

Submission to the Ministry of Economic Development

Review of Regulatory Control Provisions
under the Commerce Act 1986



6 July 2007

SUBMISSION TO THE MINISTRY OF ECONOMIC DEVELOPMENT

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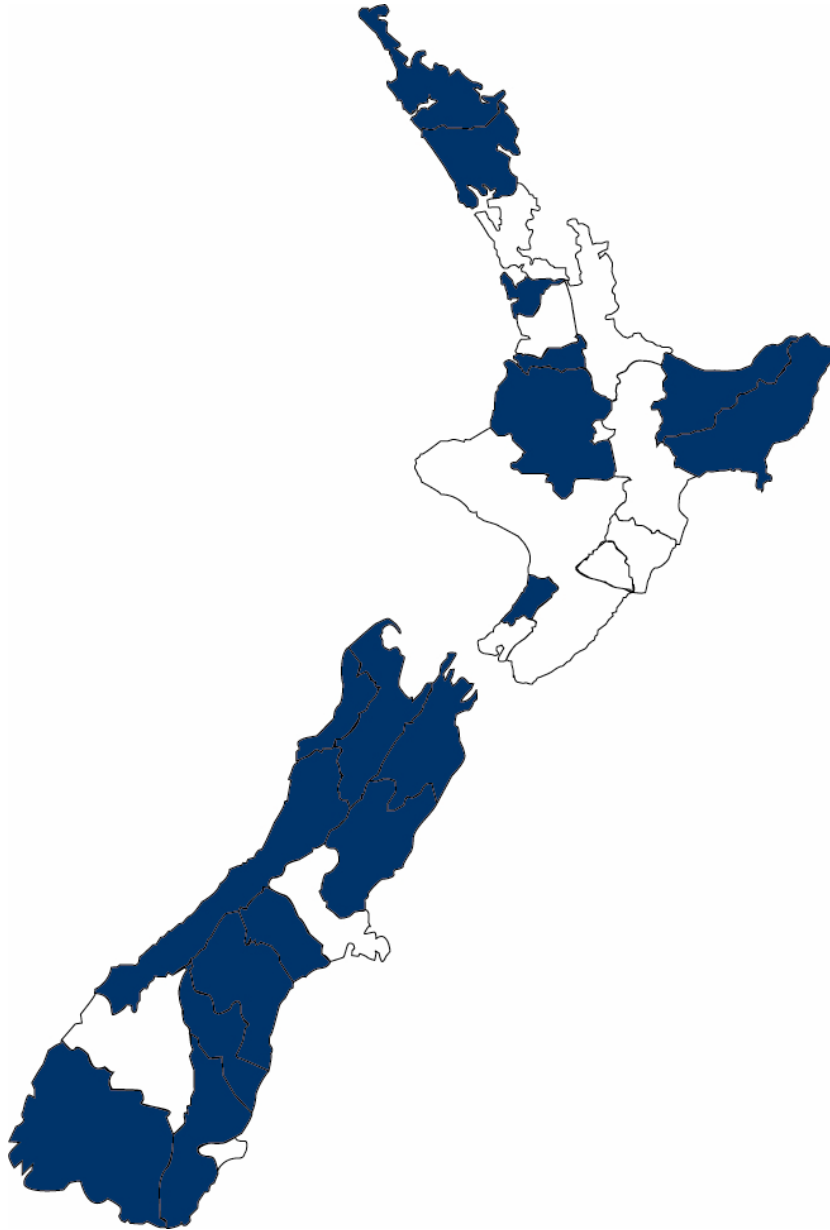
I) INTRODUCTION

The Ministry of Economic Development (“the MED”) has initiated a review of the regulatory control provisions of Parts 4, 4A and 5 of the Commerce Act (“the Act”). It is these provisions which provide for the economic regulation of markets where there is little or no scope for competition, such as natural monopolies. As part of the MED’s consultation process the following discussion paper has been released: “Ministry of Economic Development, Review of Regulatory Control Provisions under the Commerce Act 1986, Discussion Document, April 2007” (“the Discussion Document”).

The MED has sought submissions on the Discussion Document from interested parties. This submission has been prepared by PricewaterhouseCoopers on behalf of the following 20 large Electricity Lines Businesses (“ELBs”):

- Alpine Energy Limited
- Buller Electricity Limited
- Counties Power Limited
- Eastland Network Limited
- Electra Limited
- Electricity Ashburton Limited
- Electricity Invercargill Limited
- Horizon Energy Distribution Limited
- MainPower New Zealand Limited
- Marlborough Lines Limited
- Nelson Electricity Limited
- Network Tasman Limited
- Network Waitaki Limited
- Northpower Limited
- OtagoNet Joint Venture
- The Lines Company Limited
- The Power Company Limited
- Top Energy Limited
- Waipa Networks Limited
- Westpower Limited.

The following map highlights the supply areas represented by the submission group.



This group of ELBs together comprises 484,712 connections (or 25% of the total electricity lines sector), and 63,374 system kilometres (41% of the total electricity lines sector). The ownership structures represented include consumer and community trusts, a listed company, local body and co-operative ownership, as well as those managed by management companies. Group members include networks with predominantly urban systems, others that are sparsely populated and a number with significant urban areas combined with rural and remote rural characteristics.

The following table summarises the key characteristics of the group.

Lines Business	System Assets at ODV \$000	System Length km	ICPs number	Network Supply Area km ²	Density ICPs/km
Alpine Energy	88,582	3,816	29,163	10,596	7.6
Buller Electricity	20,277	587	4,211	4,654	7.2
Counties Power	115,580	3,260	34,813	2,220	10.7
Eastland Network	92,501	3,667	24,864	11,858	6.8
Electra	101,507	2,179	40,458	1,628	18.6
Electricity Ashburton	116,190	2,802	15,795	6,664	5.6
Electricity Invercargill	44,494	681	16,889	33	24.8
Horizon Energy Distribution	73,501	2,404	23,887	8,389	9.9
MainPower New Zealand	127,559	4,420	30,671	12,000	6.9
Marlborough Lines	107,869	3,213	22,932	11,272	7.1
Nelson Electricity	20,290	244	8,915	24	36.5
Network Tasman	115,966	3,265	34,400	10,800	10.5
Network Waitaki	49,703	1,994	12,006	7,741	6.0
Northpower	141,682	5,586	50,753	5,737	9.1
OtagoNet Joint Venture	89,423	4,344	14,497	12,349	3.3
The Lines Company	98,940	4,409	26,181	13,623	5.9
The Power Company	209,109	8,540	32,243	28,740	3.8
Top Energy	100,702	3,987	28,486	6,830	7.1
Waipa Networks	59,948	1,955	21,538	1,864	11.0
Westpower	76,808	2,021	12,010	18,017	5.9
Group Average	92,532	3,169	24,236	8,752	10.2
Group Total	1,850,631	63,374	484,712	175,039	
Industry Total	6,151,915	154,211	1,904,630	266,034	
% of Industry Total	30.1%	41.1%	25.4%	65.8%	

Source: New Zealand Gazettes, Electricity Lines Business Information Disclosures, 2006

Scope of this Submission

Part 4A of the Act currently provides for the Commerce Commission (“the Commission”) to implement a statutory scheme for the regulation of electricity distribution and transmission services supplied by electricity lines businesses, line owners, and electricity distributors – collectively, ELBs. The key features of Part 4A which are relevant to ELBs are:

- a threshold regime (subpart 1), by which a declaration of control may be made if the Commission assesses an ELB has breached the thresholds the Commission sets;
- a declaration regime (subpart 1), which specifies the process to be followed by the Commission when making a declaration of control; and
- the information disclosure regime (subpart 3) for public information disclosure by ELBs.

Section 57E of Part 4A of the Act contains the Purpose Statement which provides the framework for the Commission in interpreting the requirements of Part 4A and states that the purpose of the targeted control regime for ELBs is:

“To promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers-

- a) are limited in their ability to extract excessive profits; and*
- b) face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- c) share the benefits of efficiency gains with consumers, including through lower prices.”*

If an ELB breaches a threshold, the Commission will commence a post breach inquiry process, which may or may not result in the imposition of price control. Once a decision to impose control has been made, the controlled good or service may not be supplied unless an authorisation to supply has been made by the Commission under sections 70-74 of Part 5 of the Act.

The existing thresholds applicable to ELBs expire at 31 March 2009. The Commission has already initiated its consultation process for the threshold reset. The Commission is also currently undertaking a major review of the information disclosure requirements currently implemented under subpart 3 of Part 4A.

The Discussion Document raises a number of issues, and proposes some alternatives to the current provisions for ELBs under Part 4A. Accordingly this submission focuses on issues of direct relevance to the electricity lines sector under Parts 4, 4A and 5 of the Act and in particular those issues which have direct implications for how ELBs are regulated post 31 March 2009.

Structure of the Submission

The submission is presented in eight sections, as follows:

- I) Introduction
- II) Key Points of the Submission
- III) The Objectives of the Review
- IV) The Purpose Statement and Regulatory Criteria

V) Regulatory Options for ELBs

VI) Regulatory Parameters

VII) Accountability

VIII) Next Steps.

Contact Details

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II) KEY POINTS OF THE SUBMISSION

1. *Objectives of the Review* - We are extremely concerned that the current regime has disincentivised crucial investment and efficiency gains in the lines sector by creating uncertainty for investors as to their ability to innovate and fund and recover the cost of their investment including a reasonable return on that investment. Accordingly reducing regulatory uncertainty to provide sufficient incentives for innovation and efficient investment is the primary concern for the ELBs which support this submission.
2. *The Purpose Statement and Regulatory Criteria* - We support the inclusion of a specific regulatory Purpose Statement which applies to Parts 4, 4A and 5 of the Act. We also support the proposed amendment which specifically recognises the need to incentivise ELBs to innovate and invest and that any regulatory decisions must consider this requirement along with economic efficiency and consumer protection incentives. We are concerned however at the inherent conflicts that exist within the Purpose Statement specifically in relation to the inclusion of the additional proposed requirement. It is likely that the achievement of the incentive criteria for innovation and investment by suppliers will need to be met before customer welfare criteria can be. Thus we submit that all regulatory decisions should be required to demonstrate consistency with parts b) and d) of the Purpose Statement.
3. *Regulatory Options for ELBs* - Much of the complexity and frustration that exists with the current regulatory regime for ELBs stems from the need to accommodate 29 ELBs (including Transpower). This has been compounded by the most recent post breach investigation processes adopted by the Commission which have expanded to include any potential concerns with performance relative to Part 4A, rather than focussing on the cause of the breach itself. The regime and the implementation thereof for ELBs, must be simplified if it is to meet the objectives of Part 4A and be able to be administered in a manner which is manageable and cost effective for the regulator and the industry. The unique ownership structures evident across much of the industry provide the most workable solution to this issue. We therefore propose for ELBs that Part 4A is retained, but that ELBs may elect either of the following alternatives if they so choose:
 - (a) For ELBs whose consumer footprint is the same as their owner's footprint, an option whereby such ELBs may elect, after consultation with their consumers a disclosure regime which requires the ELB to demonstrate performance consistent with the Part 4A Purpose Statement.

- (b) For all ELBs, if they so choose, a Propose/Respond model whereby they propose specific control terms, consistent with the Purpose Statement – similar to that proposed in the Discussion Document.

These options would be underpinned by thresholds for those unable to elect (a) and who do not require the specific terms that would result from choosing (b).

- 4. *Regulatory Parameters* - We strongly support the determination of input methodologies at the beginning of a regulatory period. One of the reasons the current regulatory regime for ELBs has become convoluted and ineffective is that these methodologies are being determined progressively as each investigation proceeds. The determination of input methodologies should be limited to the methodology itself, not the specific assumptions and inputs required to apply the preferred methodology, as these are likely to be firm specific and they will change over time. They should also be set by entities which are independent of policy makers and ideally independent of those responsible for administering the regime.
- 5. *Accountability* - We support the proposal that merits reviews be provided for setting control terms and actions following a breach. We also believe, given the significance of the decisions, merits reviews should apply to setting recommended input methodologies and Propose/Respond decisions. This process should be supported by a strengthening of the requirements for the regulator to justify its decisions specifically against each component of the Purpose Statement.
- 6. *Next Steps* - The Discussion Document does not include a forward looking timetable for the review, although we understand from officials that it is possible that new legislation may be drafted later this year with implementation mid 2008. We are extremely concerned at the implications of this potential timetable for ELBs in the context of the targeted control regime. We therefore propose that interim thresholds should be implemented at 1 April 2009, consistent with the existing framework and initially for a period of 12 months. If necessary this could be extended for a further 12 months if insufficient progress was made by that time. To make this process as simple and cost effective as possible, it would be acceptable to maintain the current quality thresholds for each ELB, and to adopt a CPI-X price path threshold for all ELBs with X equal to 0 for this period.

III) THE OBJECTIVES OF THE REVIEW

7. The Discussion Document identifies the following issues with the current thresholds regime for ELBs:

- The absence of a mechanism for firms to seek ex ante approvals for significant, step changes, in capital expenditure;
- Uncertainty as to the consequences of the thresholds breach; and
- A tendency for adversarial processes.

We agree that each of these is an issue which currently results in a regulatory regime for ELBs which does not meet the objectives of the Purpose Statement and has incentivised behaviours which are contrary to the long term interests of both suppliers and consumers of electricity distribution goods and services. We are extremely concerned that the current regime has disincentivised crucial innovation and investment in the lines sector by creating uncertainty for investors as to their ability to fund and recover the cost of their investment including a reasonable commercial return on that investment.

8. This increase in uncertainty has come at a crucial time for the electricity lines sector, where many assets are reaching the end of their useful lives and require replacement. At the same time, significant and sustained demand growth on many networks is requiring major network reinforcement. The current regulatory environment is very difficult for ELBs needing to make these investment decisions.

9. In addition, although the price path threshold is intended to create incentives for efficiency gains by imposing the CPI-X form of regulation, the manner in which the thresholds have been specified and are being administered has prevented much of the desired innovation from being implemented. The very existence of 29 ELBs suggests that enterprising partnerships, (for example through ownership or operating alliances or information sharing) could provide opportunities for innovation. Given the high degree of uncertainty that exists as to the likely outcomes for ELBs under the current regulatory regime and for the next regulatory period however, these incentives have been severely weakened.

10. We have also identified the following issues with the current application of Part 4A for ELBs:

- It is difficult to apply the Purpose Statement in practice because there are tradeoffs between its requirements meaning that they cannot all be met at the same time, or even within a regulatory period. As a result there is too much discretion available to the regulator in interpreting the Purpose Statement, particularly the relative weights applied to each requirement in each investigation. This leads to inconsistent regulatory decisions.
- There is no process available to challenge the decisions of the regulator other than via judicial review and there are insufficient requirements for the regulator to justify its decisions.
- The adoption of a benchmarking approach to setting thresholds has proven to be difficult to apply in practice because it is almost impossible to normalise for the factors which contribute to performance and are outside the influence ELBs.
- The thresholds were set using information which reflected a historical snapshot for each ELB, which did not take into account the events leading up to that period nor the future demands and decisions that needed to be made. Accordingly frequent breaches of the thresholds were inevitable and these have been mostly unintentional. The investigation process adopted by the Commission has resulted in very few of these being resolved.
- The current post breach investigation process adopted by the Commission is not limited to identifying the cause and potential remedies for the breach itself. It includes consideration of all aspects of performance of the ELB, including those unrelated to the breach. Given the nature of the thresholds, which have led to multiple unintentional breaches, this approach has provided the regulator with extremely broad powers of investigation into the electricity lines sector.
- Regulatory parameters and methodologies have been developed throughout the regulatory period as investigations have progressed, resulting in changes in emphasis and approaches within and between investigations.
- The process for negotiating an administrative settlement is unclear to everyone except those who have been or are currently engaged in one. The administrative settlement processes are also unacceptably prolonged, requiring significant amounts of rework on behalf of the ELB involved where information previously submitted becomes outdated.
- The information disclosure requirements are inconsistent with the thresholds and the review and restatement of these requirements has been continually and unacceptably delayed.
- The compliance cost to the industry is extraordinary and unacceptable, given the limited benefits achieved since the introduction of the regime.

- Resources within the Commission appear to have been insufficient to support the regime and the manner in which the Commission has chosen to implement and administer it.

11. As a consequence the practical implementation and administration of the regime has resulted in a level of uncertainty which has meant that most ELBs are currently extremely reluctant to breach their thresholds. This has resulted in de-facto control of all ELBs based on thresholds which did not in the first place fully reflect business specific circumstances, and were based on backwards looking information. These issues must be addressed for the next regulatory period and therefore we support this review.

Purpose of Regulation

12. We accept that where there is little or no scope for competition, such as in the electricity lines sector, some regulatory oversight is required to ensure services of a quality consistent with customer demands, are provided at efficient prices. We also accept that economic regulation should consider both economic efficiency and consumer protection principles. For owners and suppliers of services derived from long life assets, such as ELBs however, any regulatory oversight must recognise that short term efficiencies will come at the detriment of long term quality of supply. Thus the achievement of the economic efficiency and consumer protection objectives can only be met with sufficient consideration of the incentives for owners and suppliers to maintain and invest in assets for the long term.
13. Accordingly reducing regulatory uncertainty to provide sufficient incentives for innovation and efficient investment is the primary concern for the ELBs which support this submission.

IV) THE PURPOSE STATEMENT AND REGULATORY PARAMETERS

14. The Discussion Document proposes clarifying when economic regulation may or should be imposed by adopting a regulatory specific purpose statement and amended regulatory criteria to specifically address when regulation may be imposed.
15. Accordingly it is proposed that the existing Purpose Statement is amended to add part (d) as follows:

“Any regulation under this Part should seek to ensure that suppliers:

- (a) are limited in their ability to earn excessive profits;*
- (b) have incentives to improve efficiency and provide services at a quality which reflects consumer demands;*
- (c) share the benefits of efficiency gains with consumers, including through lower prices; and*
- (d) have incentives to innovate and to invest including in replacement, upgraded and new assets and in related businesses.”*

16. We support the inclusion of a specific regulatory Purpose Statement which applies to Parts 4, 4A and 5 of the Act. We also support the proposed amendment which specifically recognises the need to incentivise ELBs to innovate and invest. This will require any regulatory decisions to consider these objectives along side economic efficiency and consumer protection incentives.
17. We are concerned however at the inherent conflicts that exist within the Purpose Statement specifically in relation to the inclusion of the proposed additional requirement d). Firms will only invest and innovate if they are rewarded for their risk and investment. They will only seek efficiency gains if they are rewarded for these also. It is our view that the consumer welfare components of the Purpose Statement will not be met if the appropriate incentives for firms are not provided for. It is therefore likely that the achievement of the firms’ incentive criteria will need to be met before the customer welfare criteria can be. We therefore submit that all regulatory decisions must demonstrate how they are consistent with parts b) and d) of the Purpose Statement.

Whether and How to Regulate

18. In the context of ELBs, the competition criterion has appropriately been applied to the natural monopoly aspects of the electricity distribution sector. The current criteria contained in the Act for the whether to regulate decision is *“where competition is limited or likely to be lessened”*. As the Discussion Document correctly points out this is not

entirely suitable for businesses that are natural monopolies such as ELBs. Therefore for ELBs we support an amendment to the proposed competition criterion which makes it inclusive in its definition of competition and potential competition, as follows:

*“Goods or services may be regulated if there is little or no competition **and** prospect of competition in the relevant market”.*

19. We also support the proposed inclusion of both economic efficiency and consumer welfare tests for determining when control may be imposed, however we believe that the tests should be inclusive, that is the efficiency and distribution test should be:

“Goods or services may be regulated if economic regulation is necessary or desirable to:

- (a) promote efficiencies in a market; **and***
- (b) provide long term benefits to persons acquiring the goods or services that substantially exceed the direct and indirect costs of regulation.”*

20. The criteria should be inclusive because the costs of control are considerable for the regulator and the business, and there should be demonstrable benefits to the users of the goods or services under investigation before it is introduced. These two criteria, when applied together, will allow the regulator to prioritise its potential investigations and therefore significantly improve on the current implementation of the regime for ELBs.

21. We believe that the consumer welfare test must be defined as “substantial” benefits rather than the alternative proposal “clearly exceed”. There are a large number of assumptions and inputs that need to be derived in order to apply these tests in practice. These typically require judgement and it is rare that all interested parties will agree on the appropriate approach or input assumptions. Thus the outcomes of the tests are seldom definitive, and almost always result in a range of credible answers. Accordingly it is appropriate to ensure the tests for whether to regulate are based on having to demonstrate substantial benefits.

22. We also support a process which considers whether and how to regulate at the same time, given that the information requirements overlap considerably.

V) REGULATORY OPTIONS FOR ELBS

Current Regulatory Process for ELBs

23. Much of the complexity and frustration that exists with the current regulatory regime for ELBs stems from the need to accommodate 29 ELBs (including Transpower). This is a large number of individual entities which must be considered and has resulted in a regulatory model which is inherently different to those applied in other jurisdictions and which has imposed significant compliance costs across the sector. The adoption of the thresholds was an approach designed to incorporate a benchmarking element to regulation and to avoid intrusive heavy handed regulation for all ELBs. It was backward looking but unfortunately it resulted in thresholds which did not adequately recognise all of the factors which were reflected in each ELBs historical performance. Thus the thresholds that were set were more benign for some than others. In addition, the need to monitor and administer the targeted control regime for 29 ELBs has proven extremely challenging and has resulted in prolonged decision making process with 102 of 127 breaches still unresolved. The total 127 breaches reported to date equates to an average of more than four breaches per ELB over the five assessment dates (2003 – 2007). Of the 29 ELBs (including Transpower) only one has not reported a breach since the first assessment date in 2003¹.

24. Importantly, only 29 (or 23%) of the 127 breaches resulted from deliberate actions by the ELB to exceed the thresholds imposed under Part 4A. These intentional breaches reflected either deliberate increases in prices above the threshold, deliberate retention of reductions in transmission charges or increases in planned interruptions as a result of increased level of activity on a network. The remainder of the breaches were unintentional, reflecting one or more of the following circumstances:

- For the price path threshold:
 - Differences between forecast and actual pass through costs, including for example the recent Transpower interim rebate.
 - Differences between forecast and actual CPI.
 - Breaches caused by price increases which occurred before the thresholds were developed and gazetted, (as the initial thresholds were applied retrospectively).
 - Anomalies in the price path threshold formulae.
- For the quality threshold:
 - Natural variances around the historical performance benchmark.
 - Extreme events such as severe storms or flooding.

¹ Source - ELB Threshold Compliance Statements (2003 to 2007) and Commission media releases.

25. Of even more concern is the extremely long periods of time which have occurred between breach and resolution, and for many there has been no resolution at this time.

For example:

- Of the 13 breaches reported in October 2003, eight were accepted with no further action (seven on 31 March 2004 and one on 17 August 2004), one has been resolved with Unison's administrative settlement published in May 2007 and the remaining four are as yet unresolved.
- Of the 37 breaches reported in 2004, nine were accepted with no further action (on 17 August 2004), one has been resolved with the Unison's administrative settlement (in May 2007) and the remaining 27 are as yet unresolved.
- Of the 44 breaches reported in 2005 and 2006, apart from Unison's settlement, the remainder are unresolved.
- An additional 33 breaches have been reported at May 2007.

26. Thus there are four breaches which remain outstanding from October 2003 – more than three and a half years since they were published and 102 in total which have not been resolved. The existing post breach process has resulted in an unacceptable degree of uncertainty for ELBs, with 25 of 29 ELBs currently having unresolved threshold breaches.

27. The very nature of the thresholds and the manner in which they were set has, and will continue to, lead to frequent unintentional breaches. This comes about because:

- The price path threshold requires distribution ELBs to estimate annual pass through costs (transmission, rates and Electricity Commission ("EC") levies) when they set prices, which is usually about 15 months before the price path assessment date.
- The price path threshold requires ELBs to estimate CPI when they set their prices, which is 12 months before the relevant CPI is published.
- The quality threshold is based on annual average quality performance from a five year historical period (1999 -2003) which means that any natural variance around the average will lead to frequent breaches even though there is no material deterioration in quality of supply.

28. The Commission has not prioritised its investigations towards clearing unintentional breaches. On the contrary, the Commission has prioritised its investigations to the most material of the price path breaches (not the quality ones) or the largest ELBs and has become locked into complex and drawn out processes of investigation and negotiation with a few ELBs. This approach has left most ELBs with unresolved breaches and no

indication of when or how these may be resolved. This is unacceptable and, for the electricity lines sector, has considerably increased (rather than reduced) regulatory uncertainty over the initial threshold period.

29. Most of these breaches are unintentional and have already been mitigated by subsequent events. It is difficult to see why the Commission is unable to accept many of the existing unresolved breaches where the breach has been mitigated. It is our view also that unintentional breaches should be accepted where the natural quality variance which caused the breach has resulted in quality performance which remains consistent with the standards agreed with consumers. These are set out in AMPs and consulted on with consumers through AMP, Statement of Corporate Intent (“SCI”) processes and the wider customer consultation processes formalised in the quality threshold.
30. In addition, the information disclosure regime for ELBs, which operates in parallel with the thresholds has, to date, largely been based on the Information Disclosure Regulations previously administered by the MED. These existed before the targeted control regime was introduced. The Commission has initiated a review of the information disclosure requirements to ensure they provide the information necessary to complement the targeted control regime and which is consistent with the objectives of Part 4A. This review was initiated in late 2004 with the publication of the Commission’s Discussion Paper.²
31. Originally it was intended that disclosures would be made by each ELB under revised requirements for each year of the current regulatory period (financial years ended 31 March 2005 – 2009) to assist the Commission assess performance and reset the thresholds at 2009 using information designed specifically for this purpose. Since this review was initiated however, only three final decisions have been made (covering the scope and principles of the review, asset valuation methodologies and Asset Management Plan (“AMP”) disclosures), a further two discussion papers³ have been released (but not finalised) and two industry workshops were held. As yet however, no revised disclosure requirements have been published either in draft or final form and a number of key work streams have yet to be consulted on, such as tax and the specification of Return on Investment (“ROI”) for example. Based on the most recent communications from the Commission, it is anticipated that revised disclosure requirements will be gazetted before the end of February 2008, against which disclosures

² Commerce Commission, Regulation of Electricity Lines Businesses, Review of the Information Disclosure Regime, Discussion Paper, 24 December 2004

³ On valuation roll forward methodologies and pricing methodologies.

for the financial year end 31 March 2007 must be published, with some prior year comparative information disclosed on the same basis.

32. Given the difficulties associated with reformatting historical information to meet revised reporting requirements, it is not certain at this stage to what extent prior year financial disclosures can be made to comply with revised requirements. Thus it is likely that the Commission will, assuming it meets its February 2008 target, only have two years of full disclosures (2007 and 2008) consistent with its requirements prior to its planned threshold reset.

Regulatory Opportunism

33. In addition, the focus of the Commission in its post breach inquiries has increasingly expanded to include any potential concerns with performance of the ELB under investigation relative to Part 4A, rather than the cause of the breach itself. This was the basis on which the Intention to Declare Control on Vector⁴ was formed and has been formally incorporated into the Draft Guidelines⁵ recently published by the Commission for investigating quality breaches.
34. For example, the Commission's Draft Guidelines include the intention to use a breach of the quality threshold to potentially investigate other performance concerns relevant to the Purpose Statement, including, as stated in Figure 1 of the Draft Guidelines, "pricing/return on investment, investment levels etc". We accept that it is appropriate for the Commission, during an inquiry into breaches of the reliability threshold for example, to investigate issues which are directly relevant to reliability performance. These may include past and future investment decisions and plans, operational processes, customer consultations and price/quality tradeoffs. The intention of the proposed process as contained in the Draft Guidelines however appears to be for the Commission to investigate any potential concerns it may have with performance in the context of the Purpose Statement which may have nothing to do whatsoever with the reliability breach. The same intention was demonstrated by the Commission's investigation into Vector's immaterial price path breach which included a broad investigation into Vector's policies and behaviours outside of the context of the original breach.
35. As noted above the Commission has very wide reaching powers and a large degree of discretion about how it applies these in practice. For this reason decision papers and associated guidelines are extremely important to ensure the targeted control regime

⁴ Commerce Commission, Intention to Declare Control on Vector Limited, August 2006

⁵ Commerce Commission, Draft Supplementary Guidelines for Investigating Breaches of the Reliability Criterion of the Quality Threshold, May 2007

meets its objectives. The current post breach investigation process in our view is inconsistent with the objectives of the thresholds, and the assumptions which were made when the thresholds were set for each ELB. It is this very inconsistency which has escalated regulatory uncertainty since the thresholds were introduced and which is currently making investment decisions difficult for ELBs.

36. The Commission's Threshold Decision Paper⁶, when commenting on the decision to set the regulatory period at five years, indicated that the Commission was mindful that regulatory opportunism, where regulators may arbitrarily overturn previous decisions, can remove value from regulated firms and harm consumers in the long run.
37. The inclusion in the process for reviewing threshold breaches of an opportunity for the Commission to consider "other" performance concerns has certainly raised the issue of regulatory opportunism and long term value. This uncertainty was one of the key principles addressed in the Government Policy Statement ("GPS") issued on the 7th of August 2006.⁷ The GPS states:

"3. The provision of efficient infrastructure requires that businesses have the confidence and incentives to make investments in replacement, upgraded and new facilities and services.

4. Particular issues arise in the case of businesses which are or may be regulated under Parts 4, 4A or sections 70 to 74 of Part 5 of the Commerce Act. The way in which prices, revenues and/or quality of goods and services produced by these businesses is regulated or controlled can affect their incentives to invest in new or upgraded infrastructure."

38. Our concerns are consistent with government policy concerns, and the concerns already noted by the Commission in its earlier papers. The nature of the thresholds means that variances around the thresholds will result, and have already resulted in frequent breaches by most if not all ELBs. Accordingly any regulatory process following such breaches must be efficient and focussed on the cause of the breach. This drives at the heart of the frustration currently evident with the current regulatory regime for ELBs. It needs to be simplified and targeted in order for it to become manageable and to focus on the real issues for the sector.

⁶ Commerce Commission, Regulation of Electricity Lines Businesses, Targeted Control Regime, Threshold Decisions (Regulatory Period Beginning 2004), 1 April 2004

⁷ Government Policy Statement, Incentives of Regulated Businesses to Invest in Infrastructure, Hon Lianne Dalziel, Minister of Commerce, 7 August 2006

Simplifying the Regime for ELBs

39. As stated above the regulatory regime for ELBs must be simplified if it is to meet the objectives of Part 4A and be administered in a manner which is manageable and cost effective for the regulator and the industry. The unique ownership structures evident across much of the industry provide the most workable solution to this issue.
40. Many ELBs are owned by the consumers that the regulatory regime is designed to protect. Consumers and the bodies which represent them such as consumer trusts, community trusts and local councils both formally and informally monitor and influence the performance of lines businesses. This currently occurs through the following processes:
- The periodic ownership review process, which includes public assessments of the performance of the ELB and consultation with consumers on preferred ownership options.
 - Elections and appointments of trustees and councillors.
 - Appointment and removal of directors.
 - The annual SCI process where financial (including pricing) and non financial targets such as quality standards are determined following a process of consultation between trusts, councils, boards and the managers of the ELB.
 - Consultation with consumers and their representatives on AMPs.
 - Consultation with consumers and their representatives on the approach to pricing and distributions to owners.
 - Negotiations with consumers and retailers over supply terms and costs.
41. These ownership structures restrict leakage of funds or profits outside of the consumers of the lines business. Accordingly, there is an opportunity for such businesses to accept responsibility for demonstrating behaviours consistent with the Purpose Statement, in a more cost effective and workable manner than the current regime. This has the effect of simplifying the regime for the remaining ELBs and the regulator because of the significant reduction in number of ELBs that need to be assessed through other processes.
42. The biggest risk for owners and consumers of services supplied by long life assets is an intergenerational risk, for example: prices may be kept low in the short term for the benefit of current consumers, resulting in underinvestment, which will harm future consumers. For entities where the consumers are the owners this risk is best managed through consultation and transparency of long term plans and approaches to pricing. It is not best managed by a regulator setting target returns or prices for a five year regulatory period.

43. Ownership structures across the lines businesses (excluding Transpower) comprise the following:

- *Consumer Trusts* – where the beneficiaries of the trust are consumers and the consumer footprint is the same as the trust footprint (for example Counties Power).
- *Consumer Trusts* – where the beneficiaries of the trust are consumers and the consumer footprint is larger than the trust footprint (for example Unison).
- *Community Trusts* – where the beneficiaries of the trust are not directly the consumers, but the community in which they reside (for example Eastland Networks).
- *Co-operatives* – where the consumers are the beneficiaries as all connected consumers own non-tradable shares in the company and are represented by a shareholders committee (for example Electricity Ashburton).
- *Local Authorities* – where the owners are the local authorities represented across the network supply area (for example Electricity Invercargill).
- *Private Entities or Private and Institutional Investors* – where the owners are private entities with no relationship to the consumers (for example Powerco).
- *Other ELBs* – where the owners are other ELBs and therefore the consumer footprint differs from the owner's footprint (example Nelson Electricity).
- *Hybrids* – where consumer trusts and private or institutional investors or local authority owners are represented (for example Horizon Energy Distribution).

The following table summarises the current ownership structures of each of the 28 distribution ELBs.

Lines Business	Ownership	Consumer/Owner Footprint
Alpine Energy	Consumer Trust / District Councils	yes
Aurora Energy	City Council	no
Buller Electricity	Consumer Trust	yes
Centralines	Consumer Trust	yes
Counties Power	Consumer Trust	yes
Eastland Network	Community Trust	yes
Electra	Consumer Trust	yes
Electricity Ashburton	Co-operative	yes
Electricity Invercargill	Local City Council	yes
Horizon Energy Distribution	Consumer Trust / Public	no
MainPower New Zealand	Consumer Trust	yes
Marlborough Lines	Consumer Trust	yes
Nelson Electricity	Marlborough Lines / Network Tasman	no
Network Tasman	Consumer Trust	yes
Network Waitaki	Consumer Trust	yes
Northpower	Consumer Trust	yes
Orion New Zealand	Local City Council and District Council	yes
OtagoNet Joint Venture	Marlborough Lines / Electricity Invercargill / The Power Company	no
Powerco	Babcock and Brown Infrastructure	no
Scanpower	Consumer Trust	yes
The Lines Company	Consumer Trust	yes
The Power Company	Consumer Trust	yes
Top Energy	Consumer Trust	yes
Unison Networks	Consumer Trust	no
Vector	Consumer Trust / Public	no
Waipa Networks	Consumer Trust	yes
WEL Networks	Community Trust (currently operating with consumers as sole beneficiaries)	yes
Westpower	Consumer Trust	yes

44. As demonstrated above, 21 ELBs currently have consumer and owner footprints which are intrinsically the same⁸. This includes consumer trusts, co-operatives, local authority ownership and community trusts. It excludes those with full or partial private investors and those where the ownership footprint only covers part of the network (eg: Unison) or is outside the network (eg: Nelson Electricity).
45. By providing a mechanism for consumer/owner ELBs to elect to demonstrate compliance with the Purpose Statement, the regime becomes significantly more manageable for the regulator and the remainder of the sector. It also allows the regulator to focus on business specific terms for each of the remaining ELBs.

Alternative Proposal

46. The Discussion Document presents two alternative regulatory options for consideration:

⁸ For some of these ELBs there are minor differences between the current consumer and owner footprint reflecting historical boundary changes, ownership of small external subdivisions or where the local authority boundary does not exactly match the network boundary.

- Option One: Part 4A (the thresholds regime) is retained and made generic so that other sectors (eg: gas pipeline services) can be placed under it. Other amendments are proposed to address the issues noted in paragraph 7 above.
 - Option Two: Part 4A is repealed and replaced with an ability to place sectors (including ELBs) under an amended control regime, which allows the Commission to set control terms using comparative benchmarking. This includes allowing firms to propose customised control terms where they can demonstrate that sector wide terms are not appropriate in their case.
47. What we are proposing for ELBs is a simple model which removes the complexity and associated compliance costs which would result from the application of either of the above options to 29 ELBs. We propose that Part 4A is retained, but that ELBs may elect either of the following alternatives if they so choose:
- (a) For ELBs whose consumer footprint is the same as their owner's footprint, an option whereby such ELBs may elect, after consultation with their consumers a disclosure regime which requires the ELB to demonstrate performance consistent with the Part 4A Purpose Statement. Consumer/Owner ELBs are able to safeguard the interests of consumers and promote efficiencies which is exactly what the regulator is attempting to do.
 - (b) For all ELBs, if they so choose, a Propose/Respond model whereby they propose specific control terms, consistent with the Purpose Statement – similar to that proposed in the Discussion Document.
48. These options would be underpinned by thresholds for those unable to elect (a) and who do not require the specific terms that would result from choosing (b). The thresholds would need to be specified in a manner which addresses the concerns raised earlier in this section and also Section III of this submission. In the following paragraphs we suggest points of principle that would need to be incorporated into each option to ensure that they are effective and manageable.

Monitoring of Consumer/Owner ELBs

49. This option would be limited to those ELBs which could demonstrate that the ultimate beneficiaries of the ownership model were the consumers of the ELB. It would require the ELB to demonstrate that its actions were consistent with the Purpose Statement. Some guidance would be required to ensure that these objectives were clearly

understood by Consumer/Owner ELBs and that they undertook sufficient processes to demonstrate compliance. Many of these processes are already in place and can be readily adapted, without additional cost or complexity, where necessary to specifically demonstrate consistency with the objectives of the Purpose Statement. It is likely that these processes would include:

- Consulting with consumer owners as to their preferred approach to regulation with the Consumer/Owner option being the preferred option.
- Showing that the long term interests of consumer/owners have been and are continuing to be considered and met through current practices, policies and plans.
- Including in consultation processes specific consultation on the price and quality of goods and services including reference to the Purpose Statement.
- Showing that the ELB is delivering and will continue to deliver performance which is consistent with the Purpose Statement.
- Demonstrating conduct consistent with good industry practice including the maintenance of robust information necessary to support the above requirements.

50. Demonstrating compliance with these requirements will be achieved through a combination of components of the existing information disclosure framework, a customer consultation process similar to that embodied in the existing thresholds and existing consultation processes between owners and consumers such as ownership reviews and SCI and AMP consultations. It is likely that these will need to be supplemented by specific consultations on the preferred form of regulation. This option therefore can be implemented easily as it is based on processes which already exist.

51. The Consumer/Owner option is a light handed regulatory approach which includes principles similar to the information disclosure regime formerly adopted for the electricity lines sector, which also currently forms part of Part 4A. The previous information disclosure regime for ELBs was dismissed as being ineffective; however this does not mean that the concept is fundamentally flawed. Improvements to the manner in which previous and current information disclosures have been specified and managed would have improved their effectiveness, including:

- Specification consistent with the Purpose Statement.
- Requirements for consultation with consumers.
- Timely reviews and updates of associated guidelines and handbooks.

If these requirements are met, light handed regulation can achieve behaviours consistent with the Purpose Statement for Consumer/Owner ELBs.

Propose/Respond Model

52. For ELBs with specific issues and concerns and for which industry thresholds are not appropriate, it is important to offer an alternative model at the beginning of the threshold period. It is also important to make this option available throughout the regulatory period for ELBs to elect should they wish to. This option is similar to the current administrative settlement process adopted by the Commission in response to breaches of the existing thresholds for ELBs. By offering the Consumer/Owner and threshold options in addition to the Propose/Respond model and by ensuring the Propose/Respond model is available for ELBs to opt into, the regulatory processes will become much more manageable. Regulatory processes will also become more timely and most importantly help to achieve the ultimate goal of reducing regulatory uncertainty.

53. This option would be underpinned by principles consistent with the Purpose Statement and therefore should result in outcomes which are similar to the other options, but with the advantage over the thresholds of being able to better reflect specific business circumstances. For this reason it should be available to all ELBs. It is anticipated that this option would include the following requirements:

- The ELB must put forward a proposal which identifies consistency or otherwise with regulatory parameters and inputs published by the regulator.
- The ELB's proposal should address each component of the Purpose Statement.
- The regulator must accept any element of a proposal which is consistent with previously agreed regulatory parameters and inputs.
- The regulator must also consider any element of a proposal which differs from previously agreed regulatory parameters and inputs for which justification for the departure is provided by the ELB. In responding to these aspects of a proposal the regulator should provide reasons for its acceptance or non acceptance of these departures.
- Finite time limits need to be legislated for reaching a final agreement and, within this timeframe, requirements for timely responses to proposals and counter proposals at each step of the process. There may be a need to limit the number of counter proposals to make the process workable within the agreed timeframes.
- There needs to be an option for reversion to an independent arbitration process if necessary.
- The Propose/Respond model needs to be underpinned by an option to revert to the thresholds if agreement on the terms of regulation either through negotiation or arbitration cannot be met within the set timeframe. This would need to be subject to acceptance on the part of both parties that the regulator and the ELB had acted

throughout the negotiation process in a manner consistent with good regulatory conduct and with the Purpose Statement.

54. The advantage of this option is that it provides a process for ELBs and the regulator to reflect business specific circumstances for individual ELBs, but provides the discipline of requiring these to be consistent with regulatory objectives. It reduces the level of uncertainty that currently exists with the threshold and post breach inquiry process as ELBs are able to lock in their regulatory parameters at the beginning of the period. The elective nature of this option however makes it manageable for the regulator because it will be targeted to those who have the most need for specific attention.

Industry Thresholds

55. Underpinning the two alternatives, price and quality thresholds should be developed for those that choose this option, however these should be developed and implemented in fundamentally different ways to the existing thresholds. Experience with the existing thresholds suggests that the current thresholds must be modified to incorporate the following:
- Exclusion of goods and services for which the terms and conditions of supply have been negotiated with the customer and the customer elects to have these fall outside of the regulatory regime.
 - Exclusion of any elements of transmission from the price path.
 - Rebasement price path quantities to reflect the services supplied at the opening period and the opening boundary between distribution and transmission.
 - Recognition of changes in the distribution and transmission boundary should they occur within a regulatory period, to provide incentives for distributors to minimise transmission costs.
 - Consideration of business specific circumstances when setting X factors.
 - Inclusion of a rolling overs/unders allowance around the price and quality thresholds (within a band if necessary) whereby unintentional breaches may be remedied in the following period without penalty and further investigation.
 - Consideration of forward looking costs and cash adequacy when setting X factors.
 - Exclusion of extreme events from the quality threshold.
 - Modification of the quality threshold to derive a better base period benchmark for each ELB, with specific consideration of base period planned and unplanned outages.
 - Inclusion of a time limit within which breaches must either be resolved or Propose/Respond type negotiations must be initiated and agreed.
 - Determination of input methodologies prior to the regulatory period.

- Inclusion of a merits review process for threshold decisions.

56. As noted above, by providing two alternatives for ELBs the thresholds will become significantly more simplistic in their design, implementation and administration. They will also become more meaningful as they will reflect business specific circumstances and as a result reduce the unacceptable level of regulatory uncertainty that currently exists.

Compliance Cost

57. Currently Part 4A imposes a threshold (and control) and an information disclosure regime on all ELBs. This has resulted in a significant increase in regulatory compliance cost resulting from its introduction. Annual compliance statements as well as information disclosures must be compiled, audited and published. As input methodologies and regulatory processes have continued to be developed, ELBs have also had to participate in an ongoing process of consultation on many aspects of Part 4A.

58. Most ELBs have no desire to breach their thresholds particularly as the consequences of a breach are not known. However the nature of the thresholds means that they do, and they have to manage the consequences of that. This comes with significant costs particularly in respect of management time spent responding to information requests from the Commission. This ultimately diverts management away from its core role – managing and operating electricity networks.

59. Our proposals will significantly reduce compliance costs across the sector by avoiding the inherent duplication that exists between the regulator and the Consumer/Owner ownership model and the duplication between the thresholds and disclosure regimes.

VI) REGULATORY PARAMETERS

Input Methodologies

60. The Discussion Document suggests that much of the regulatory uncertainty which exists at present is because a large number of technical parameters must be determined for each investigation. These include the following parameters or input assumptions:
- Weighted Average Cost of Capital (“WACC”).
 - The form of control.
 - Asset valuation methodology including the treatment of vested assets.
 - Allocation of common costs.
 - Tax.
 - Pass through costs.
 - Reset period.
 - The circumstances for re-opening control during a regulatory period.
61. In order to reduce uncertainty the Discussion Document suggests that many of these could be common across industries and/or firms and could be set in advance (either once an inquiry is initiated or at the time regulation is imposed). We strongly support the determination of input methodologies at the beginning of a regulatory period. One of the reasons the current regulatory regime for ELBs has become so convoluted and ineffective is that these methodologies are being determined progressively as each investigation proceeds. For example it was not until the Vector inquiry commenced that the Commission introduced the removal of cross subsidies between consumer groups as a key requirement of the Unison settlement, which was already well advanced at that stage. The issue of how tax should be factored into regulatory models for ELBs has also never been consulted on. ELBs have therefore had no guidance on how the Commission expects them to behave other than from the high level guidance provided by the Purpose Statement and the Assessment and Inquiry Guidelines.
62. The determination of input methodologies should be limited to the methodology itself, not the specific assumptions and inputs required to apply the preferred methodology as these are likely to be firm specific and they will change over time.
63. The input methodologies should be set by entities which are independent of policy (ie: the MED or the Minister) and ideally independent of those responsible for administering the regime. In practice this may be difficult to achieve, but the inclusion of regulatory methodologies in the scope of processes subject to merits review could mitigate this risk.

VII) ACCOUNTABILITY

Merits Review

64. The lack of a merits review process has, in our view, considerably harmed the credibility of the regulatory regime for ELBs and its effectiveness. We therefore support the inclusion of merits review in the process but acknowledge that this needs to be limited to some extent to avoid constant disruption to regulatory processes.
65. Currently the only accountability check on the regulator is through the judicial review process – the grounds for which include illegality, unfairness and unreasonableness. Merits reviews can be provided for in addition to judicial reviews to review the substance and reasoning of a decision. We support this process because it strengthens incentives for high quality analysis by the regulator and it potentially corrects poor decisions thus providing more robust principles for future cases.
66. We acknowledge that the inclusion of merits reviews does come with some extra costs and potential delays to regulatory processes. We therefore support the proposal that merits reviews be limited to setting control terms and actions following a breach. We also believe, given the significance of the decisions, merits reviews should apply to setting recommended input methodologies and the outcomes of the Propose/Respond option. If, as proposed earlier however, there is a strengthening of the requirements for the regulator to justify its decisions specifically against the Purpose Statement then there may be less demand for merits reviews than otherwise.
67. Much of the frustration of ELBs with the manner in which Part 4A has been implemented to date is the prolonged process for consultation and decision making and an apparent disregard for views held in common by submitters and independent experts. Increased accountability for the regulator should include a requirement for timely responses to views expressed during relevant consultation processes.
68. We accept the proposal to limit the scope of any merits review to an “appeals by way of hearing” format – whereby all of the previous evidence is allowed to be submitted for examination but any new evidence may only be submitted if it could not have been presented earlier.
69. We support an option which provides for a specialist tribunal to undertake merits reviews, which would be independent of officials and the Commission. This will allow the input of relevant experts as well as Judges with relevant expertise. The same experts can be

used for the judicial review process to ensure consistency and the appropriate level of expertise is developed from our relatively small pool of resources.

VIII) NEXT STEPS

Timing of the Review

70. As indicated earlier, the thresholds implemented for ELBs under Part 4A of the Act end at 31 March 2009 (with the exception of Transpower which currently has its threshold set annually). The Commission has indicated that it is proceeding with its process for resetting the thresholds, and it has already commenced some of its work streams in this respect.
71. The Discussion Document does not include a forward looking timetable for its review, although we understand from officials that it is possible that new legislation may be drafted later this year with implementation mid 2008. We are extremely concerned at the implications of this potential timetable for ELBs in the context of the targeted control regime because:
- As pointed out in this submission, there are alternative regulatory options from those proposed in the Discussion Document that we believe will better meet the objectives of the Part 4A Purpose Statement for ELBs which require further consultation with interested parties.
 - The Discussion Document is a high level paper which provides very little information about how the proposals will be implemented in practice. It is our view that there is considerable work yet to be undertaken before any meaningful changes to the regulatory regime for ELBs can be implemented.
 - There are a huge number of unresolved breaches of the existing thresholds which will require significant and concentrated effort from the Commission before they are resolved. It is unhelpful at this stage of consultation to have these breaches unresolved for the 25 ELBs affected and also for the rest of the industry.
72. Having experienced the targeted control regime for ELBs over the past few years, and having noted how difficult it has been for the Commission to derive inputs and processes which are consistent with the intention of the regime, we are extremely concerned that the current timetable will not allow the review to be completed successfully.
73. The issues with Part 4A identified by the MED, and the additional ones we have identified throughout this submission are not issues that are readily resolved. It is our view that officials along with the industry have an opportunity at this time to take our collective experiences of Part 4A and derive a regime that addresses the issues that have arisen with its design and application to ensure the next regime better fulfils its objectives. This

requires considerable work on a number of overlapping issues and we are extremely concerned that the current timetables are far too tight to achieve this.

74. In order to allow the MED and the Commission to effectively undertake the required design and consultation processes we submit that interim thresholds should be implemented for ELBs at 1 April 2009, consistent with the existing framework and initially for a period of 12 months, similar to Transpower's thresholds. If necessary this could be extended for a further 12 months if insufficient progress had been made at that time.

75. To make this process as simple (and cost effective as possible) it would be acceptable to maintain the current quality thresholds for each ELB, and to adopt a CPI-X price path threshold for all ELBs with X equal to 0. This would be acceptable in the short term and any perceived benefit or dis-benefit to individual ELBs arising from the interim threshold could be factored into the new regulatory framework. It would not be appropriate in our view to continue with the existing price paths, given these are significantly more onerous for some than others. Although those ELBs which are having difficulty complying with their thresholds do have the option of breaching their thresholds, for the very reasons outlined earlier in this submission, many may elect not to.