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28 September 2011

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Commerce Commission
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Dear Mr. Mitchell,

Please regard this letter as our submission on the Discussion Paper from the Commerce Commission ("the Commission") on the Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path. In this submission I will use MDL to refer to the Gas Transmission Business (GTB) of Maui Development Limited. Our submission is structured under the following headings:

- Introductory Remarks
- Revenue Forecast Comments
- Operating Expenditure Comments
- Capital Expenditure Comments
- CPP Considerations
- Under- and Over-Recovery Treatments
- Closing Remarks

Introductory Remarks

1. We support starting prices that are based on current and projected profitability, however we have doubts about the use of projected throughput quantities.
2. We support a Total Revenue Cap for MDL.
3. We support the use of CPI-X indexing with $X=0$ to calculate increases in maximum net revenue.
4. We support use of the most recent data available for the setting of starting prices.
5. We support updates of the price path and Regulated Asset Base for actual inflation during the regulatory period.

Revenue Forecast Comments

6. Revenue for MDL is driven exclusively by the variable amount of gas passed through the Maui pipeline. MDL currently does not impose capacity charges and does not have any other sources of revenue. The only current revenue drivers for MDL are:
 - income from total throughput, which is charged with Tariff 2 per GJ, and
 - income from throughput multiplied by distance travelled through the Maui pipeline for each shipment of gas, which is charged with Tariff 1 per GJ.km.
7. The tariffs are defined in the Maui Pipeline Operating Code (MPOC). The MPOC does not allow discrimination and tariffs are the same for all MDL customers.

8. MDL currently retains an independent expert each year to provide demand forecasts for its annual tariff setting. These forecasts provide annual GJ nominated throughput¹ estimates for the next five years, and an approximation of GJ.km demand for the coming year. Results from the last forecast report, dated March 2011, together with actuals for 2009 and 2010, are presented below.

Year	2009	2010	2011	2012	2013	2014	2015
Total Throughput PJ	139	147	136	137	130	144	147
North of Mokau PJ	76	83	82	83	86	90	93
PJ.km	20,660	21,852	20,510				

9. As the table shows, overall growth in throughput from 2010 to 2015 is expected to be zero, with increases in some years and declines in other years. The projected declines are related to planned shutdowns of large customers.
10. Growth in GJ.km is expected to remain negative for the next years. In fact, in the first seven months of 2011 the actual results so far are 5% below the forecast presented above. (Total throughput is 1% below forecast.) As production from the Maui field declines, and contributions from more Northern fields increase, the average distance is declining even while throughput may stay approximately the same.
11. Long-term growth for MDL is driven as much by supply in the Taranaki region as by demand. Because the Maui pipeline carries more than 80% of the gas produced in the country its growth potential is limited by supply availability. Growth could turn more positive than forecast above if significant new gas finds are made in the Taranaki region. Even if that happens, however, it may take more than 5 years to bring new production on line.
12. The forecast assumes that gas used by Methanex will remain the same from 2011 to 2015. As the Commission itself pointed out, any changes to this assumption can have a significant impact on MDL's throughput. We believe the future prospects for Methanex in New Zealand are mostly driven by gas supply considerations.
13. We will not comment on revenue drivers for Distribution Businesses. We assume, however, that the inclusion of MDL in table 4.2 is a mistake. All of Vector's transmission pipelines are interconnected with the Maui pipeline. As mentioned before, more than 80% of the gas used in the country travels through the Maui pipeline. Regional allocations are mostly irrelevant for MDL.
14. The above comments have particular relevance for the discussion in Section 4.29 of the Discussion Paper. We think that for companies like MDL that will operate under a revenue cap the procedure suggested appears to be over-complicated. In essence the changes in the allowable revenue each year will be driven by the allowable changes in the building blocks components and the assumptions made for the changes in MDL's operating expenditure. As noted above, MDL's gas transmission volumes are not expected to change significantly in the future, although there will be risks of changes due to climatic factors such as "dry" years. The average distance gas is travelling in the pipeline is also tending to decrease and this affects tariff income too.

¹ Note that nominated throughput is not the same as metered throughput. This is because gas may be nominated in both directions between points on the pipeline. MDL's tariffs are based on nominated throughput.

15. In these circumstances it would be preferable to rely on past throughputs for tariff calculation purposes rather than estimates of future throughput as the former are at least known accurately. The use of past throughputs should also introduce an element of compensation for past under and over-recovery during the regulatory period.

Operating Expenditure Comments

16. The Commission's assumption that labour cost increases for a GTB can be derived from an average across all sectors of the economy is unrealistic. Work in the gas transmission sector is performed by highly skilled professionals who are in short supply. Moreover, those professionals are in high demand outside New Zealand too, particularly in Australia.
17. We agree that changes in output quantity are mostly irrelevant for estimating changes in operating expenditure for a GTB. Except for fuel gas, our operating costs are practically independent of throughput.
18. The cost of fuel gas, which is used for the Mokau compressor station, is very difficult to predict. It can depend on throughput, but in a highly non-linear fashion. In the last ten years the average compressor utilisation rate has been as high as 97% (in 2002) and as low as 15% (in 2004). Compressor utilisation averaged 73% in 2010. Factors to consider include the following.
 - 18.1. Compressors are only needed during periods of high demand and are switched off during periods of low demand.
 - 18.2. Even within a year the compressor utilisation can be highly seasonal. A compressor may be running for most of the time during winter months, and only occasionally during summer months.
 - 18.3. Increasing volatility of demand may require more use of the compressors, even while overall throughput does not change.
 - 18.4. Increasing demand North of the Mokau station, as presented in the forecast, will also require a higher utilisation of the compressors; even in years when overall throughput is forecast to decline.
 - 18.5. MDL has in recent years been able to source fuel gas at no cost or at very low cost. These opportunities are expected to run out in the near future and MDL will then have to purchase all of its fuel gas at full commercial rates. As a result the expenditure on fuel gas is certain to increase significantly over the regulatory period.
19. MDL's future operating expenses are also expected to include some new items that have not been included in our historical results. Specific examples are:
 - 19.1. insurance costs, which have historically been carried by the Maui joint venture partners without being charged to MDL; and
 - 19.2. Board fees, which have historically not been charged.
20. We agree that zero is an appropriate assumption for partial productivity growth. The Maui pipeline is the only asset that MDL manages and it has done so for more than 30 years. We do not expect by now to have missed any learning curve benefits or obvious efficiency increases. Given the increasing regulatory burden on our business from all sources, including certifying authorities, we expect that productivity growth is more likely to be negative than positive.

Capital Expenditure Comments

21. Historical trends on capital expenditure are not a good guide to project future capex at a GTB other than for routine replacement. We acknowledge that routine asset replacement expenditure can be reasonably predictable. Other types of capital expenditure tend to be very lumpy, however, and are poorly predictable in advance.
22. MDL is currently preparing a major capital expenditure project, together with Vector, to move sections of MDL's and Vector's pipelines that are threatened by coastal erosion near Whitecliffs. The costs of this project will have no relationship to MDL's historical expenses whatsoever. The front-end engineering and design (FEED) contract for the Whitecliffs project is currently being allocated. The capital expenditure budgets resulting from that should be available by the end of 2011. Because this expenditure will certainly be incurred we would greatly appreciate an ability of the Commission to include this in its decisions for MDL.
23. Based on the throughput forecasts provided above, MDL currently does not have plans to incur capital expenditure for capacity increases. Despite those forecasts, however, such capacity increases may become necessary during the 5-year regulatory period.
24. The most likely major project would be an investment in additional compression capacity to increase throughput North of Mokau. Such an investment could become necessary for at least two reasons:
 - o demand increases on Vector's Northern pipeline that exceed expectations embedded in the current forecast; or
 - o volatility increases that require significantly higher peak capacity, even if average throughput remains within current forecast levels.
25. It is not practical, and probably not even possible, for MDL to have robust verified projections in advance for all capital expenditure projects that may take place during the 5-year regulatory period. Such projections can certainly not be derived from historical trends (other than routine replacement). Incurring advance costs for projects that may not be necessary would not be in the best interests of consumers. Deferring projects when they do become necessary, because MDL cannot obtain a return on them during the regulatory period, would not be in the best interests of consumers either. Therefore, we would like to work with the Commission to find a mechanism to accommodate such projects when they become necessary.

CPP Considerations

26. Actually, a Customised Price-Quality Path (CPP) is something we would prefer not to consider at all. The Commission's Discussion Paper describes this as an appropriate "safety net" for situations where we are not able to earn a normal return. As we have submitted earlier, and many other parties have submitted too, we do not share this view. Considering the expenses and resources required for preparing a CPP, and the risks of an uncertain outcome, MDL would be more likely to avoid getting into any situations that might lead to a CPP.

27. In particular, we believe that capital expenditure projects should be considered a normal business activity that should be accommodated without need for a CPP; even in cases when the capital expenditure cannot be derived from historical trends. We would be happy to work with the Commission, and with similar affected parties, to find mutually acceptable solutions for this. The alternative would be that every such project would require a CPP. A second such project during the regulatory period could even require a second CPP, to replace the first one. We do not believe that approach would be optimal for anyone, and MDL would be much more likely to defer projects and investments as a result.

Under- and Over-Recovery Treatments

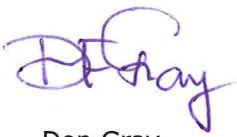
28. When setting its tariffs in the last five years MDL has included adjustments for:
- 28.1. under- and over-recoveries of revenues in prior years against MDL's required revenue and recovery specified in the MPOC; and
 - 28.2. smoothing to reduce pricing volatility for MDL's customers.
29. As a result of these adjustments MDL has under-recovered in four of the last five years. As at 31 December 2010 MDL still had a slight under-recovery balance in aggregate.
30. We believe these adjustment mechanisms are a valuable approach to compensate for the inevitable differences that arise between actual and intended results with tariffs that are based on projections. The result is that MDL can make its required return over the long run, while reducing price shocks for its customers. Perhaps more importantly for the Commission, MDL has not made more than its required return over the years (actually slightly less) and has passed on all efficiency gains to its customers.
31. We propose to continue use of the tariff mechanisms in the MPOC to the extent that they are consistent with the Commission's determinations.
32. Assuming that remains permitted, we support the use of projected profitability in the setting of starting prices by the Commission, subject to our comments above on the use of future throughput estimates. We concur with the Commission's preliminary view that it may be more practical to deal with our unders and overs adjustments through the way in which our compliance with the Initial DPP is assessed.

Closing Remarks

33. We trust the Commission's financial model for GPBs will avoid the conceptual errors that were apparently made in the model prepared for the EDB's Draft Decisions Paper. We believe these errors have been pointed out in the submissions from EDBs on that paper. Our brief views on the topic are as follows.
- 33.1. It is not appropriate in any model to allocate cash flows to sub-periods smaller than the resolution of the model. If the Commission wants to have a model resolution of less than a year then it needs to decide on the appropriate resolution and break out all items by the selected periodicity.
 - 33.2. If the Commission wants to consider timing break-outs of less than a year for GTBs it probably needs to take into consideration that seasonality becomes a significant factor. Average MDL throughput in August can be almost double that of January.

- 33.3. If the Commission wants to determine or accommodate actual cash flows in a model then it needs to include working capital provisions too. Combining a model with cash flows in the P&L but without cash provisions on the Balance Sheet is a mistake.
34. We support inclusion of a margin in the context of addressing uncertainty in the projections for GTB. The range that is provided by using the 75th percentile of the WACC estimate merely addresses the uncertainty in estimating the WACC. The additional uncertainty in relation to all the other projection parameters can justify the inclusion of a margin when setting the DPP.
35. In this context we would like to note that the cost to consumers of MDL's transmission business averages at only 36 cents/GJ or 0.13 cents/kWh (our average income from tariffs 1 and 2 combined). Even though we have historically tried to avoid price shocks for shippers on the Maui pipeline, we note that consumers barely notice the effect of increases or reductions in our prices. (Even for changes of more than 10%.) The consequences of under-investment, however, may become dramatically noticeable.
36. We appreciated the opportunity to provide this submission. For any additional questions or clarifications please do not hesitate to contact us.

Yours sincerely,



Don Gray
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for Maui Development Limited