



POWERCO SUBMISSION COMMERCE ACT REVIEW

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A EXECUTIVE SUMMARY

- 1 Powerco welcomes the opportunity to submit at this stage in the process.
- 2 Powerco appreciates the current proposals are intended to deliver a package that is closer to standard regulatory practice, and gives investors the certainty and accountability that is clearly lacking in the status quo (ie the thresholds regime for electricity and the inquiry/price control regime for gas pipelines).
- 3 However, the proposal as currently configured is unlikely to increase the accountability of the Commerce Commission (the *Commission*), and so will not deliver the practical outcomes intended by the Government, and sought by the industry.
- 4 Powerco is not going to re-litigate the Cabinet decisions at this stage. Rather, Powerco would like to work with officials on the implementation details, and put forward suggestions aimed at correcting this gap between what is intended and what is likely to eventuate in practice.
- 5 The focus of Powerco's submission is on identifying areas where the Act can give more certainty over how decisions get made and how the Commission will be held accountable.
- 6 The remainder of this submission is set out as follows:
 - 6.1 in Part B we discuss the likely practical outcomes under the proposed regulatory framework
 - 6.2 in Part C we submit Part 4 needs an explicit commitment to what the Commission identifies as the principal objective of price regulation;
 - 6.3 Part D contains Powerco's comments on the propose/respond model;
 - 6.4 in Part E we comment on the merit review proposal;
 - 6.5 and in Part F we address some more detailed transition issues and questions.
- 7 Powerco would appreciate the opportunity to discuss with officials the issues raised in this submission. Given the tight timeframe for submission, the issues are presented here at a necessarily high level.
- 8 Powerco also suggests that officials circulate a discussion draft of the Bill for comments on design and drafting (not policy) issues. In Powerco's

opinion where this has been done by MED recently it has been a very valuable exercise. The present Bill is likely to present a number of difficult design and drafting issues, and consultation on a discussion draft would be a good investment in a robust final outcome.

B THE REGULATORY FRAMEWORK

Powerco agrees with the Government's direction

- 9 Powerco appreciates the Government has responded to the concerns that investors have raised regarding the current way of regulating. In particular, Powerco endorses the decision to make available a default/customised price control option that utilises pre-set input methodologies.
- 10 The attractive features of this model are intended to be:
- 10.1 transparency and accountability in relation to the setting of the input methodologies;
 - 10.2 a low discretion in applying the input methodologies (ie the consideration of any customised price path proposal). This materially increases the certainty for investors;
 - 10.3 accountability for the way the Commission applies the input methodologies and exercises any residual discretion.
- 11 Powerco's concerns are that the current package will not deliver these benefits in practice.

Practical shortcomings

- 12 The likely practical outcome of the proposed package is a high discretion model and low accountability, similar to the current position (around which there is a consensus that it is unacceptable).
- 13 The features that contribute to this outcome are:
- 13.1 the Commission sets the input methodologies, and does not have the same incentives as an independent rule maker to err on the side of specificity;
 - 13.2 for an input methodology to be settled in the abstract and potentially applicable to any sector, the Commission is likely to err on the side of generally worded rules, and/or default rules with the option of specific solutions in particular cases;
 - 13.3 at this level of analysis, merit review will correct extreme decisions but otherwise not constrain the Commission;
 - 13.4 the Commission will have a large discretion when applying the input methodologies to particular cases, and will make material methodological choices;

- 13.5 merit review will not be available to hold the Commission accountable for its decisions in particular cases. Powerco notes that officials recommended a wider scope for merit review.
- 14 The sum total of these factors present a challenge for officials and investors. In this submission Powerco raises suggestions that would address some of these concerns within the framework set by Cabinet. Powerco would appreciate an opportunity to discuss these issues further with officials.

C THE PURPOSE STATEMENT

- 15 Powerco agrees with the Cabinet decision to add a purpose statement to Part 4.
- 16 There is a risk that the discussion to date of the appropriate purpose statement has been overly focussed on resolving or addressing the public benefit/wealth transfer debate. This has resulted in a purpose statement that simply identifies a number of outcomes to be promoted. Powerco's recent experience in the gas authorisation context is that what is most useful is a clear statement of the objective of regulatory price setting.
- 17 Powerco submits this should be setting terms that are consistent with outcomes in a workably competitive market.
- 18 This is one area where Powerco and the Commission agree. In paragraph E.21 of the draft decisions paper on the gas pipelines final authorisation the Commission stated:

Consistent with the legal requirements under the Act and having regard to the relevant Government Policy Statements, the Commission sees the primary objective of the Authorisation as setting control terms for the controlled businesses that promote outcomes that are consistent with a workably competitive market. Over time, businesses that operate in a workably competitive market

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- (a) *are limited in their ability to extract excessive profits;*
 - (b) *face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands;*
 - (c) *share the benefits of efficiency gains with consumers, including through lower prices;*
 - (d) *have incentives to invest in replacement, upgraded and new infrastructure.*
- 19 As can be seen from the Commission's statement, the detailed outcomes in a workably competitive market are not too different from the outcomes identified in the proposed purpose statement. Powerco is not proposing a major shift from the purpose statement endorsed by Cabinet. What has become clear in practice, however, is that a clear principal objective (in the Commission's words) of reflecting outcomes in a workably competitive market provides a robust framework for regulatory price setting. Without it,

the purpose statement is simply positing a number of worthy outcomes to be weighed and pursued.

- 20 An express principal objective of reflecting workably competitive outcomes is consistent with the Commerce Act framework. As officials will be aware, the purpose of the Commerce Act is (section 1A):

to provide competition in markets for the long term benefit of consumers within New Zealand.

- 21 Competition is defined in the Commerce Act as workable or effective competition (section 3(1) of the Commerce Act). The High Court¹ has endorsed the meaning of “workable competition” as:

a market framework in which the pressures of other participants (or the existence of potential new entrants) is sufficient to ensure that each participant is constrained to act efficiently and in its planning to take account of those other participants or likely entrants as unknown quantities.

- 22 Seen in this broader framework, a key objective here is to make sure the specific purpose statement in Part 4 does not cut across or displace the overarching purpose of the Commerce Act (and the principal objective of regulatory price setting).

- 23 This is also consistent with the approach internationally, where there is a consensus that the objective is to reflect workably competitive outcomes. In Australia, the Australian Competition Tribunal has stated:

... the primary quest is for a proper contemporaneous value from which to deduce a tariff that will replicate a hypothetical competitive market. It is not to provide subsidies to customers. Pricing below a tariff based upon true value would not replicate a competitive market.

- 24 Powerco is interested in working with officials on how the objective of workable competition is captured in the purpose statement. As a discussion draft, Powerco proposes:

The purpose of this Part is to provide for regulation of prices and quality of goods and services to promote the long term benefit of consumers in markets where there is little or no competition and prospect of competition. Any regulation provided for under this Part

¹ In *ARA v Mutual Rental Cars (Auckland Airport) Ltd* (1987) 2 TCLR 141 and *Fisher and Paykel Ltd v Commerce Commission* [1980] 2 NZLR 731, 757.

should set terms that promote outcomes consistent with a workably competitive market. This includes suppliers:

Deleted: such that

(a) having incentives to innovate and to invest, including in replacement, upgraded and new assets and related businesses;

Deleted: have

(b) facing strong incentives to improve efficiency and provide services at a quality that reflects consumer demands;

Deleted: face

(c) sharing the benefits of efficiency gains with consumers, including through lower prices;

Deleted: share

(d) being limited in their ability to extract excessive profits;

Deleted: are

(e) charging prices that do not foreclose the threat of entry that would exist in a workably competitive market.

D THE PROPOSE/RESPOND MODEL

Setting the input methodologies

- 25 Powerco endorses the concept of pre-set input methodologies. This could be a significant advance on current practice.
- 26 However, as noted above in section B, the practical outcome under the Government's proposed framework is a high discretion model that lacks the predictability and accountability benefits of a propose/respond model.
- Set a required degree of specificity**
- 27 As currently proposed, the input methodologies would be set by the Commission in the abstract. This means that the debate over the input methodologies will be very high level, as the task will be to set appropriate methodologies that could apply to any sector and to any company.
- 28 The Commission is likely to suggest a framework of default settings with the possibility of flexibility in individual cases. Given the way the framework has been set up, requiring an input methodology that could apply to a range of sectors and firms, this level of generality and flexibility is likely to be the Commission's preference.
- 29 An example is the Commission's approach to the important question of whether to index the regulatory asset base. The Commission has expressed a preference for indexation, but said it will consider the alternative approach of locking in the asset base and making additions and disposals at actual cost where this is appropriate in the specific case. Powerco has submitted to the Commission that its approach runs together the issues of indexation and economic depreciation. For present purposes, however, this illustrates how the Commission's likely approach defers the substantive decision on methodology until the Commission considers a particular customised proposal. At this point the Commission is far less accountable.
- 30 To deliver the certainty and accountability benefits of the propose / respond model endorsed by Cabinet, Powerco submits the Act should require the input methodologies to be sufficiently specific such that:
- 30.1 the Commission could reasonably expect to consider a customised proposal without having to make decisions on any significant methodological issue;
- 30.2 the investor has certainty about how to calculate the inputs to the building blocks model, and therefore the value of the inputs. This includes knowing the criteria against which the Commission will

assess company-specific parameters, such as opex and capex forecasts.

- 31 This would be one of the criteria against which the input methodologies are measured on merit review.
- 32 The contrast is with Australia, where the methodological rules are set by the Australian Energy Market Commission, and applied by the ACCC. The AEMC has the correct incentives to set an appropriate degree of specificity. While a decision has been made in the New Zealand context not to split the roles of rule making and rule applying, the task is to find an alternative way of creating the same incentives.

- Industry-specific input methodologies

- 33 A second way that the specificity issue could be addressed would be to require the Commission to set industry-specific input methodologies (where it is known that it will apply).
- 34 Setting input methodologies at the industry level will allow the Commission to make more specific choices between alternatives that would otherwise have to be presented as options in the input methodology (undermining certainty). The Commission could take better account of forecast growth, available information, future investment needs, and so on.
- 35 This would be much more consistent with Cabinet's decision to adopt a model requiring the Commission to give certainty over input methodologies upfront, and to give investors an opportunity to correct errors on merit review.

Setting the default price path

- 36 The Cabinet decision envisages that the current exercise to reset the thresholds from 1 April 2009 would also serve as the process by which the default price path would be set. There are a number of significant practical difficulties with this approach.
- 37 In all likelihood, the default price path will only apply for non-trust-owned lines businesses (of which there are 11). Trust-owned lines businesses are likely to select the option created to take advantage of the trust ownership structure. This means that it is now unclear whether the price/quality analysis for the 1 April 2009 reset should be set on the basis of the 11 businesses, or the whole 28.
- 38 The current thresholds have now produced "over 100 breaches dating back to 2003" by "27 of 28 lines businesses". While this is liveable (but not acceptable) in the context of a thresholds regime, this outcome would be chaotic under a default price path (which is standard price control). This

illustrates there is a significant difference between a default price cap, which is nevertheless a price cap, and the thresholds that have been set by the Commission. If the 1 April 2009 reset is to double as the default price cap, the Commission will need to set a materially different “threshold”.

- 39 More fundamentally, there is a real concern that requiring the Commission to develop, consult on and set a default price cap will significantly delay the development of the input methodologies. This delays the entire regulatory package, as the test for regulation, information disclosure and price control aspects of the proposed package rely on input methodologies being in place.
- 40 Relying on the Commission’s current Guidelines for such an extended period of time is not a credible option. These were not drafted with the propose/respond model in mind, and will not deliver the certainty and accountability intended by Cabinet. These benefits will only come from specific, made for purpose input methodologies. If the Commission must first focus on setting a default price cap, these benefits are several years away.
- 41 An immediate, short term step officials could take is to clarify that the Commission is to set a single default price cap, and not attempt the multi-path approach taken in the thresholds regime. While this would not resolve the significant timing issue, it would foreclose the possibility of the Commission making the task more complicated.
- 42 Powerco submits that the default price cap could be set in regulation now, until the Commission has finalised its formal input methodologies, while the Commission develops the input methodologies as a first priority. Powerco endorses the ENA submission that the default path for the first period should be CPI (i.e. $CPI - X$, where $X=0$), with no P_o adjustment. The thresholds regime has put all lines businesses on a glide patch to acceptable efficiency and returns, and CPI is now an appropriate default setting while other aspects of the regulatory framework are developed.
- 43 Regardless of how the default price path is developed, Powerco submits a P_o adjustment is inappropriate. The Cabinet paper leaves open the possibility of a P_o adjustment if it can be done using the information disclosure accounts. As the Commission has used the information disclosure accounts in the past to set X factors, the Commission clearly does not see this as a constraint.
- 44 In a default price cap setting, however, a credible P_o adjustment requires a building blocks approach, which in turn requires the Commission to complete its input methodologies. Powerco submits the Commission

should be limited to the ability to consider a Po adjustment (prospective only) once it has finalised its formal input methodologies.

Approving customised proposals (ie applying the input methodologies)

45 Issues of concern to Powerco are that:

45.1 when a firm proposes a customised price control path, the Cabinet paper is unclear as to whether the Commission will have a discretion beyond checking compliance with the input methodologies. If the Commission did have a discretion this would leave the Commission free to pursue wider objectives and significantly erode certainty for investors;

45.2 the suggestion that the Commission could respond to a customised proposal by setting different terms;

45.3 there will be no merit review or other accountability on the Commission's decision-making.

46 This is quite different from how the proposal was presented in the discussion paper, and the proposal that was endorsed by the industry. Powerco acknowledges that officials recommended a wider scope for merit review. If there is to be a material increase in regulatory certainty from where we are now, it will be important that the role of the Commission is limited to checking compliance with the pre-set input methodologies.

E MERIT REVIEW

Setting the input methodologies

- 47 Powerco endorses the availability of merit review at this stage. However, as noted in section B given how general the input methodologies are likely to be, merit review of the Commission's proposals for input methodologies is only going to act as a check on extremes.
- 48 Powerco notes that the proposed grounds for judicial review are based on existing and proposed Australian legislation regulating gas.
- 49 On merit review, the criteria against which the correctness of the input methodologies is tested will be crucial. The proposal seems to be that input methodologies will be tested against the new purpose statement.
- 50 This is a very general test and Powerco doubts the degree to which this increases the accountability of the Commission.
- 51 In this context, the proposal discussed above in section C, that the purpose statement contain an explicit commitment to efficient pricing and reflecting the outcomes in a workably competitive market, will also improve accountability. This provides a clear, well understood and internationally accepted standard against which to test regulatory proposals.
- 52 Powerco would also like to explore with officials whether there should be further detailed criteria against which the input methodologies can be tested, including a requirement for adequate specificity (discussed above in section D).

Applying the input methodologies

- 53 Powerco notes that, in order to improve certainty and accountability of the Commission, it is likely that ultimately the regulation will need to include the ability to seek merit review of the Commission's decision to approve or decline a proposal by a firm for a customised price path (ie the application of input methodologies in a particular case).

F OTHER ISSUES

Transition arrangements for gas pipelines

- 54 The transition arrangements for gas pipelines are unclear.
- 55 The Cabinet paper states that the final authorisation currently being set by the Commission would apply until the end of the “first regulatory period”. This has created some confusion. The draft decision from the Commission proposes two regulatory periods, with the second finishing at the end of the period set in the control order. It is unclear whether the Cabinet decision is for the final authorisation to apply for only the first of these two periods, or for the entirety of the period of the control order.
- 56 If the first outcome is intended, this has material consequences for some of the decisions being made by the Commission in the context of the final authorisation. As the gas final authorisation process is continuing, with submissions on the draft discussion already made and a conference planned for February, Powerco requests that officials clarify this point at the earliest opportunity.

Transition issues for the electricity lines regime

- 57 The Cabinet decision is for the current guidelines issued by the Commission to be used as the input methodologies until the Commission issues formal input methodologies. This lack of certainty or oversight on one of the key aspects of the new regime is not appropriate. Powerco submits the Act should set a time limit by which the Commission must have proposed formal input methodologies that replace the current guidelines.
- 58 Powerco has seen the submission made by Orion, and shares Orion’s concerns regarding the transition issues highlighted in that submission.

The customised price path model

- 59 Powerco has some detailed questions around how the customised price path model will work, and would be grateful for the opportunity to discuss these issues.
- 60 The stipulation that the Commission only has to consider four proposals a year could potentially create a backlog. Will there be any kind of safety valve or back up?
- 61 It is not clear what happens if a proposal is rejected, beyond the firm staying with the default price path. Does this count as the firm’s one proposal during the regulatory period – or can the firm revise and resubmit its proposal?

- 62 What happens if a firm has already made one customised proposal, and had that proposal accepted, but the circumstances of the firm materially change? Can the terms be reopened?