

Submission to the
Ministry for Economic Development on
Review of Regulatory Control Provisions under the Commerce Act
1986 Discussion Document

June 2007

Review of Regulatory Provisions under the Commerce Act 2006 Discussion Document

Summary

This submission is particularly focussed on the electricity transmission and distribution sector.

In this submission we argue that the current regime provides a disincentive to investment and does not focus on achieving the optimal economic outcome for the community served. We propose a regime which:-

- encourages investment to address growth and security of supply issues
- provides incentives for continuous performance improvement
- moves away from a reallocation of wealth between provider and consumer model, and which looks at maximises the economic wellbeing of the community served.

Introduction

Priority One is the economic development agency for Tauranga and the Western Bay of Plenty. Unlike many EDAs, Priority One is driven largely from a private sector membership, comprising over 200 local companies, and is funded through contributions from members and from the three local authorities.

Priority One is concerned at perceptions that the power supply in the Western Bay of Plenty is fragile, and that this undermines business confidence, with a potential to inhibit regional investment. It is important to achieve a stable and certain regulatory environment to facilitate investment in electricity infrastructure. In a high growth community there are long term risks of underinvestment.

The Western Bay of Plenty sub-region is experiencing strong population growth which is expected to continue.

- The current population is 147,100.
- The region has experienced a growth rate of 12.9% from 2001 to 2006, and projections are for the population to reach 198,000 by 2021 and 284,000 by 2051.
- This growth rate is approx twice the national average.
- By 2013, Tauranga will be New Zealand's 4th largest city (counting Auckland as one city).
- GDP for the sub region is expected to grow above the national rate, averaging 2.5% pa over the next 50 years.
- Total employment is projected to increase by 70% by 2051.
- The development at Papamoa East will house 40,000 people.

In this high growth environment it is essential that investment in electricity infrastructure not only keeps pace with sub-regional demand, but also that existing deficiencies in the network are addressed.

To ensure that this growth is planned and managed, the Councils in the region have partnered with community agencies, to form SmartGrowth – a long term growth management strategy

targeted at ensuring infrastructure is built ahead of demand, and that growth is managed in a sustainable way. Smart Growth has planning horizons of 20 and 50 years.

SmartGrowth and Priority One have lead roles in advocacy to ensure sufficient capacity and security of electricity supply for the sub-region.

Recently Priority One organised a workshop where representatives from the four local councils, the Smart Growth chairman, and Priority One, met with Powerco and Transpower to discuss security of power supply for the sub and full region. Representatives from a number of generator/retailers also attended. It was very clear in this meeting that in many cases the regulatory regimes imposed on the transmission and distribution companies provide a disincentive to investment, which means that investment to address growth and reliability issues may be sub optimal.

In writing this submission we acknowledge that we do not have a complete understanding of the various tools which are used under the thresholds regime to control behaviour of transmission and distribution companies. Our submission is therefore based on looking at the importance of a secure electricity system to the local economy, and the need to look beyond simple control of monopoly behaviour, to establishing a regime which recognises that consumers should be protected, and also incentivises natural monopolies to invest. The consequence of this would be continuous performance improvement, to meet reasonable consumer demands, and which would optimise the economic value to the community.

Significance of a secure electricity supply

A modern economy has a very high dependence on a secure power supply. With the advent of electronic data processing and communications, most companies cease to operate during a power outage. There is thus a strong trade off between the cost of provision of electricity supply, and the economic value to the consumer.

Unlike other services, electricity is supplied in real time. It cannot be stored, and alternative forms of supply are generally cost prohibitive, except for mission critical activities, where some companies install standby generators. Customers have negligible ability to switch to other services in the event of a disruption.

The costs of a power outage can be substantial. Not only do companies lose production and revenue when they cannot produce, but they are also exposed to additional costs in paying for unproductive staff in anticipation of the power supply being restored. In the Western Bay of Plenty we have a number of companies employing large numbers of people in semi rural areas. Fault tracing and network repairs in these areas can take long periods, resulting in heavy costs to industrial consumers.

Transmission and distribution costs make up a relatively small component of a consumers power bill, yet the transmission and distribution providers have the greatest impact on security of supply. Rarely does a generation fault result in an outage to the consumer. There is anecdotal evidence that consumers demand for high levels of reliability and capacity means that they would be prepared to pay more, for these services. This is about understanding consumer demands and then creating the investment to meet these reasonable demands

For investors to be willing to commit to doing this requires them to operate within a regulatory regime where the regulator is making judgements about the future tradeoffs between the increased prices resulting from the investment, and the additional benefits that would arise. It would be desirable to have a regulator regime where the regulator is focussed on making these judgements about the future, rather than criticising investments of the past. Required is a regime where investment is recognised as an objective that the regulator is focussed on obtaining, rather than a secondary consideration to that of protecting today's consumers.

To this end, the current focus on restraining network providers' profits has the potential to result in sub-optimal performance, with cost impacts to the community in excess of the value of the price/profit under control. In setting any regulatory intervention, a balance must be achieved between the impact on the provider (i.e. profits and incentives) and the impact on the local economy.

Focus of Commerce Act

The primary focus of the Commerce Act is to maintain and promote competition. In the case of monopoly businesses, the predominant regulatory mechanism is to impose sanctions restricting the achievement of super profits by monopoly businesses. The drawback of this approach is that the focus is on redistributing wealth by restraining the monopoly provider, rather than looking at the net benefit or otherwise to the overall economy.

There is nothing fundamentally wrong with a sanctions approach, if you are dealing with markets that could feasibly be competitive. The lines companies, however, operate in an environment where they are natural monopolies, where it is reasonable and desirable to have a single provider. This arises from the economies of scale from a single provider, compared to the costs of duplicated and underutilised assets which would arise in a fully competitive model. In this environment a sanctions model is inappropriate. A sanctions regime:

- is backward looking and questions investment decisions already made,
- does not encourage commitment between the regulator, government and investors to ongoing investment, and,
- takes the focus away from looking at the net economic benefit (or otherwise) to the community of having the provider offer service options to the community

From a consumer perspective, concerns over security of supply, as measured by power outages, and investment to address growth, prevail over the issue of price for the service. We support a regime where one of the objectives is to protect consumers against excessive pricing, but one which also incentivises performance and investment for the economic growth of the community.

There have been examples overseas where overly heavy handed regulation has led to the collapse of electrical infrastructure, imposing an economic burden on the community vastly greater than the value gained from the regulation. This demonstrates the asymmetrical risk profiles between the service provider and the community serviced.

It is important in reviewing the electricity sector regulatory regime, to take a community economic view, rather than view economic regulation as being about transferring profits earned by service providers to today's consumers.

Criteria for regulation

The discussion paper proposes a test for when regulation may be imposed. The proposed test comprises:

“economic regulation is necessary or desirable to

- *Provide efficiencies in a market*
- *Provide long term benefits to persons acquiring the goods and services that exceed the direct and indirect costs of regulation.”*

We support this proposal as it moves the analysis beyond simply looking at the costs to the service provider, and introduces a balance of requiring a review of whether there is benefit to the consumer. This should address the issue of price vs performance.

Threshold regime

The discussion paper identifies that the threshold regime does not target optimal performance, and may result in the regulator focussing on the wrong firms. The threshold regime has no impact on companies who are able to operate within the established thresholds. Similarly there is a lack of consistency in actions taken in the event of a breach. This creates an environment of uncertainty, which restricts companies' willingness to invest and impedes service providers from directly addressing the needs of the community.

What is needed is a regime which incentivises continuous performance improvement, for all service providers, with the regulator able to focus on clear performance breaches.

As an example, the current Powerco SAIDI threshold is set at the average of the previous 5 years performance. Even with modest performance improvements, there is a high probability (close to 50%) that they will breach this performance threshold. The consequence is an expensive and time consuming investigation, yet we understand that where companies have made similar breaches, none have resulted in regulatory controls being imposed.

This approach does not incentivise performance improvement, and there is no data to demonstrate whether this results in a “soft” or “hard” target, or indeed whether a breach warrants intervention by the regulator.

We support the abolition of the thresholds regime and suggest the use of a commercial negotiation regime, which would discover the appetite of consumers for trade offs between price and service delivery. Benchmarking against other providers would inform those negotiations.

CPI-X

CPI-X is a recognised device to force continuing downward pressure on prices. It is particularly relevant to large stable organisations with a high potential for productivity improvement – e.g. high labour content businesses.

We understand that CPI-X is a threshold established by the Commerce Commission and not a direct requirement of the Commerce Act. It is however relevant to investment in the electricity industry and deserves comment.

Our recent regional electricity forum indicated that the CPI-X regime had the potential to inhibit investment to address growth or system reliability issues. In particular, CPI-X is not appropriate for capital intensive industries with long investment cycles (where there is little ability to achieve cost reductions between investments) and where new asset costs have recently incurred substantial price increases. Examples given were recent step changes in international prices for electrical copper for conductors, and for high quality magnetic steels for transformers. Our comments under thresholds apply to the CPI-X regime.

Purpose Statement

The current purpose statement (s 57E), focuses on limiting monopoly company profits. The discussion document proposes including a statement to have incentives to innovate and to invest. We support this proposal.

While this goes some way to address the need to incentivise investment, we suggest that there is an additional requirement to balance the costs/prices for consumers against the broader economic interest of the community served. For example, a relatively minor imposition of prices/profits may limit investment and impose substantial economic impacts on the community.

Alternative Risk/Reward regimes for electricity transmission and distribution companies.

The current regulatory regime is based on first establishing a breach, before interventions are made. The process for establishing acceptable performance, and therefore setting the limits at which a breach is identified are not robust. There is potential for companies to take advantage of “soft” thresholds, while the regulator may inappropriately target companies with “hard” thresholds.

What is needed is a regime which provides ongoing incentives for continuous performance improvement. Such models exist in private sector relationship contracts such as alliancing or partnering. In essence a power distribution company is in partnership with the community it serves, and a partnering approach is a legitimate solution.

A typical model for this style of contract is for open book direct flow through of costs, with returns to shareholders being linked to achievement of performance criteria. Elements of the incentive regime profit linked KPI's could include:

- Network reliability improvement
- Cost reductions to consumer
- Public and employee safety.
- Comparative benchmarking

While this concept is possibly outside the scope of a review of the Commerce Act, it potentially provides an environment where the interests of the monopoly provider and the community served are aligned, and where incentives are in place to reward behaviour which is in the interests of the community. Under this type of regime, the need for regulatory intervention would be much reduced.

Repeal of Part 4A

We have previously discussed shortcomings with the thresholds system, which is the focus of part 4A.

We support the establishment of a regime based on comparative benchmarking, but which enables individual companies to develop individual proposals for consideration by the Commission. This regime would enable an appropriate balance to be achieved between competing issues of price, system performance, investment, return to the investor, and economic benefit to the community.

Summary of submission points

We support the following:

- Development of a purpose statement which provides incentives to innovate and invest for improved performance
- Inclusion of a requirement in the purpose statement for regulations to consider efficiency and performance improvement as well as consumer price protection.
- Inclusion of a requirement in the purpose statement for interventions to be balanced against the greater community economic performance.
- Removal of the thresholds regime, in favour of a commercial negotiation system, backed by benchmarking against other providers.
- Removal of the CPI-X regime in favour of a community partnership regime which balances investment against the needs of the community, and which allows the service provider a reasonable rate of return on that investment.
- Establishment of a benchmarking regime which would enable the public to readily identify relative performance of their local electricity network provider.
- Repeal of section 4A and establishment of a comparative benchmarking regime

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