payable approach to calculate regulatory taxable income by applying the Income Tax Act 2007 and common law to the extent practicable and subject to other relevant provisions in the IM Paper. The tax payable approach utilizes relevant building block components to derive an estimation of tax for the regulated business. MDL is of the view that this is in line with MDL's submissions and its current tariff calculation processes.

8.3 The major issue raised by MDL in discussions with the Commission is the treatment of regulatory asset values when assets are transferred. As MDL is in the unique position of operating through an unincorporated joint venture structure, any change in the tax base for regulatory purposes would lead to unnecessary complexity in the pricing and revenue allocation models. In MDL's view, the Commission has agreed with its submissions and has ruled that the regulatory tax asset value of assets acquired from another gas pipeline business should remain unchanged in the event of an acquisition.

8.4 Deductible operating expenditure is to be calculated using an analysis of operating expenditure contained in the "Building Blocks Allowable Revenue" calculation for deductibility using the taxation rules of the time. The Commission has indicated that the tax deductible debt interest should be calculated using a notional leverage of 40 percent. This is

[17] Section 5.5.4 (2)(c)(i), Contingency Projects, Draft Determination

the notional leverage ratio for gas pipeline businesses adopted by the Commission based on the analysis of comparable businesses and is in line with MDL's current calculations.

8.5 Overall, in terms of regulatory tax, MDL supports Commission's decisions MDL to date.

9. COST ALLOCATION

9.1 The Maui Pipeline is a ring fenced business. It does not currently engage in activities that it considers fall outside gas transmission. Thus it does not anticipate there being any requirement to address cost allocation issues.

9.2 MDL supports the "5% of revenue" materiality threshold provided by the Commission in the Draft Determination document[18].

10. CONCLUSION

10.1 Gas demand is not predicted to wane in the foreseeable future, particularly in terms of electricity generation. Thermal generators will increasingly provide essential firming services to renewable generators.

10.2 MDL views the encouragement of investment as a paramount objective for a regulatory platform which seeks to stimulate economic growth. Gas transmission costs are not considered a major driver of gas prices. However where a lack of investment incentives causes a supply constraint, the detrimental impact on users that rely on gas can be very significant.

10.3 MDL notes that the Commission has not provided any detail surrounding quality standards for GTBs to date, particularly in terms of "reliability" standards. MDL assesses robust reliability standards are required to estimate whether supply constraints exist on gas transmission pipelines.

10.4 The Commission's initial estimation of cost of capital is considered too low, particularly in terms of the Asset Beta estimate. KMPG will provide a separate submission to address cost of capital.

10.5 The Commission's definition of pass through costs appears narrow. MDL assesses that the exclusion of balancing gas related costs (pending further information) would exacerbate the problems associated with cost allocation in this area

10.6 MDL notes that a DPP is the lowest cost form of regulation and as such MDL prefers a DPP structure and will carefully consider whether it can use it.

10.7 MDL continues to request a revenue cap and wash up under a DPP and is encouraged by the Commission's support for this structure in its initial views.

10.8 MDL supports the flexibility features inherent in the CPP such as contingent projects, events, catastrophic events, and potential for alternative depreciation methods.

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[18] Section 2.2.4, Cost allocation materiality screening criteria, Draft Determination

10.9 MDL requests IRIS under a DPP.

10.10 MDL requests the ability to reopen a DPP in certain circumstances. In MDL's view, volatility in customer prices already exists under a revenue cap and is accepted by GTB customers. In MDL's view, opening a DPP to allow for such things as; accelerated depreciation, contingent projects, and other events approved by the Commission will have a minimal impact on GTB customers.

Yours sincerely,

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