



**RESPONSE TO THE
DISCUSSION DOCUMENT
ON THE REVIEW OF
REGULATORY CONTROL**

Provisions under the Commerce Act 1986

SUBMISSION to

Ministry of Economic Development

6 July 2007

Powerco Limited (Powerco)

Powerco is New Zealand's second largest gas and electricity Distribution Company. Our network areas are spread across the upper and lower central North Island servicing over 400,000 consumers, which represents 46% percent of the gas connections and 16% per cent of the electricity connections in New Zealand.

Powerco's electricity distribution business is regulated via price and quality thresholds, Part 4A of the Commerce Act and its gas distribution business presently operates under provisional price control, which is under Part 5 of the Commerce Act.

The Customer base for Powerco is broad with low volatility, diversified both regionally and by customer class. Electricity and gas customers are largely residential, generally contracted via retail energy companies. Powerco's growth opportunities for New Zealand electricity connections and consumption are mainly in the Tauranga area.

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1. Executive Summary

1.1. Our objectives

- 1.1.1. Powerco values the opportunity to provide a submission in response to the discussion document on the review of regulatory control provisions under the Commerce Act 1986, issued by the Ministry of Economic Development (MED). Powerco's objectives for engaging in this process are to offer constructive recommendations that enable pragmatic solutions to be put in place.
- 1.1.2. As part of our engagement and desire to contribute to New Zealand's understanding of economic regulation for natural monopolies, Powerco commissioned Case Associates¹ to provide an independent assessment of the current regime. We believe that the insight and experience that the authors offer to the discussion is extremely valuable.
- 1.1.3. We have deliberately asked Case Associates to provide an independent view. This is because we wanted to focus our submission on solutions, which meant forgoing some of the important analysis of the problems with the current threshold regime. We also wanted to give Case Associates an opportunity to speak frankly and provide an outsider's view of how New Zealand economic regulation is working. So while Powerco's submission has been informed by their review, our submission should be read independently of their work.
- 1.1.4. Powerco acknowledges that New Zealand has had a long history of questioning the benefits of using economic regulation, particularly ex-ante incentive based regulation. New Zealand has attempted to avoid using this approach to managing natural monopolies where possible. While the value of the policy thinking surrounding this approach is not to be devalued, it has, in our view left New Zealand in a place where economic regulation is not offering the benefits that it should to encourage commitment to investment at the same time as protecting consumers.
- 1.1.5. Powerco and its owner Babcock & Brown Infrastructure Limited (BBI) accept that Governments have a role in the regulation of natural monopolies. Accordingly, we are of the view that we need to be pragmatic and focus on the solutions for New Zealand. It is our view there is little value to be had in continuing to question the merits or otherwise of implementing economic regulation for natural monopolies, since the uncertainty this creates is not advantageous to investors or to a Government wanting to build a robust and effective regulatory regime.
- 1.1.6. To this end Powerco has focused its submission on recommending pragmatic solutions for three key issues, which we believe are criteria that will ensure the successful application of an ex-ante incentive based regulatory regime in New Zealand. These are:
 - using economic regulatory mechanisms for the right reasons;
 - developing a regime that builds trust and confidence for consumers Government and investors; and

¹ Case Associates, *Effective Regulation: Assessment and Reform of Economic Regulation of Electricity Distribution Services in New Zealand, June 2007*,(provided as a separate submission).

- supporting regulatory solutions for an electricity industry with a number of participants of different sizes and ownership structures.

1.2. The reason for implementing economic regulation

- 1.2.1. The reason for implementing economic regulation matters for New Zealand. Is it intended to be a last resort mechanism to control “out of control” entities achieving excessive profits, or is it a mechanism designed to be a pragmatic and ongoing response to balancing the interests of consumers and investors? We consider that in New Zealand we adopted the first approach so that economic regulation is only to be used as a last resort to sanction the “out of control” abusive conduct of a monopolist.
- 1.2.2. This approach has created significant uncertainty for investors and is impacting directly on New Zealand’s long term economic growth objectives. We don’t believe that economic regulation was intended to act as a sanction. Rather, our understanding is that economic regulation is a pragmatic solution, a regulatory framework designed to act as a proxy for a competitive market. Therefore, economic regulation is intended to simultaneously protect consumers as well as to promote efficient investment and operation.

1.3. Developing a robust regulatory regime

- 1.3.1. Once we are operating within the right paradigm for why we are implementing economic regulation then we believe it is possible to support MED’s range of regulatory options. However, we believe the effectiveness of these options will depend on their design and implementation. Irrespective of the model adopted, effective regulation requires a robust regulatory framework with clear guidelines on the objectives and implementation of the regime, set out in regulations. In addition, the company should be required to determine which regulatory model it wants and stay with its decision unless it meets the criteria to be able to shift. The company’s decision will be guided by the pre-set criteria for the regulatory models and pre-set key parameters.
- 1.3.2. The regulator can be assisted through use of regulations and/or licences to provide direction as to the most appropriate models to use given the natural monopoly service. A central advantage of this approach to regulation is the commitment to putting the rules in regulations upfront.
- 1.3.3. There are a number of design features that need to be present in order to capture the full benefits of this approach to regulation namely:
 - separating the policy function of setting the rules from the regulatory function of applying the rules;
 - the availability of merits review;
 - low discretion regulation; and
 - stability in the rules.

1.4. Adopting alternative solutions for the electricity sector

- 1.4.1. Finally, we believe the solutions offered for the electricity sector are a pragmatic response to economic regulation. With that in mind we support the three pathway approach proposed by the Electricity Networks Association (ENA). Under this proposal, the following options would be available for the regulated electricity distribution services under Part 5:
- a default price path;
 - propose/respond regulation; and
 - an alternative regulatory option which utilises the governance framework of the company (i.e. a model potentially suitable for trust-owned electricity lines businesses).
- 1.4.2. The proposed model recommended by the ENA submission essentially attempts to resolve the issues of the costs of regulation for a sector with a large number of entities. We believe that the adoption of an ex-ante incentive based regulation is the most straightforward model to adopt (effectively the propose/respond model). However, we accept that other alternative options, such as recognising trust ownership as offering regulatory governance, should be given the opportunity to achieve the desired outcomes for economic regulation, as a way of potentially reducing the regulatory burden.
- 1.4.3. The most important consideration is that all regulatory models are clear, well understood and implemented in advance, through regulations or licences. This approach will enhance regulatory certainty and signal the Government's commitment to investors of natural monopoly services, operating under Part 5.

2. Introduction

2.1. Economic growth and economic regulation

- 2.1.1. Powerco appreciates the opportunity to provide a response to the MED's discussion document. Powerco believes that getting the answers right to the questions of why and how to use economic regulation in New Zealand are critical not just to encouraging investment but also to securing outcomes that will support New Zealand's long-term economic growth objectives.
- 2.1.2. Getting the balance right between pricing that meets consumer's short-term demands for low energy prices and prices that support investment over the medium to long-term to meet the future demands of consumers tomorrow, is a matter of judgment. When dealing with infrastructure, such as electricity and gas networks, that is critical to New Zealand's economic growth, the judgement required to balance the demands of today and the future becomes more complicated and the outcomes more important, as observed in the Government's commitment to the issue through the New Zealand Energy Strategy (NZES).
- 2.1.3. The challenges increase further when these services are delivered by one provider, a natural monopoly, where it is reasonable and in fact desirable to only have one provider of the service. In this situation there is a role for an economic regulator to manage the concerns of consumers around pricing and output demands, at same time as providing assurance to investors that the regime, through its design and operation, is committed to supporting investments.
- 2.1.4. The reasons for implementing economic regulation matters in this context. Is it intended to be a last resort mechanism to control "out of control" entities achieving excessive profits, or is it a mechanism designed to be a pragmatic and ongoing response to balancing the interests of consumers and investors. We consider that in New Zealand we adopted the first approach as our policy rational for using economic regulation.
- 2.1.5. To this end the regime involved avoiding using economic regulation through the use of "light handed" options and regulatory tests, so that economic regulation was only to be used as a last resort. The consequence of this approach is that economic regulation became the tool to redistribute wealth between producers and consumers to address excessive pricing, as the prevailing view was that this was the only logical reason for using economic regulation. In essence economic regulation in New Zealand has become the sanction to address "out of control" abusive conduct by a monopolist.
- 2.1.6. This approach has created significant uncertainty for investors and is impacting directly on New Zealand's long term economic growth objectives. We don't believe that economic regulation was intended to act as a sanction. Rather, our understanding is that economic regulation is a pragmatic solution, a regulatory framework designed to act as a proxy for a competitive market, as noted in the Case Associate's independent report². Economic regulation is intended to

² "In competitive markets, vigorous competition results in a redistribution of wealth between producers and consumers as prices come down. But it is competition which drives this transfer. More efficient firms earn higher returns because they provide consumers better quality service and/or product at a lower price. Hence, competitive markets result in wealth transfers *and* improved efficiency. The principal role of economic regulation is to mimic a competitive market outcome in the absence of competition.", Case Associates, *pg 12*

simultaneously protect consumers as well as to promote efficient investment and operation. To do this involves having an independent regulator; to do this well requires the design of a robust regime; to get this right means implementing economic regulation for the right reason.

2.2. The New Zealand situation

Government's Policy Objectives

- 2.2.1. It is clear to Powerco that, since at least last year, the Government has increasingly realised that the long term needs of business, investors and consumers cannot be met within the constraints of the design and operation of the current electricity legislative and regulatory regime.
- 2.2.2. The first significant indication came in August 2006 when Lianne Dalziel, Minister of Commerce, issued a statement of the Government's economic policy under s26 of the Commerce Act. The s26 statement focused on the importance of regulated businesses, like electricity lines businesses, investing in new lines and other infrastructure. Issuing the Statement, the Minister of Commerce said, "it is important that consumers are protected from excessive pricing by businesses that face little or no competition, but it is also vital that businesses have the confidence and the incentives to make new investments".
- 2.2.3. This was followed in October 2006 with the Minister of Energy stating that changes to the Government Policy Statement on Electricity Governance were about "reinforcing the need for security of supply, alongside environmental and price objectives".
- 2.2.4. Then, in December 2006, the Government released the Draft New Zealand Energy Strategy. The Draft Strategy notes that the Government's vision is to "maintain high levels of security and reliability" under "Electricity", the Draft notes that strong grid and lines arrangements are particularly important for security and diversity of supply".
- 2.2.5. Since August 2006, the Minister of Energy has been saying the Government wants to make it easier for lines companies to invest in generation. In the December 2006 Draft Energy Strategy, the "reduction of barriers to generation and related retailing by lines companies" is listed as a desirable action, in order "to increase competitive pressures on existing generators/retailers".
- 2.2.6. Powerco believes it can rightly be concluded from the above that the Government clearly regards security of supply and the promotion of increased competition, investor confidence and long term investment as vital to the meeting of future energy supplies for New Zealand.

New Zealand's Electricity Distribution Services

- 2.2.7. While reflecting on the policy objectives stated by Government we consider the current predictions for investment forecasted by the Electricity Lines Businesses (ELBs). New Zealand's ELBs are forecasting capital expenditure of \$3.8 billion over the next ten years³. This compares with their combined Optimised Depreciated Valuation of all system assets of \$6.2 billion⁴. This forecast expenditure reflects a

³ Taken from 2006 asset management plans

⁴ As at 31 March 2006

combination of growth in some networks (and not in others), and a substantial replacement programme in many networks. These investments will support economic growth through both meeting the new demand needs and renewing existing assets so that capacity and quality can be maintained for new and existing consumers.

- 2.2.8. The last three years have seen continued strong growth in demand, consumption and increasing consumer expectation for quality, as the use of electricity becomes more “digital”. The growing expectations for electricity are reinforced by the observations made as part of the national strategy in the NZES, while we are observing evidence of this change at an operational level, in particular in the Bay of Plenty region.
- 2.2.9. In addition, there is growing recognition of the aging nature of electricity infrastructure assets and the approaching bow-wave of required replacement. With this in mind recent large-scale outages have brought a focus on the economy’s reliance on electricity. An analysis of these outages reveals that the risk versus cost is asymmetric, which means that the cost of investing to minimize risk is far less than the cost to the economy of an outage event occurring. We refer the reader to the BBI submission for further examples of this issue for not only inew Zealand but also internationally⁵.
- 2.2.10. Of the 28 entities, the four largest ELBs are forecast to spend \$3 billion over the next ten years⁶, which accounts for 81% of the forecast capital expenditure and represents connections with around 66% of the electricity consumers in New Zealand. We are aware that most of this financing will need to be raised from third party investors.
- 2.2.11. There is a future role for ELBs in supporting environmental sustainability where the drive for sustainability requires innovative solutions. ELBs are well positioned to provide solutions to local communities, particularly given that ELBs have been seeking to service these communities with distribution prices falling by over 10% in real terms, while reliability and investment have been maintained. However, to capture the new and changing consumer demands for electricity, additional investment is required and old assets need to be replaced, particular in the areas of significant economic growth. In addition to the traditional areas of investment ELBs are well positioned to support investment that facilitates and delivers energy efficiency solutions, renewable distributed generation, and creates the necessary “smart network” foundation to facilitate customer involvement in future energy management solutions⁷.
- 2.2.12. Given the level of forecast capital expenditure and the need to innovate to meet New Zealand’s changing energy environment, it is imperative that any regulatory regime provides investors with the confidence to invest and innovate. The economic consequences of getting this wrong are well known, particularly for critical infrastructure such as electricity. Therefore, the design of economic regulation must be able to pass the investor-confidence test, from the perspective of those providing the capital.

⁵ Babcock and Brown Infrastructure: *Response: The Investor’s Perspective New Zealand Ministry of Economic Development – Review of Regulatory Control Provisions under the Commerce Act*

⁶ Taken from the 2006 asset management plans

⁷ The United Kingdom, Department of Trade and Industry, paper titled: *Meeting the Energy Challenge*, A White Paper on Energy, May 2007, provides a interesting analysis of the issues and expected technological changes

2.3. Format of the submission

- 2.3.1. Powerco's submission focuses on the broader issues associated with regulating natural monopoly services and the required changes to Part 4 and 5 of the Commerce Act to reflect this. In addition to our submission, Powerco has commissioned Case Associates to provide an independent assessment of the current regime, as part of Powerco's contribution to the current review. Case Associates is an internationally renowned economic consulting firm, working across a wide range of regulatory, competition and economic matters. Case Associates has provided its paper under separate cover, directly to the MED. The independent review is titled:

Effective Regulation: Assessment and Reform of Economic Regulation of Electricity Distribution Services in New Zealand, June 2007.

- 2.3.2. The paper reflects the views of Case Associates, based on its independent, objective assessment of the regime and the MED discussion document. Powerco did not influence Case's review in any way and does not necessarily concur with all of the views expressed in the paper. Nonetheless, we believe that the paper offers a very worthwhile contribution to the debate and, most importantly, we fully support the principal conclusion reached by Case Associates, that:

"The current regime does not reflect international best practice and claims that it is light-handed and cost effective are debateable. Changes need to be made to provide companies with incentives to meet the Government's stated aim to promote investment in electricity infrastructure".⁸

- 2.3.3. In addition, Powerco supports the views and recommendations expressed by our owner, BBI, in its submission, which provides insight into how regulatory regimes affect investment decisions. The BBI submission is titled:

Response: The Investor's Perspective New Zealand Ministry of Economic Development – Review of Regulatory Control Provisions under the Commerce Act.

2.4. Relationship to Electricity Networks Association submission

- 2.4.1. Powerco supports and has signed the ENA submission on the response to the discussion document on the review of the regulatory control provisions. The Powerco submission is focused on enhancing the debate within the review around what is the correct paradigm within which to consider economic regulation and to provide additional detail on how regulation should be designed and implemented.
- 2.4.2. Powerco has submitted its views on whether to control natural monopolies, as we believe this is a foundation concept that will shape the design and implementation of the regulatory regime. To this end, Powerco has focused more on the "starting point" for economic regulation than the ENA submission has done. This is because we believe it is important to get the context right in terms of whether to control natural monopolies.
- 2.4.3. Powerco agrees with and supports the solutions provided in the ENA submission, which include introducing investment incentives into the purpose statement, increasing the accountability of regulators and providing three regulatory pathways

⁸ Case Associates, pg 26

to address regulatory cost issues within the electricity sector. In addition, we believe that overlaying a change in rationale for implementing economic regulation so that the regime is about managing concerns around natural monopoly services will enhance the “operation” of the recommendations provided in the ENA submission⁹.

- 2.4.4. In considering the regulation of “natural monopoly services”, we have suggested an alternative purpose statement and regulatory approach to Part 4 that fits more appropriately with this context. Powerco also provides an alternative approach for developing the required rules/guidelines than that which is recommended in the ENA submission. This includes the use of licences as are commonly used in other jurisdictions.

⁹ We discuss, in more detail below, what this would mean in practice and what changes should be made to the legislation.

3. Recommendations for changes to Part 4

3.1. Economic regulation for natural monopoly services

Why it is a policy decision to be made by Parliament

- 3.1.1. The Case Associate's review discusses the "*Problem of Natural Monopoly*"¹⁰ and points out that infrastructure such as electricity distribution services have natural monopoly characteristics arising from economies of scale. These scale effects mean that it is usually more efficient to have a single provider of the service, rather than multiple competing providers. The high costs of new entry mean that natural monopolies face no competition and no reasonable prospect of competition for the provision of infrastructure services. This is a market state as opposed to the use of market power, which can result in a monopoly situation arising in a competitive market.
- 3.1.2. Therefore, natural monopolies should be regulated as natural monopoly services upfront (or ex-ante), an approach used in most other OECD economies, rather than be subjected to a competitive market inquiry into abusive market conduct, which involves investment and pricing decisions being reviewed retrospectively to assess if those investments and associated pricing decisions were evidence of abusive conduct.
- 3.1.3. This is because natural monopolies can cause concerns for both consumers and investors. Internationally economic regulatory regimes have been developed to manage the potential risks and in so doing offer benefits to both consumers and investors¹¹.
- 3.1.4. The policy issue for Government and Parliament is whether to use economic regulation in a pragmatic way to manage the concerns of consumers, with respect to pricing and output (e.g. quality and capacity), and manage the concerns of investors, which relate to whether the Government is committed to an investor being able to generate a reasonable market based return over the life of the infrastructural asset.
- 3.1.5. There are benefits to both the consumer and the investor in knowing which services parliament wants economic regulation to apply to, so the list of applicable services should be set out in a schedule in legislation. Establishing the schedule is ultimately a policy decision to be made by Parliament, as it is a decision about the perceived future benefits for consumers and investors and therefore the New Zealand economy, in having these services regulated under an ex-ante, incentives based economic regulatory regime.
- 3.1.6. At first glance the benefits for the consumer are easier to understand than for the investor. For the consumer the benefits are that the regulator makes decisions about how the entity sets its prices for the particular monopoly services. This means that prices are restricted in terms of how much they can be raised and output continues to be provided at a level that meets reasonable consumer demands. However, consumers concerns will only be fully addressed if the regime is forward

¹⁰ Case Associates, pg 10

¹¹ A point well made in the Case Associates review, pg 11

looking so that their future service demands for a higher degree of quality and capacity can be met.

- 3.1.7. The benefit for the investor is the regulator's and Government's commitment to its future investments, which arises as a consequence of the regulatory decision-making process around pricing. For this to work, the regulator and the Government need to be committed to the agreed decisions that are made before the investment occurs, and the scope for opportunistic intervention once the investment has been committed, should be significantly reduced. This is important to avoid discouraging the investor from wanting to make significant commitments to invest. The regime needs to encourage investors to promote additional investment that meets future consumer demand. The United Kingdom and Irish experience suggest that regulatory decisions are ultimately a matter of balance and judgement. That is why good regulatory practise is so critical to giving the investor confidence, and this is required to reinforce that ongoing commitment on behalf of the regulator and the Government exists.
- 3.1.8. However, the regulator is not well placed to make a policy decision on behalf of New Zealanders as to the future benefits for New Zealand of implementing economic regulation. The regulator generally lacks the mandate for broader considerations such as a focus on New Zealand's economic growth, and will quite rightly, in order to maintain its independence, limit its focus to the objectives set out in legislation.
- 3.1.9. We believe that Parliament has effectively recognised that there are concerns surrounding natural monopolies for both consumers and investors and made policy decisions for a number of sectors where the natural monopoly characteristic exists, although we question the paradigm underlying the approaches used. Parliament has adopted economic regulation policy solutions for electricity lines services, gas distribution services, telecommunications and airports. Our recommendations don't suggest Government or Parliament review the merit of having concerns about natural monopolies. We acknowledge that there are legitimate concerns for both consumers and investors, and therefore, submit that it is counterproductive to investigate and obtain evidence of abusive conduct.
- 3.1.10. A change to the paradigm is required to provide better outcomes, so that economic regulation is not about imposing control on "out of control" entities, it is about setting up a regulatory framework that enables natural monopolies to make the required future investments, while still protecting consumers. This offers benefits to both consumers and investors. We consider that this requires changing the regulatory regime to be ex-ante, incentive based economic regulation.
- 3.1.11. To the extent to which the concerns about natural monopolies have already been identified, the current Part 4 approach, in our view, is effectively redundant. With this in mind it is timely to change the Part 4 framework to state the proposition that economic regulation is a policy decision for Parliament. More importantly, we believe it is necessary to remove the Part 4 process from the economic regulatory regime because of the impact that the process has on how the regulator, the Government and businesses think about economic regulation. The current part 4 process inhibits the development of constructive relationships between the parties and the development of an effective incentive based regime. We discuss this in more detail below.

Issues with the current Part 4 Process

- 3.1.12. Our view of economic regulation has been reinforced by the two inquiries conducted under Part 4 and the operation of the Part4 A threshold regime. The evidence from the airport and gas control inquiries suggests that an inquiry does not answer the policy questions adequately and in fact, rather than address the concerns of investors, the current approach under Part 4 and 4A reinforces these concerns.
- 3.1.13. The lack of clear policy making is highlighted by the fact that the rationale for starting the inquiries was not clear and could potentially have been influenced from lobbying by self-interested parties. Once the inquiries had been initiated, the process for deciding on the outcomes was complicated by both the Commission and the Minister's officials providing advice on whether to impose control. This meant that the policy process for implementing economic regulation lacked transparency and predictability, as it was not clear what factors led to the Minister's decision.
- 3.1.14. While we consider that the imposing of economic regulation is a decision to be made by Parliament, we think that the regulator should implement regulation and as such should be set up to make independent judgements that balance the concerns of both consumers and investors with respect to the provision (pricing, quality and investment) of natural monopoly services under economic regulation. The regulator should be guided and its discretion should be limited to a reasonable degree by a comprehensive set of pre-determined rules for regulation. The regulator should be able to be held to account for its decisions.
- 3.1.15. The requirement for the regulator to conduct a cost benefit analysis by applying an efficiency test is unnecessary and, in our view, detrimental to the development of an economic regulatory regime. First, this approach requires the Minister to assume that the figures provided with the analysis are reliable, which is questionable at best given the nature of costs and benefits, where it is possible to determine costs of regulation, but the benefits are in the future and are much harder to objectively quantify. In addition, this approach requires the regulator to make a judgement about the operator's current pricing by constructing a counter-factual. Not only does this process encourage dispute about what are the right prices based on value judgements about the way to price, it also requires an ex-post analysis of previous decisions.
- 3.1.16. When the Minister chooses to act on an ex-post inquiry and implement economic regulation, as in the gas control inquiry, the Government offers a potential windfall gain to the consumers at the expense of the investor. This is because the Part 4 efficiency test requires identification of an historical inefficiency, for instance it requires the regulator to assume that an investor may have paid too much for an investment. Such an action is viewed as setting up an incentive for abusive conduct and could lead to excessive pricing. Since it is reasonable to assume that the investor's purchase price reflects the market-based value of the assets at the time of purchase, then this claim is based on two assumptions:
- the nature of the competition in the market place; and
 - the assumption that in order to get the return, the investor will be required to increase prices over and above what consumers should reasonably be expected to pay; in other words the prices are excessive.

- 3.1.17. To determine this requires some assessment of the lack of competitiveness in the market, which suggests that the entity can earn excessive prices because there is no competition in the market. In addition, it requires a counterfactual to be developed that assesses the efficiency of current prices compared to what is expected to be efficient. The largest component of a price formation is the determination of the value of the asset base. Essentially, to create a different pricing path from that assumed by the investors requires the regulator to make a judgement about the legitimacy of the price paid for the assets. In addition, in order to get a benefit out of implementing economic regulation, the Part 4 process requires a welfare transfer between the producer and consumer to occur. This creates the windfall for consumers.
- 3.1.18. It is reasonable to assess the competitiveness of the market. This assessment has implicitly been done when natural monopoly services are identified for the purpose of applying economic regulation. The problem with Part 4 is the process of testing to determine if the investor is in fact exhibiting market power through excessive pricing. The process requires:
- retrospective questioning of the investor's decisions to invest,
 - the regulator and Minister determining a value to be transferred from the investor to the consumer, and
 - then valuing this transfer as being worth more to New Zealand than the value of encouraging future investments.
- 3.1.19. These implications are not unique to an investor operating under Part 4 of the legislation; they create concern for investors operating under Part 4A because the inquiry process for the threshold regime is designed to find the "out of control" entities. Therefore, the inquiry process is influenced by the perceived legitimacy of an ex-post, questioning and untrusting regulatory process to identify excessive conduct.
- 3.1.20. In the short term this process compels the investor to dispute the assumptions being made and the consequential actions of the Government, as evidenced in the recent judicial review proceedings. In the longer term it signals to the investor that the Government is not committed to the investor and will potentially take advantage of the investor's prior decisions to invest, most likely to its detriment. This outcome discourages investment and in the long-run, is not beneficial to consumers.
- 3.1.21. Effectively the inquiry becomes the determinant of policy and so if the Government decides not to implement economic regulation as it did in the airport inquiry then it is hampered in its ability to review that policy decision without another inquiry. While this may appear to signal to the investor that the Government is comfortable with the previous pricing decisions, the investor knows that this decision effectively still leaves the policy question unanswered. At any time the Government or the Commerce Commission may choose to conduct another inquiry, which because it uses an ex-post approach, is likely to be detrimental to the investor's decisions.
- 3.1.22. In fact, conducting an inquiry does not answer the policy question of whether there are benefits to consumers and investors in implementing economic regulation. In addition, it does not suggest how the benefits to consumers and investors should be achieved through the design of the regime. What it does is review historical investment decisions and encourage the regulator, the commentators and the

Government to make retrospective value judgements about the decisions of the investor into significant infrastructure.

- 3.1.23. While we don't dispute that infrastructural assets such as electricity are of strategic importance to New Zealand and that Governments will always have an active interest in the provision of these services, retrospective value judgements don't encourage constructive dialogue with the provider of the services about how these services are being provided to meet the future needs of consumers. The investor is looking to make a long-term commitment to invest in assets, and in so doing is effectively seeking to establish a long-term strategic relationship with key stakeholders, with Government being a critical relationship.
- 3.1.24. Unfortunately for New Zealand the starting point for our economic regulatory regime and these strategic relationships has been to question the wisdom and intention of the investor's past decisions rather than discuss the investor's future decisions. An economic regulatory regime designed upfront within which the investor operates, provides the investor with knowledge about how the Government wants to manage the potential concerns of consumers and investors. Investors and regulators can then set expectations and agree decisions about future investments.

3.2. Changes to Part 4 would make Part 4A redundant

- 3.2.1. On the basis that the question of whether to implement economic regulation for particular services that have natural monopoly characteristics is a policy decision, then the decision appears to have already been made for electricity distribution services. In order to reflect this policy decision in legislation, the relevant services can be listed in the schedule along with other services where the Minister considers that economic regulation is required. Once listed then the Part 5 regulatory options apply. We have made recommendations on how Part 5 could work later in our submission.
- 3.2.2. The key issue here is that given that the policy decision to address concerns for electricity distribution as natural monopoly services is effectively the same policy decision to be made for other natural monopoly services, there is no requirement to distinguish the treatment of electricity distribution services from other services. This effectively means that Part 4A would no longer be required.
- 3.2.3. We note that under Part 5 particular regulatory options may be used which are more suitable than others given the nature of the electricity distribution sector, with the multiple participants and various ownership structures. Application of the regulatory options can be achieved through the redesign of Part 5 and does not necessitate a separate part of the Act for electricity distribution services.

3.3. Recommended changes to the legislation for Part 4

- 3.3.1. In the context of considering natural monopolies, the purpose statement would likely be expressed as:

The purpose of this Part is to provide for economic regulation of goods and services offered in markets where there is no competition and no reasonable prospect of competition, identified in Schedule 1, for the long term benefit of consumers in New Zealand".

Any regulation under this Part should seek to ensure that:

- (a) all reasonable demands of final consumers are met;*
- (b) suppliers have incentives to innovate and to invest including in replacement, upgraded and new assets and in related businesses and are capable of financing these undertaking;*
- (c) suppliers can finance their efficient operations and investments to earn a reasonable market based return;*
- (d) services are provided in a safe and efficient manner; and*
- (e) services offer continuity, security and reliability of supply.*

3.3.2. Our proposed additions to the purpose statement focus on the supplier's incentives to innovate and invest under (b) and (c). For there to be incentives to innovate and invest the supplier needs to have the financial capability to do so. Adding "financial capability" would strengthen the incentive and we note that the UK and Irish electricity regulation regimes have obligations on the regulator to ensure suppliers are able to finance their activities.

Regulated services

- 3.3.3. As discussed above, Powerco submits that the goods and services subject to economic regulation should be identified in a schedule to the Commerce Act. Further, this schedule should be changed by amending legislation, not an Order in Council.
- 3.3.4. This means Part 4 only requires a simple provision to the effect that the goods and services in the schedule are subject to Part 5. The existing processes of recommendations by the Commerce Commission (Commission) and decisions by the Minister can be repealed.

Review of competition

- 3.3.5. There could be a valuable role, however, for the Commission in periodically reviewing the state of competition in the markets in which scheduled goods or services are sold. If the Commission believes a material degree of competition has developed in any of these markets, then this will be relevant to any consideration by the Minister and Parliament as to whether the good or service in question should stay on the schedule.
- 3.3.6. For this reason, Powerco submits Part 4 should provide for the Commission to report to the Minister and to Parliament on the state of competition in the scheduled markets.

4. Recommendations for the electricity distribution services

4.1. Support for the three pathway approach proposed by the ENA submission

- 4.1.1. The proposed model recommended by the ENA's submission essentially attempts to resolve the issues of the costs of regulation for a sector with a large number of entities, comprising of different sizes and ownership structures. We believe that the adoption of an ex-ante incentive based regulation is the most straight forward model to adopt (essentially the purpose/respond model). However, we accept that other alternative options, such as recognising trust ownership as offering regulatory governance, should be given the opportunity to achieve the desired outcomes for economic regulation, as a way of potentially reducing the regulatory burden.
- 4.1.2. We also believe that all the regulatory models need to be clear and well understood and most importantly implemented in advance, through regulations or licences, to avoid regulatory uncertainty and also to signal the Government's commitment to investors of natural monopoly services operating under Part 5.
- 4.1.3. We consider that if different governance models are to be used, then there may, for example, be different perspectives of what constitutes an acceptable rate of return or acceptable levels of operating efficiency. Differences arising in the way businesses are run as a consequence of the different regulatory pathways requires that there should not be any form of benchmarking applied across the three different regulatory pathways. In particular, if the company opts into the propose/respond pathway then its operating and capital expenditure decisions should be reviewed against its own past performance.
- 4.1.4. To this end we believe there is a considerable amount of learning that can occur, drawing on overseas experience, in particular from the United Kingdom, to ensure that the fundamentals behind the regulatory regime create an effective incentive based economic regulatory regime.
- 4.1.5. We support the high level design proposal put forward by the ENA, but consider that the details of the options within the regime and how they operate together will need to be worked through. We would expect that the Government, in designing up the regime, will consult extensively with industry participants to ensure the model and the various options work together in a cohesive framework.

5. Recommendations for Part 5

5.1. Developing a robust regulatory regime

- 5.1.1. We support the MED considering a range of options, however, we believe the effectiveness of these options will depend on their design and implementation. Further clarity is required around the various options put forward and if they are to be used interchangeably by the Commission or if they comprise different options for future regulation. In particular, information disclosure is a component of all regulatory models, and the negotiate/arbitrate model could be designed to be a component of a default path and the propose/respond model.
- 5.1.2. Irrespective of the model adopted, effective regulation requires a robust regulatory framework with clear guidelines on the objectives and implementation of the regime, set out in regulations. In addition, the company should be required to determine which regulatory model it wants and stay with its decision unless it meets the criteria to be able to shift. The company's decision will be guided by the pre-set criteria for the regulatory models and pre-set key parameters.
- 5.1.3. To this end we support the three pathway approach proposed by the ENA. Under this proposal, the following options would be available for the regulated electricity distribution services under Part 5:
- a default price path;
 - proposed/respond regulation; and
 - an alternative regulatory option which utilises the governance framework of the company (i.e. a model potentially suitable for trust-owned electricity lines businesses).
- 5.1.4. Powerco proposes that the controlled services would be subject to the default price path unless the company elected one of the other models of regulation. The following framework would apply:
- the Commission establishes the default price path according to preset criteria;
 - the propose/respond regulation and the governance framework regulation would be available on the election by the company (and subject to the company meeting the criteria preset in regulation, discussed below);
 - the negotiate/arbitrate regulation would be available to the company on application to the Commission. There will need to be pre-set criteria to assist the Commission in assessing whether the negotiate/arbitrate regulation is appropriate for the specific circumstances of the company; and
 - rules would establish the process and requirements for the company moving from one form of regulation to the other. This would include notification periods, requirements to meet the criteria for the regulatory model being adopted and minimum requirements to ensure the company is not simply taking advantage of timing differences.

5.1.5. Each of these regulatory models would have the following features:

- criteria (for the propose/respond regulation and the governance framework regulations) and/or key parameters (for the default price path and the negotiate/arbitrate regulation) would be set in regulation prior to the Commission applying the regulation to any particular company;
- the Commission would have an appropriate, but limited degree of discretion in applying the criteria or key parameters;
- the process for determining any breach, and the consequences of any breach would be set in regulation.
- the Commission would have an appropriate, but limited degree of discretion in responding to any breach; and
- merit review is available in relation to:
 - the recommendation (by an expert panel, as discussed below) to the Minister of the criteria or key parameters to set in regulation;
 - the decisions by the Commission in applying the regulation; and
 - the decisions by the Commission in responding to any breach.

5.1.6. A central advantage of this approach to regulation is the commitment to setting the rules for regulation upfront.

5.1.7. This highlights a number of design features that need to be present in order to capture the full benefits of this approach to regulation namely:

- separating the policy function of setting the rules from the regulatory function of applying the rules: this is critical for determining how the criteria and/or key parameters is designed and set into regulation and/or set out in licences. Powerco submits this role should be separated from the Commission, which will be applying the rules. We recommend the formation of a panel of experts used to consult on these issues and make recommendations to the Minister;
- the availability of merits review: as discussed below, merits review of the recommendations by the expert panel should be available;
- low discretion regulation: the criteria and key parameters must be at a sufficient level of specificity. The Commission should only have an appropriate level of discretion when applying the rules to the circumstances of a particular company;
- stability in the rules: investors pay particular attention to the process for making changes to the rules. The process should be known beforehand, and give the entities and the Commission equal rights to recommend any changes to the rules.

5.1.8. MED has also raised for consultation the option of a negotiate/arbitrate model. Powerco has reservations about whether the negotiate/arbitrate model would be appropriate for every sector. Inherent in the negotiate/arbitrate model is the idea of negotiation “in the shadow of regulation”. While this may be made easier by setting key parameters in regulation, nevertheless there will be some sectors and

commercial relationships where the availability of a regulatory “backstop” such as the regulator acting as an arbitrator will lessen rather than increase the chance of a commercial resolution. In such a situation, the negotiate/arbitrate model only increases the cost, delay and uncertainty of regulation.

5.2. Importance of commitment for investors

- 5.2.1. Regulatory commitment gives confidence to key stakeholders of the regime including consumers, the Government, and investors. Commitment to the regime and the objectives of the regime, namely protecting consumer and incentivising investment, enables parties to set expectations about what and how things will be achieved. It is within this environment that significant investment decisions can be made.
- 5.2.2. In a regime which lacks commitment from the parties, opportunism will occur and decisions that appear to favour one perspective and don't take into account how this may affect the incentives of the other parties. This is true of most relationships, and is no less true of the relationship between Government and the owners and providers of essential infrastructure services. The implementation of economic regulation should seek to enhance these relationships not undermine them. Therefore, the way the regime is designed and implemented is critical to reinforcing the commitment of the parties to the shared objectives of protecting consumers *and* incentivising investment that meets reasonable consumer demands.
- 5.2.3. Economic regulation can be viewed unfavourably as an intrusive form of micro-management of an entity's operational and strategic decisions. This is because the relationship between the regulator and the regulated entity is a difficult one to develop. The objective is to get to the stage where the regulator and the entity are able to engage consistently on a constructive basis about what level and type of investment should occur and as a consequence what revenue and tariff levels are required.
- 5.2.4. Discussions with the staff at Ofgem in the United Kingdom reveal that considerable work has been done over the years to achieve this type of relationship. An understanding of the importance of an ongoing shared commitment to investment has helped to reinforce this approach and develop this culture. With this knowledge the regulator operates in a committed way and so the investor in kind is prepared to commit to the investment that is needed to meet the broader Government objectives for economic growth. Licence arrangements have helped to establish the relationship.

5.3. Licence arrangements

- 5.3.1. New Zealand currently does not have a licensing regime for natural monopolies. This is in contrast with other comparable OECD jurisdictions, namely England, Wales, Ireland and Australia, where licences are the principal means of ex-ante control and a central plank of utility regulation.
- 5.3.2. A licence is the key instrument for implementing ex-ante regulation. Its primary role is to further the objectives of the Government's regulatory policy through the prescription of detailed rights, duties and obligations of both the licensee and licensor. A licence effectively forms a regulatory contract between the Government (the licensing authority) and the licensee.

- 5.3.3. Licences set out in detail the obligations of the parties to the licence and cover both price and non-price regulation. Licences may impose detailed constraints and obligations on the licensee, and usually provide the powers through which regulators carry out many of their functions. Licences also include terms to govern the relationship between the regulated entities, the regulator and the Government, including dispute settlement, arbitration and review of regulatory decisions.
- 5.3.4. Licences for electricity network businesses usually define the territory within which the licensed entity has jurisdiction. In the UK, the electricity lines businesses have an exclusive franchise to distribute electricity within a given geographic zone. The exclusive licence pertains just to the lines business as retail companies are free to supply within any geographic zone. An exclusive franchise can enhance incentives for investment as it is a bankable asset which significantly reduces risks for investors. A licence need not be exclusive, however. In particular, if the Government wishes to promote competition between networks, it may not grant exclusivity. Or else a company may have de-facto exclusivity, but not formal exclusivity.

5.4. Licences signal commitment to the regulatory regime

- 5.4.1. Like any contract, a licence can signal a high degree of commitment by both parties to the regulatory regime. The duration of the licence and its ability to adjust to changing external factors (such as commodity prices) is particularly important in this regard. Utility investments are long-lived and sunk (i.e. are specific and cannot easily be re-deployed). These factors can increase the risk that investors may not be able to recoup their costs and may reduce the incentives for investment in long-lived assets.
- 5.4.2. Matching the duration of the licence to the duration of asset lives can therefore provide a strong incentive for investment, as investors in the regulated entity will have greater assurance that they will be able to recoup both the return of (depreciation) and return on (WACC) their investment. At the same time, however, licences of 20-25 years can be untenable if there are rapid changes in the operating environment, such as the development of new technology or changes in input costs.
- 5.4.3. It is therefore important for licences to be drafted in a way which allows the parties to be able to accommodate changes. Hence, licences may allow for pass-through of costs beyond the control of the licensee and/or for the regulated entity to charge tariffs that reflect its actual costs rather than a benchmark of hypothetical new entrant costs – which may result in asset stranding. These are provisions which the regulator and the regulated entity will need to agree in advance.
- 5.4.4. Effective licensing regimes are characterised by a clear statement of:
- rights, duties and obligations of the licence holder;
 - role and responsibility of different institutions (Minister, regulator, review body – competition authority, audit commission) administering the licensing regime and the achievement of effective coordination between them;
 - criteria for monitoring licensee behaviour;
 - criteria for terms between licensee and other market participants covering: network access, cost pass-through provisions;

- reporting requirements;
- credible and proportionate enforcement policy (including penalties); and
- revocation clause.

5.5. Licenses enhance the transparency and predictability of a regulatory regime

- 5.5.1. The main benefit of a licence for all market participants (investors, consumers, Government and regulator) is that it is a transparent and unambiguous statement of rights, duties and obligations of all parties. Such transparency and clarity promotes confidence in the regulatory regime. Provided the licence is clearly drafted and provides sufficient detail to avoid ambiguity, all market participants can reasonably predict the rules of the game, i.e. the environment in which they make investment and consumption decisions. They can also reasonably predict the approach and methodology that will be used to set prices and revenues. Such a high level of transparency and predictability reduces the risk of companies being in breach of regulatory obligations, on the basis that obligations are unclear or may have been interpreted in a different way.
- 5.5.2. Transparency is also pro-competitive as it enables new market participants (including suppliers and generators who transact with licensed distribution entities) to understand the rules of the game much more quickly than if there were no licence and companies had to rely on experience. Licences can therefore promote new entry. Licences can also help provide assurance to companies that they are not being discriminated against or singled out for special treatment, hence there can be a uniformity of licence terms among companies in the same sector, with any differences reflected in specific price control provisions, such as the X factor in the CPI-X formula.

A typical Electricity Distribution Licence

Obligations and Conditions

Obligations on the Entity include:

to connect (all) customers who request a supply

to purchase economically

provision of information to the regulator

submission of regulatory accounts

not to discriminate between customers within each class

cost allocation rules (if distribution is integrated with supply or generation)

to comply with distribution network code, metering code and other technical agreements

restrictions on cross-ownership (e.g. generation and or supply businesses)

ring fencing, i.e. no financial guarantees of non regulated businesses

to comply with customer service/quality standards

Obligations on the Regulator include:

process and duration of public consultation

treatment of commercially confidential information

timely decision making

Conditions relating to the Licence include:

Tariff formulae and review process

Ongoing annual/monthly licence fee

Termination events

Dispute settlement/ arbitration procedures

Enforcement

Right of appeal

Licence modification procedures

5.6. Use of regulations

- 5.6.1. A licence better captures the nuances of the relationship between entities that are jointly committed to achieving long term outcomes. We believe our regulatory regime would benefit significantly from using licences to signal commitment to long term investment outcomes and the stability of rules. However, we are conscious that a move to a licence regime may not be practical given our current starting point for implementing economic regulation. For that reason, as an alternative we advocate designing our regulation so that we can look to achieve the same degree of certainty and mutual commitment that many other countries achieve under their licence regimes.
- 5.6.2. This means paying careful attention to how the regulatory criteria and key parameters are set in regulation, including:
- who makes recommendations to the Minister;
 - the consultation process prior to any recommendation, and before the Minister's decision;
 - the availability of merits review;
 - the appropriate level of detail and the appropriate degree of discretion for the regulator; and
 - the process for promoting changes to the regulation – the regulator and the company should have the same rights and opportunities to promote changes to the rules.

5.7. Achieving independence and accountability

- 5.7.1. Appropriate accountability of the regulator is critical to provide predictability and stability in economic regulation. We consider it is fundamental to good regulatory design that the regulator is an entity independent of Government, and that any instructions from Government occur in a structured and transparent manner¹².
- 5.7.2. In addition, we believe there should be a statutory obligation on the regulator to provide reasons as to why it considers its decisions are consistent with the purpose statement, regulatory criteria and any other matters it is obliged to take account of.

Merits Review

- 5.7.3. Fundamentally we support merits review as the key mechanism to achieving accountability. The benefits and costs on allowing merits review of regulatory decisions has been comprehensively canvassed in recent years, including how it could be used in New Zealand and the relevant institutional questions¹³.
- 5.7.4. The MED Discussion Paper accepts the need for merits review. Powerco agrees the form of merits review should be by way of a rehearing, with an opportunity for updating evidence.

¹² We refer to, the Case Associates, pg 19 for comprehensive analysis of the importance of accountability

¹³ We refer to, David Goddard QC, *The Modern Reality of Dealing with the Commercial Regulators*, Legal Research Foundation conference, 29 September 2006

- 5.7.5. A key issue is the appropriate scope of merits review. The MED proposes the distinction that merits review will be available where the Commission makes a final decision or is the “ultimate decision maker”, but not where the Commission is making recommendations to the Minister.
- 5.7.6. On this basis, the MED Discussion Paper proposes that merits review be available for:
- setting of customised control terms for a given company and action in the event of a breach;
- but not for:
- recommendations on input methodologies;
 - recommendation to the Minister on whether or not to impose control (however note that, as discussed in this submission, it is not appropriate for the Commission to have this function);
 - setting of initial control terms for a given company or industry; and
 - the Minister’s decision on the Commission’s recommendations.
- 5.7.7. This sets up an unnecessary tension between the proposals to improve regulatory certainty and investment incentives, and the proposals to improve the accountability of the Commission. If the approach proposed in the discussion paper was adopted, the benefit of knowing the rules up front comes at the cost of losing the accountability of merits review when setting those rules. This would be “one step forward, one step backward” reform.
- 5.7.8. Powerco submits that merits review should be available for recommendations made by the rule-making entity on the design of the regulations or licences, once the Part 4 schedule has been set by Parliament. We recommend that this rule-making entity is independent of the Commission and we also recommend the use of licenses in addition to regulations.
- 5.7.9. The practical reality is that these recommendations are decisions by the rule-making entity in all but name, and are an important input into the Minister’s regulation making process. The Minister has as much interest as the company in the correctness of any recommendation by the rule-making entity, and in the long-term accountability of the entity in making recommendations.
- 5.7.10. Powerco agrees that merits review should not be available for the Minister’s decision. But the same can not be said of allowing merits review of any recommendation by the rule-making entity. This will improve the long-term credibility and integrity of the regulation making process.

5.8. Transitional arrangement

- 5.8.1. Powerco supports the transitional arrangements proposed in the ENA submission, paragraphs 64 to 71, given that there is a potential clash in the timing of the intended reset of the current thresholds to apply from 1 April 2009 and the timing of the implementation of Powerco’s recommended changes to Part 4.

- 5.8.2. The need for the Commission to reset thresholds in 2009 arises from the fact that the Commission gazetted the current thresholds as applying for a five-year period from 1 April 2004. There is no legislative requirement for the length of time that thresholds are to apply. For example, we note thresholds applying to Transpower are reset every year.
- 5.8.3. We understand any changes to our recommended Part 4 would potentially be passed by mid-2008 at the earliest. We expect that if changes to Part 4 were made along the lines of our recommendations they would take about eighteen months to two years to implement. This suggests that such changes could be implemented by about mid 2010, and therefore could apply to the year commencing 1 April 2011 at the earliest.
- 5.8.4. The work programme to implement our recommended changes to Part 4 would be very different from that to reset thresholds under the current Part 4A, and would have a different focus. The relevant input methodologies would need to be established prior to the setting of the propose/respond models and are likely to differ from those currently used by the Commerce Commission if investment incentives are to be incorporated effectively into the regime.
- 5.8.5. Therefore, the work undertaken using previous methodologies would not be required and the work by the Commission and lines businesses on resetting the current thresholds would be wasted. To avoid this, and at the same time ensure the Commission continues to fulfil its statutory duties, we support the recommended transition arrangements as set out in the ENA submission:
- The Commission should reset thresholds from 1 April 2009 for a two-year period.
 - the current price thresholds should be rolled forward on an undifferentiated basis of $CPI - X$, with $X = 0$. This undifferentiated basis, and $X = 0$, is recommended to avoid the need for extensive work to identify different X s.
 - the service quality thresholds should be rolled forward at their current levels.
- 5.8.6. The current Part 4A should stay in force until 31 March 2011 whether or not changes arising from this review are passed into law. This would allow over two years (if legislated changes are passed in 2008) for an orderly implementation of the changes, which would contribute to certainty and investor confidence over the transition period.
- 5.8.7. It would be within the statutory powers of the Commission to follow this transition path, but there are no provisions for the Minister to require it to do so. However, a relatively smooth transition is in the interests of the Commission, consumers and suppliers. It may be appropriate for the Minister to write to the Commission and suggest this transition path at the earliest opportunity.

6. Conclusions and Recommendations

- 6.1.1. Powerco's objectives for engaging in this process are to offer constructive recommendations that enable pragmatic solutions to be put in place. As part of our engagement and desire to contribute to New Zealand's understanding of economic regulation, Powerco commissioned Case Associates¹⁴ to provide an independent assessment of the current regime. We believe that the insight and experience that the authors offer to the discussion is extremely valuable.
- 6.1.2. Powerco and its owner Babcock & Brown Infrastructure Limited (BBI) accept that Governments have a role in the regulation of natural monopolies. Accordingly, we are of the view that we need to be pragmatic and focus on the solutions for New Zealand. It is our view there is little value to be had in continuing to question the merits or otherwise of implementing economic regulation for natural monopolies, since the uncertainty this creates is not advantageous to investors or to a Government wanting to build a robust and effective regulatory regime.
- 6.1.3. To this end Powerco has focused our submission on recommending pragmatic solutions for three key issues, which we believe are criteria to ensuring the successful application of ex-ante, incentive based regulatory regime in New Zealand. These are:
- using economic regulatory mechanisms for the right reasons;
 - developing a regime that builds trust and confidence for consumer, Government and investors;
 - supporting regulatory solutions for the long term benefit of consumer; and
 - supporting regulatory solutions for an electricity industry with a number of participants of different sizes and ownership structures.
- 6.1.4. We believe that economic regulation was not intended to act as a sanction, which involves transferring wealth from the producer to the consumer. Rather, our understanding is that economic regulation is a pragmatic solution, a regulatory framework designed to act as a proxy for a competitive market. Therefore, economic regulation is intended to simultaneously protect consumers as well as to promote efficient investment and operation.
- 6.1.5. We believe an effective economic regulation regime requires a robust regulatory framework with clear guidelines on the objectives and implementation of the regime. In addition, the regulator should be required to determine which regulatory models are to be used and stay with its decisions as to which model to use and how it is to be used.
- 6.1.6. The regulator can be assisted through use of regulations and/or licences to provide directions as to the most appropriate models to use given the natural monopoly services in question. A central advantage of this approach to regulation is the commitment to putting the rules in regulation upfront.
- 6.1.7. There are a number of design features that need to be present in order to capture the full benefits of this approach to regulation namely:

¹⁴ Case Associates, *Effective Regulation: Assessment and Reform of Economic Regulation of Electricity Distribution Services in New Zealand, June 2007*, (provided as a separate submission).

- separating the policy function of setting the rules from the regulatory function of applying the rules;
 - the availability of merits review;
 - low discretion regulation; and
 - stability in the rules.
- 6.1.8. Finally, we believe the solutions offered for the electricity sector are a pragmatic response to economic regulation. With that in mind we support the three pathway approach proposed by the Electricity Networks Association (ENA).
- 6.1.9. The most important consideration is that all regulatory models are clear, well understood and implemented in advance, through regulations or licences. This approach will enhance regulatory certainty and signal the Government's commitment to investors of natural monopoly services operating under Part 5.

