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REVIEW OF PARTS 4 AND 4A OF THE COMMERCE ACT

- 1 Thank you for this opportunity to comment on design details relating to Appendix B of the paper entitled "Review of Parts 4 and 4A of the Commerce Act" (the "Review Paper").
- 2 Our focus in this brief submission is upon the key issues facing ELBs, including Orion, in the transition from the current threshold regime under Part 4A, to the new proposed default/customised price-quality path.
- 3 We set out below two key problems relating to the proposed migration from the current threshold regime to the proposed default path. We also suggest a solution for the transition period to overcome the concerns that we raise.

Problem 1: Transitional issues relating to the proposed default path fail to properly account for the inter-relationship between the establishment of input methodologies by the Commerce Commission ('Commission') and the potential impact of applications for customised paths

- 4 It is proposed that:
 - 4.1 Default paths for ELBs will come into force on 1 April 2009, based on the price-quality standards established under the 2009 threshold reset.
 - 4.2 At this time the development of input methodologies will be ongoing. It is recorded on page 46 of your review paper to Cabinet that the

Commission has estimated that it will take three years to develop these methodologies. Therefore, a complete suite of the input methodologies will likely not be available until around 2011-12.

- 4.3 However, from 1 April 2009, ELBs will have the opportunity to lodge an application to be placed on a customised price path. The Commission will be required to adjudicate upon such applications within 150 to 180 working days.
- 5 The disjunction between these work streams is obvious.
- 6 Applications for customised paths are likely to be made early-on under the proposed new regime.¹ The current thresholds were only ever intended to be used as an initial screening device. The conversion of these thresholds into regulatory default paths will potentially be unacceptable to many ELBs and this will, we predict, result in applications for customised paths.²
- 7 This will mean that the Commission in adjudicating upon any such application in 2009 will, in essence, be required to develop and apply all of the input methodologies at this time in any event. The problems here are that:
- 7.1 The Commission would be required to adjudicate on input methodology matters within a time frame which it maintains is not achievable (150 to 180 days compared with three years, as already noted).
- 7.2 The work stream for the determination of input methodologies would be subsumed by a single application for a customised path. This clearly runs contrary to the one of the fundamental objectives of the proposed amendments to Parts 4 and 4A, namely, the desirability of

¹ There are two further, and related, design issues in this context. First, the proposed default path to apply from 1 April 2009 must be set far enough in advance to enable affected parties adequate time to consider whether they will apply for a customised path on or about 1 April 2009. Second, the Review Paper appears to proceed on the assumption that there are meaningful non-statutory Guidelines to assist in deciding whether or not to apply for a customised path, prior to the finalisation of input methodologies by the Commission. We are unaware which Guidelines the Ministry has in mind. Our preliminary view is that the non-statutory Guidelines the Commission has issued to date (including the outcome to administrative settlements) are not of adequate precedent value for this purpose. We invite the Ministry to elaborate in background papers to the draft legislation which Guidelines it considers to articulate meaningful instruction in this context.

² Businesses with significant forward-looking capital requirements may find the prospect of complying with a default price path particularly unsatisfactory and will likely be eager to lodge customised proposals.

determining robust initial input methodologies to improve regulatory certainty.

Problem 2: The first determination of the default path needs to be properly undertaken. The use of the 2009 threshold reset for this purpose (a) does not accord with fundamental economic principles and (b) may have unintended consequences

- 8 The proposed default price path is to operate as an instrument of control, as from 1 April 2009. It will not be a mere threshold screening device. It is inappropriate to base the first set of control terms upon a threshold developed in the past (even if updated) for purposes other than actual control. The input methodologies to be developed by the Commission will be relevant for the proper establishment of the default price path, yet these will very likely be unavailable at the time this price path is set.
- 9 Unless there is some alteration to the transitional timetable, or a requirement placed on the Commission to develop and finalise its input methodologies before it sets the default price path ELBs risk being placed in an untenable position. Specifically, ELBs may find themselves in the situation of operating under an inappropriate price path but with no clear understanding as to what the alternative may involve, substantially undermining the improved certainty the new regime is intended to deliver.
- 10 Further, the adoption of the current thresholds as the default path may have unintended consequences in the future. This point is neatly illustrated by the approach taken by the Commission to asset valuation in its recent draft gas distribution services decisions paper. If the Commission were to replicate this analysis in the context of a customised proposal application lodged by an ELB it would risk inappropriately understating the initial value of the initial asset base, with serious attendant consequences to efficiency. The debate could very well develop upon the following lines:
 - 10.1 The applicant for a customised path would, properly, assert that its opening regulatory asset base should be based on the cost that would be faced by a hypothetical new entrant of average efficiency, as at the date of the submission of the customised proposal.
 - 10.2 The Commission would likely seek to establish a significantly lower initial regulatory asset valuation, based on retrospective ODV values applying under the threshold regime (which were not set on a systematic, consistent basis in any event).

- 11 The potential inconsistency of the Commission's approach on this issue with fundamental economic principles is described in the attached report from NERA (dated 30 November 2007).
- 12 There must be the opportunity for the proper application of the input methodologies at the time that the default or customised paths are set. The proposed migration of the threshold regime into the proposed new default path regime may, on the Commission's approach to date, mean that ELBs will for all time be denied the opportunity for a properly determined application of input methodologies.

The solution

- 13 The problems we have identified above would be overcome by the continued application of the current threshold regime, without the application of the 2009 threshold reset. The default path should not come into force until such time as a full suite of input methodologies is finalised.

Further submissions

- 14 This submission is necessarily brief, given the time and scope of this exercise. We have simply attempted to address what we consider to be some of the most obvious design concerns arising out of the current proposals.
- 15 We propose to make further detailed submissions on the proposed new regulatory regime once the draft legislation becomes available. We have some real concerns about the substance and potential operation of the proposed new Part 4, and we look forward to sharing our views with you on these matters.
- 16 If you have any questions relating to these comments, please contact Dennis Jones (Industry Developments Manager) DDI 03 363 9526 email dennis.jones@oriongroup.co.nz.

Yours sincerely



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