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Commerce Act Review
Ministry of Economic Development
Level 8
33 Bowen Street
Wellington
New Zealand

6 December 2007

Dear sir or madam

**Proposed Changes to the Regulatory Control Provisions under the
Commerce Act 1986**

Please find enclosed our response to the proposed changes announced on 22 November and as set out in the Cabinet Paper issued by the Minister of Commerce and the Minister of Energy.

Babcock & Brown Infrastructure ("BBI") supports the Government's decision to amend the regulatory provisions of the Commerce Act 1986 and the policy intent behind the proposed changes.

We are concerned, however, that some aspects of the proposed reforms have the potential to defeat the Government's intentions. In our submission we explain a number of potential loopholes in the proposed accountability and error correction mechanisms.

We would be pleased to discuss and elaborate on any aspect of our submission. If you have any questions please contact Adriaan van Jaarsveldt, General Manager Regulation on +612 9229 1956 or adriaan.vanjaarsveldt@babcockbrown.com.

Yours faithfully

Jeff Kendrew
Acting Chief Executive
Babcock & Brown Infrastructure

Review of the Commerce Act: Submission on Government Proposals

6 December 2007



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Executive Summary

Babcock & Brown Infrastructure (“BBI”) supports the Government’s decision to amend the regulatory provisions of the Commerce Act 1986 (“the Act”) and the policy intent behind the proposed changes. As an international infrastructure investor, BBI has been increasingly concerned by the growing gap between the mainstream approach to regulation in the OECD, and the way the regulatory framework has been evolving in New Zealand. We commend the Government for listening to the concerns of investors and responding with timely policy changes.

We are concerned, however, that some aspects of the proposed reforms have the potential to defeat the Government’s intentions. Overall, we think the Government is correct in seeking to improve the regulatory environment by introducing mechanisms which limit the exercise of regulatory discretion through appropriate error correction mechanisms and pre-specification. This is consistent with other OECD jurisdictions, and will return New Zealand to the regulatory mainstream.

However, the accountability mechanisms set out in the proposed changes to the Commerce Act leave a number of loopholes.

The Government’s decision that the application of input methodologies to individual cases should not be subject to merit reviews leaves significant gaps in the error correction process. The problem is that it will be extremely difficult to develop input methodologies which are sufficiently detailed and comprehensive so that they fully anticipate all the methodological and policy issues which arise in individual cases. If individual decisions can not be reviewed on their merits, there will be room to make regulatory policy on a case-by-case basis without appropriate accountability.

Moreover, clause E3 of the proposed changes states:

The Commission may determine the level of prescription of the input methodologies.

This clause, in effect, allows the Commission to decide how much its regulatory discretion will be constrained. For example, the Commission will be able to set high-level, low-prescription input methodologies, retaining almost undiminished and unfettered discretion over how the methodologies are applied in individual cases. This would push many contentious decisions (that should be reviewable on their merits) further down the process, where no merits review is possible.

In our view, the absence of merit reviews for the application of input methodologies to individual cases, together with the freedom for the Commission to decide the level of detail in specifying the input methodologies undermines the progress intended by the Government.

We remain convinced that merit reviews for the application of input methodologies to individual decisions are necessary to ensure high quality regulatory outcomes. However, we appreciate the concerns around the potential costs and practical difficulties of this approach. As a possible practical compromise, we suggest that:

- The list of input methodologies be determined by the policy makers, not left to the discretion of the regulator.
- Clause E3 be amended to require the Commission, in relation to each form of regulation, to set methodologies that are sufficiently detailed to allow regulated business to estimate, with reasonable accuracy, the impact on their revenue of that form of regulation being applied.
- A new clause be inserted that explicitly requires the Commission to initiate a process for defining a new input methodology or amending a relevant existing input methodology, where in the process of making an individual decision, the Commission identifies a new issue that:
 - is not specific to the decision at hand, and
 - is not explicitly addressed in an existing input methodology.
- A new sub-clause is added to clause E1 that reads “any other matter that impacts or has the potential to impact a group of regulated businesses subject to a form of regulation under this part”.

These changes, taken together, would ensure that methodological issues are properly identified as such, and that all methodological issues are subject to regulatory accountability.

We are also concerned that the Government’s proposal leaves the setting of the default price path entirely at the Commission’s discretion. It is true that the ability to opt into a customised price path provides a backstop, and hence a check on the exercise of this discretion. However, we think relying on such a backstop is unnecessarily costly, and underestimates the amount of time it will take for the Commission to develop input methodologies, and hence be ready for the implementation of the customised price paths as an effective and predictable regulatory backstop.

Given a realistic timetable for the setting of the input methodologies, the default price path will play an important role in determining the regulatory risks and incentives for investment in the electricity distribution sector for some years to come. This suggests that in order to achieve the objectives which the Government has set for the proposed changes to the Commerce Act, it will be important to insure that improved regulatory accountability and error correction is also applied to the default price/quality paths.

We believe that decisions on the methodology for setting the default paths, especially in the key first regulatory period of the new regime, should be subject to a merits review. We therefore suggest that a new sub-clause should be added to clause E1, specifically listing the method for setting default paths as an input methodology.

Finally, we note that the Government has not accepted the propose-respond regulatory model recommended by the industry participants. We believe that a genuine propose-respond model—where the regulator is able to turn down a proposal in its entirety, but does not have the discretion to respond with a completely new determination of its own—is a more efficient way to balance the objective of reducing regulatory risk with the need to ensure that consumer interests are preserved.

1. BBI Supports the Policy Intent of the Proposed Changes

Babcock & Brown Infrastructure (“BBI”) supports the Government’s decision to amend the regulatory provisions of the Commerce Act 1986 (“the Act”) and the policy intent behind the proposed changes. As an international infrastructure investor, BBI has been increasingly concerned over the growing gap between the mainstream approach to regulation in the OECD, and the way the regulatory framework has been evolving in New Zealand. We commend the Government for listening to the concerns of investors and responding with timely policy changes.

2. Implementation Detail Will Determine the Effectiveness of the Changes

The objectives of the review of regulatory provisions of the Act (“Review”) were to:

- *Provide an efficient and credible regime to address the potential to exercise market power in markets where competition is not possible*
- *Improve clarity, certainty, timeliness and predictability for businesses*
- *Tailor the regime to New Zealand’s small size (with small firms and limited resources)*

The requirement for the Commerce Commission to develop regulatory input methodologies in advance of their application to individual cases, and the introduction of merit reviews of the input methodologies should indeed make the regulatory process more predictable, and should improve the accountability of the regulator.

We also agree that a combination of a default price path and the ability to propose a customised price path based on a conventional building blocks methodology should provide a sensible balance between the need to have a simplified regime which reflects the limited resources available for regulation in New Zealand, and the ability of infrastructure investors to place reliance on a mainstream regulatory process.

However, there are a number of matters of detail that could undermine the policy intent behind the changes. These matters relate to:

- The level of discretion accorded to the Commerce Commission when applying input methodologies.
- Ambiguity on the process and method for setting the default price/quality path(s).
- Ambiguity in the process and method for setting a customised path(s).

3. Level of Discretion When Applying Input Methodologies

As BBI has emphasised in its earlier submission on the Commerce Act review, the quality of the regulatory environment critically depends on how regulatory discretion is constrained by the existence of the error correction mechanisms. Some degree of regulatory discretion is inevitable, and there is no doubt that the need to balance the interests of investors and customers will always leave room for argument and discontent. Experienced investors recognise this. However, it is critically important that regulatory discretion be constrained in a way which would ensure that arbitrary and unpredictable decisions or regulatory actions, which are detrimental to investment, can be properly scrutinised and reversed as appropriate.

The proposed changes to the Act go some way towards constraining the exercise of regulatory discretion through appropriate commitment and accountability mechanisms. The Commission will need to commit to applying pre-set input methodologies when making an individual regulatory decision, while the development of the input methodologies will be subject to merits reviews.

However, the Government's decision that the application of input methodologies to individual cases should not be subject to merit reviews leaves significant gaps in the error correction process. Appeal on point of law and judicial review will remain the only options available to settle a dispute over whether the Commission has properly applied its input methodologies when making a decision. The problem with this is that it will be extremely difficult to develop input methodologies which are sufficiently detailed and comprehensive so that they fully anticipate all the methodological and policy issues which arise in individual cases. If individual decisions can not be reviewed on their merits, there will be room to make regulatory policy without appropriate accountability.

We would like to illustrate this problem by reference to the Commission's recent draft decision on gas price control. In this decision, the Commission uses the ODV methodology to set the Regulatory Asset Base (RAB) at the start of the regulatory period. As the regulatory period starts in 2006, the Commission proposes to use the 2005 ODV valuation to set the RAB. This indeed appears orthodox, and consistent with the Commission's current input methodology.

However, the Commission then takes a highly unorthodox step of declaring that it will treat revaluation gains prior to the commencement of the regulatory period as income, and that the allowable revenues will be set so as to maintain the financial capital of the business at the level of the 2000 ODV valuation. *De facto*, this additional methodological step is equivalent to using an out-of-date 2000 ODV to set the RAB.

The Commission's decision to maintain the financial capital of the business at a level which is different to the RAB is completely out of line with international regulatory practice. It undermines the investors' legitimate expectations and sends a negative signal about investing in regulated businesses in New Zealand.

In our view, this approach would not survive if the application of the input methodologies to the individual cases were subject to merit reviews. Yet, in the absence of such merit reviews, it is possible that such arbitrary decisions will stand.

In order for judicial review to be a sufficient error correction mechanism, the input methodologies will need to be highly prescriptive and would need to anticipate a wide range of unorthodox methodological innovations. In the example described above, the input methodology on valuation would have needed to anticipate the possibility that the RAB concept would enter the building blocks calculation in an unusual manner, and that some other arbitrarily selected valuation could be used as the basis for applying the financial capital maintenance principle.

The alternative to allowing merit reviews of individual cases is ensuring that the input methodologies are sufficiently detailed and prescriptive. However, clause E3 of the proposed changes states:

The Commission may determine the level of prescription of the input methodologies.

This clause, in effect, allows the Commission to decide how much its regulatory discretion will be constrained. For example, the Commission will be able to set high-level, low-prescription input methodologies, retaining almost undiminished and unfettered discretion over how the methodologies are applied in individual cases. This would push many of the highly contentious decisions (that should be reviewable on their merits) further down the process, where no merits review is possible.

In our view, the absence of merit reviews for the application of input methodologies to individual cases, together with the freedom for the Commission to decide the level of detail in specifying the input methodologies, has the potential to defeat the very objective of the proposed changes to the Commerce Act.

We appreciate that it is very difficult to create a set of input methodologies which fully anticipates all relevant methodological issues. This is precisely why we think the Government should reconsider its approach to merit reviews of application of the input methodologies to individual cases.

However, we also understand concerns about opening individual cases to merit reviews. We would like to suggest a practical middle ground, which would close loopholes in regulatory accountability without imposing unacceptable costs and complexity. We suggest that:

- The list of input methodologies be determined by the policy makers, not left to the discretion of the regulator.
- Clause E3 be amended to require the Commission, in relation to each form of regulation, to set methodologies that are sufficiently detailed to allow regulated business to estimate, with reasonable accuracy, the impact on their revenue of that form of regulation being applied.
- A new clause be inserted that explicitly requires the Commission to initiate a process for defining a new input methodology or amending a relevant existing input methodology, where in the process of making an individual decision, the Commission identifies a new issue that:

- is not specific to the decision at hand, and
- is not explicitly addressed in an existing input methodology.
- A new sub-clause is added to clause E1 that reads “any other matter that impacts or has the potential to impact a group of regulated businesses subject to a form of regulation under this part”.

These proposed changes, taken together, would ensure that methodological issues are properly identified as such, and that all methodological issues are subject to regulatory accountability.

4. More Guidance Required on Setting the Default Path(s)

We see two potential issues with setting the default price/quality path(s) under the proposed specifications for the changes:

- Confusion around what information and approaches can, or cannot, be used to make any potential P_0 adjustments to the default path(s).
- Whether the method for setting default path(s) is an input methodology in its own right and, therefore, is subject to merits review.

Clause H2. of the detailed specifications states:

- *... The default path(s) should be based on factors such as productivity/efficiency trends and comparative benchmarking (domestic or international). The Commission **may not undertake a building blocks or detailed forward-looking investigation of firms in setting default paths.***
- *The Commission may specify price-quality paths in any form or in any way it sees fit, but **may not include a P_0 adjustment except on the basis of information disclosed pursuant to the information disclosure requirements.***

[Emphasis added]

Although not noted in the detailed specifications, paragraph 43 of the Cabinet Paper recommends that the power to set information disclosure requirements should include “the ability to require forward-looking information (such as asset management plans, investment intentions, regulatory accounts, prices and quality standards)”. Clause H2. therefore appears to be somewhat contradictory:

- on the one hand, it forbids the Commission from undertaking a detailed forward-looking investigation of firms in setting default paths, yet
- on the other hand, it allows the Commission potentially to make P_0 adjustments based on detailed forward-looking information obtained through the Commission’s information disclosure powers.

More generally, the Government’s proposal leaves the setting of the default price path entirely at the Commission’s discretion. It is true that the ability to opt into a customised price path provides a backstop, and hence a check on the exercise of this discretion. However, we think this is an unnecessarily costly way to constrain regulatory discretion, and ignores the negative consequences of uncertainty and arbitrariness in the setting of the default price path within a broad range of outcomes which do not trigger the option to propose a customised path.

In particular, we think it is important not to underestimate the amount of time it will take for the Commission to develop input methodologies, and hence be ready for the implementation of the customised price paths as an effective and predictable regulatory backstop. Even though the Commission has undertaken substantive work on the relevant topics, that work was undertaken in the context of a different regime than the one to come. In Australia and the United Kingdom, the processes to update regulatory rules (either within the context of an existing regime, or to roll them over into a new one) have taken a substantial amount of time. We present a few examples of this in the table below.

Country	Regulator	Sector	Methodology Being Updated	Start	End	Duration
UK	OFGEM	Gas and Electricity	Previously Established Method for Network Monopoly Pricing Controls	Aug-02	Jun-03	10 months
Australia	AEMC	Electricity Transmission	Previously Established Electricity Transmission Revenue and Pricing Rules	Jul-05	Jan-07	18 months
Australia	NGPAC	Gas Distribution	Methodology in Gas Pipelines Access Act 1997 providing for price controls and pass-through mechanisms in the context of third party access to gas transmission networks	Apr-01	Apr-03	24 months

We think it would be inappropriate to rush the development of input methodologies. Indeed, many of the problems of the currently regulatory regime in New Zealand stem from the Commerce Commission setting itself ambitious deadlines, and then either rushing decisions or dealing with issues out of logical sequence. For example, the Commerce Commission is still conducting a consultation on the form of control for gas distribution networks, yet it has rushed ahead with a draft decision on the price path, which makes some of the ongoing consultation moot.

Given a realistic timetable for the setting of the input methodologies, the default price path will play an important role in determining the regulatory risks and incentives for investment in the electricity distribution sector for some years to come. This suggests that in order to achieve the objectives which the Government has set for the proposed changes to the Commerce Act, it will be important to insure that improved regulatory accountability and error correction is also applied to the default price/quality paths.

The setting of default paths is further complicated by the fact that:

- Default paths are to be set using comparative benchmarking and total factor productivity analysis (TFP), which are based on historical data and are backward looking.
- Electricity and gas distributors are facing a large increase in capital expenditure levels going forward, as well as faster growth in the cost of materials and labour, compared to historic levels of growth.

We note that the process of defining the methodology for setting the default price/quality path(s) for gas and electricity distribution is not listed as one of the input methodologies. It is not clear to us whether this is intentional. We believe that decisions on the methodology for setting the default paths, especially in the key first regulatory period of the new regime, should be subject to a merits review. We therefore suggest that a new sub-clause should be added to clause E1, specifically listing the method for setting default paths as an input methodology.

5. Customised Paths Should be set Using a Propose/Respond Process

The key aims of the proposed changes include improving regulatory certainty and incentives for investment. In our understanding this was the main reason for introducing the requirement for the Commission to set input methodologies up front and to apply those methodologies when making individual decisions. Given these aims and the mechanisms introduced to achieve them, an option for the Commission to set a lower customised price path than a default one seems contrary to the purpose of the changes.

If the regime works as intended—regulated companies are able to reasonably accurately predict how the Commission will set a customised price path—no company would ever apply for a customised price path unless it reasonably expected higher prices to be set than under the default path. Therefore, if the proposed regime is working properly, and a company applies for a customised price path (that is higher than the default), but the Commission determines that prices should be set lower than the default path, there can be only one cause — the company has grossly misinterpreted the input methodologies and how they would be applied by the Commission. In other words, the cause for the discrepancy can only be regulatory uncertainty — a failure of the regime to deliver on its stated goals.

In our original submission, BBI suggested a “propose/respond” approach to making individual regulatory determinations. Under this approach, the regulated business develops and submits proposals in accordance with the input methodologies set by the Commission. The Commission then approves the proposals if they comply with the input methodologies, or rejects the proposals if they do not comply. In rejecting any proposals, the Commission would be required to indicate where the criteria have not been met.

The Propose/Respond model is currently part of the national regulatory regime for gas transmission in Australia, as well as the regulatory regime for electricity transmission in Western Australia. Australia is also moving towards a single national approach for

regulating electricity transmission. As part of that process, the Propose/Respond model is one of the main options being considered. We consider this model would create greater certainty than the current proposals.

6. Constructive Engagement to Develop Legislation

BBI would like to contribute constructively to the development and implementation of the legislation that will put in place the changes decided on by the Government. We would be pleased to provide examples of practical experience with the detailed aspects of regulatory regimes applying to infrastructure assets we own in New Zealand compared with other regulatory jurisdictions, including Australia, the United Kingdom and the United States.