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**SUBMISSION**  
**TO THE MINISTRY OF ECONOMIC DEVELOPMENT ON THE**  
**REVIEW OF THE REGULATORY CONTROL**  
**PROVISIONS OF THE COMMERCE ACT 1986**

**BY**

**PowerNet**  
Limited

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## 1. INTRODUCTION

- 1.1 The Ministry of Economic Development has invited interested parties to give their views on the review of the regulatory control provisions of the Commerce Act 1986 (the Act).

This paper represents some of the views of PowerNet Limited (PowerNet) with respect to the issues raised in the paper based on PowerNet's experience of the regulatory environment to date.

## 2. BACKGROUND

### **PowerNet Limited**

- 2.1 PowerNet is a network management company with a head office in Invercargill. PowerNet was established in 1994 as an incorporated joint venture to manage the electricity assets of its owners Electricity Invercargill Limited (EIL) and The Power Company Limited (TPCL).
- 2.2 PowerNet has subsequently won contracts to manage the electricity distribution networks of Otago Power Limited (OPL) and the Stewart Island Electrical Supply Authority (SIESA).
- 2.3 In June 2002 the electricity distribution assets of OPL were sold in an open market competitive sale process to EIL, TPCL and Marlborough Lines Limited (MLL) acting as the OtagoNet Joint Venture (OJV). PowerNet retained the management contract with OJV following that change of ownership.
- 2.4 The networks currently under PowerNet's management have an ODV in excess of \$350 million and convey over 1,350GWh through 13,500 km of lines and cables to 65,000 consumers. The networks under PowerNet's management are EIL, TPCL, OJV, and SIESA.
- 2.5 The line businesses managed include some of the least (OJV) and most dense (EIL) in New Zealand and have had various forms of ownership including:
- Local authority (EIL, SIESA)
  - Consumer Trust (TPCL post 1998)
  - Central Government (TPCL pre 1998)
  - Consumer Cooperative (OPL)
  - Investor owned (OJV)
- 2.6 The X factors allocated by the Commerce Commission (the Commission) resulted in the three regulated networks PowerNet manages receiving C factors of two efficient and one average efficiency rating and two low returns and one average return rating.

### **Price Path Breaches**

- 2.7 Two of the networks PowerNet manages being TPCL and OJV have chosen to breach the price path with prices increases above the threshold in the assessment period ending on 31 March 2006 and these breaches have continued into 31 March 2007 and will continue though until the end of the current reset period.

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- 2.8 The breaches related to price increases on 1 April 2005 for TPCL and 1 July 2005 for OJV. As submitted to the Commission the increases were broadly to prevent impairment writedowns of the network asset values, to fund investment in the networks and to provide the owners with an improved and more reasonable return on their investment.
- 2.9 In 2006 the Commission opened two new inquiries following the receipt of the price path and quality threshold statements. The inquiries relate to TPCL and OJV. The present status of the inquiries is: we have provided the Commission with initial information in response to their standard letters which has been followed up by the Commission seeking clarification of some items which has been provided.
- 2.10 We presently await further developments from the Commission.

#### **Quality Breaches**

- 2.11 Two of the networks PowerNet manages (EIL and OJV) have breached the quality thresholds due to a number of reasons including an extreme event in 2004 which has been cleared by the Commission, a series of extreme events in 2004 which have yet to be cleared by the Commission.
- 2.12 Further breaches of the quality threshold have occurred for OJV mainly due to an increase in planned outages on the OJV network due to a significant increase in the capital work being undertaken.

### **3. OTHER SUBMISSIONS**

- 3.1 PowerNet has involvement with other submissions that are being made as part of this review of the Act. We support these submissions in principle while recognising that they each bring different views on certain aspects of the review. We see this as a positive outcome as a wider range of views will further serve to inform the MED on the issue before it.

### **4. EXECUTIVE SUMMARY**

- 4.1 At the inception of the current regulatory period there was realization amongst the stakeholders that the first regulatory period was always going to have a steep learning curve for all the Commission and lines businesses alike. Perhaps this could be seen as a period of uncertainty.
- 4.2 Looking back there has undoubtedly been a steep learning curve but there are still far too many key parameters and areas that are arguably unresolved or wrong such as regulatory asset base values, return on investment, tax treatments, pass through costs, extreme event criteria and outstanding breaches and inquiries to name a few. Unfortunately this uncertainty has continued too long from an investor perspective and probably from a regulator and Government perspective.
- 4.3 The number of breaches either deliberate or otherwise and the simultaneous need to establish key parameters to deal with the breaches has proven to be either costly or unmanageable from a sector or regulator perspective.
- 4.4 However, in our view we do not see that the current thresholds regime has performed in a manner that requires abandonment of the thresholds and the implementation of something new. A new round of uncertainty would result from such an outcome. We believe there needs to be some adjustment to the existing regime and support the general thrust of the paper prepared by the MED which appears to be heading in this direction.

- 4.5 In principle we see it as being particularly important that there is a regulatory environment that:
- Minimises uncertainty to investors.
  - Provides a balance between price, quality and returns.
  - Considers the net benefits to the public.
  - Is manageable and cost effective.
  - Provide incentives to invest and improve efficiency.
  - Allows for perceived errors to be questioned.
- 4.6 To enable this to happen we believe that the following suggestions would help address the above points:
- Bringing an investor view point to the purpose statement
  - An extension of the current regulatory period
  - The introduction of a merits review
  - A propose / respond regulatory pathway
  - An alternative pathway for consumer owned networks
  - Information disclosure and monitoring through benchmarking
  - Refined price path and quality thresholds
  - A legislated timeframe for addressing breaches and inquiries

## 5. THE PURPOSE STATEMENT

- 5.1 PowerNet supports a change to the purpose statement that will bring balance to the regulatory environment through considering investment incentives. We recognise that the inclusion of investment incentives in the purpose statement adds balance care needs to be taken that it will not add conflict and further uncertainty for all concerned.
- 5.2 Rather than delving into the merits or otherwise of the statement we refer you to the LECG, Castalia and PricewaterhouseCoopers (PwC) submissions.

## 6. THE REGULATORY RESET AND A REVIEW

- 6.1 PowerNet is extremely concerned about the conflicts and confusion that will arise as a result of carrying out a review of the Act and at the same time designing the next reset when the outcome of the review of the Act is not known. Better use of the Commission's valuable time would be achieved by designing the reset after the review of the Act is complete.
- 6.2 **PowerNet strongly urges that the current CPI-X regime is extended for a period of up to two years (similar to the present arrangement that exists for Transpower) to enable the regulatory reset to take into account changes to the Act resulting from the review. We recommend an X of zero is used for all businesses in that period.**

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## 7. MERITS REVIEW

- 7.1 PowerNet is of the view that the credibility of the existing regime will be enhanced by the inclusion of a merits review process. In PowerNet's view some of the decisions of the Commission have been potentially challengeable for various reasons. One item in particular is tax.
- 7.2 Any merits review process should be limited to specific areas and should not be a forum for items of a frivolous nature.
- 7.3 While it is recognised as being costly and could potentially delay decisions it will add a level of credibility to the regulatory environment and result in improved decision making. We recommend that an independent panel be used.

## 8. A PROPOSE / RESPOND PATHWAY

- 8.1 For reasons mentioned earlier in our submission two of the entities PowerNet manages have deliberately breached the price path threshold. In effect these breaches have operated as a form of propose and respond however due to the design of the thresholds our 1 April 2005 price increase which has led to the 31 March 2006 breach was not able to be considered until some 14 months after the event when the threshold compliance statement was submitted to the Commission. This delay and the existing work streams the Commission has had to deal with has resulted in both breaches progress no further than an initial standard letter from the Commission requesting information.
- 8.2 Due to the design of the threshold regime the Commission is not even able to deal with the breach in a timely manner despite being notified of the increases beforehand. The reason being there was no formal breach of the thresholds. In the meantime both the entities that have breached have made significant increases in the level of investment in their capital and maintenance work programmes. This has required an additional contracting work force which has required investment in new trucks and equipment, increases in pay rates to attract new employees to the sector and a great deal of time and training in those employees.
- 8.3 PowerNet believes that lines businesses require more certainty from the regulator with respect to their pricing, investment decisions and allowable returns. Such decisions will naturally reflect in the investment made in the network assets. Attracting and building up a work force to undertake investment in the networks has long lead times and is not able to be easily turned on again after it has been turned off.
- 8.4 To provide the certainty for those that require it **PowerNet recommends that a propose respond pathway is included as an option for companies to choose.**

## 9. CONSUMER OWNED LINES BUSINESSES

- 9.1 As outlined above there are a considerable number of work streams that the Commission presently has on its plate which has been added to from breaches due to the design of the thresholds regime. PowerNet understands there have been over 127 breaches amongst the 28 lines businesses since 2003 of which an ever increasing number (now 102) are still unresolved. Some of the breaches dating back to 2003 are still unresolved.
- 9.2 The design of the quality threshold results in a lines business having approximately a 50% chance of breaching the threshold each year. For most businesses this probability will be significantly higher due to increases in capital and maintenance work. For some who have made technology improvements the chances will be less. The reality in a normal year there are likely to be 14 of the 28 lines businesses breaching the either the SAIDI or SAIFI elements of the quality threshold.
- 9.3 The introduction of a price path threshold with low X's for business that had returns at levels well below WACC (mainly due to implicit discounts by Trust owned companies) was always going to lead to asset impairment issues for those who complied with the thresholds. TPCL and OJV are two examples of lines businesses that have breached the price path threshold as a result of the setting of unrealistically low X's.
- 9.4 PowerNet believes that the responsibility for ensuring consumers receive a reasonable quality service for a reasonable price at a reasonable return should be handed back to the owners of those lines businesses who have the ability to influence and make changes to boards and companies who are not performing adequately. PowerNet sees that lines businesses with Consumer Trust and/or Territorial Local Authority (Council) ownership are best placed to monitor price and quality through the Statement of Intent and Asset Management Plan processes and influence these areas through the appointment of Directors.
- 9.5 Removing these lines businesses from the price path and quality threshold process will have the added benefit of freeing up regulator time to deal with issues of significance without having to deal with the present backlog of seemingly low priority breaches which have been mounting over time.
- 9.6 **PowerNet recommends the removal of lines businesses whose consumers lie within the ownership boundaries such as Consumer Trusts and Councils from the regulatory regime and that the previously light handed information disclosure and regulatory benchmarking which is publicly notified (not unlike the Ernst and Young lines businesses ratings of the late 1990's and early 2000 era) be utilised to ensure reasonable behaviour, performance and efficiencies are maintained by these lines businesses.**

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**10. INFORMATION DISCLOSURE AND MONITORING THROUGH BENCHMARKING**

- 10.1 As mentioned above Ernst and Young published a list of lines business ratings (albeit crudely rated) in the late 1990's and early 2000's. The reality of the publishing was that lines businesses paid attention to where they were rated and a competitive desire to improve ones relative rating developed over time. The ratings we publicly notified and commented on by the media.
- 10.2 As a result a culture of self congratulation and naval gazing developed over time. Numerous references were made by highly rated lines businesses to the ratings and although poor performers discredited the ratings they did try to improve their relative position.
- 10.3 **PowerNet recommends that as part of the information disclosure and benchmarking process carried out by the Commission that a publicly notified ratings system be considered,** perhaps not dissimilar to the Meyrick C factor analysis.

**11. A LEGISLATED TIMEFRAME FOR ADDRESSING BREACHES AND INQUIRIES**

- 11.1 PowerNet is of the view that some of the breaches that the Commission has had to deal with are of a nature that is too small (in nature or number of consumers affected) to warrant prioritizing as resolving them may set precedents that will allow other higher priority breaches to be predetermined.
- 11.2 No doubt similar issues exist for other entities such as the IRD and taxpayers, however the IRD are restricted by statute from investigating tax returns outside a certain period.
- 11.3 **PowerNet recommends that a statute bar period be considered for outstanding breaches that have not been progressed to the inquiry level by the Commission (and for inquiries where no correspondence has been made by the Commission within a defined period of time).**