



**Powerco submission to the Ministry of Economic  
Development's discussion paper on funding the  
Regulation of Electricity, Gas and Airports Sectors  
under the revised Commerce Act 1986**

**14 November 2008**

## Introductory comments

1. This submission provides Powerco Limited's (Powerco) comments on the discussion paper "Funding the Regulation of Electricity, Gas and Airports Sectors under the revised Commerce Act 1986", published by the Ministry of Economic Development (the Ministry) on 2 October 2008.
2. The passing of the Commerce Amendment Act 2008 marks a fundamental change to regulation of the infrastructure sector in New Zealand. Powerco looks forward to working with the Ministry and the Commerce Commission to ensure its successful implementation and welcomes the opportunity to comment on the allocation method of the regulation levy between the various sectors.
3. The Ministry has stated in its Discussion Paper that, at this time, it is not consulting on the level of funding for the Commerce Commission to complete its various regulatory activities. As a consultation timeline is not provided, Powerco has used this opportunity to provide some brief comments on the level of funding in the indicative budget, and the treatment of levies under future price control.

## Comments

### *Principles and framework*

4. Regulators can be funded in a variety of ways, varying from public funding, license fees, company levies and consumer charges. Before providing comments on the Ministry's proposals, it is helpful to discuss principles and a framework for approaching this issue.
5. The Commerce Commission exists to protect consumers, who ultimately fund the Commission's actions. This is both the most logical way of funding a body established to protect their interests, and also the best way of facilitating the Commission's independence.
6. While the cost of regulation is initially passed to regulated companies, it is widely accepted in New Zealand and internationally that this cost will be passed onto energy users in the long term. For example, levy costs are often included in the indirect costs of a company when determining its allowable revenue under incentive regulation, and in New Zealand, the Commission has classed levies under Section 53ZE of the Act as pass through costs<sup>1</sup> in its recent Authorisation of Powerco's gas services.
7. Ensuring that the amount consumers pay for regulation is proportionate to the amount that they benefit from regulation can be very complicated. Firstly, what price are consumers willing to tolerate for the administration and implementation of regulation? While the Ministry has not asked for comments on this issue, Powerco provides some comments later in this submission.

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<sup>1</sup> Commerce Commission Authorisation of Powerco Services, 31 October 2008, Section 6.4 states that "levies payable under section 53ZE of the Act" are to be treated as pass through costs.

8. Secondly, how should the total cost of regulation be divided between consumers? For example, do rural and small gas consumers benefit more from the regulation of gas networks than large industrial gas consumers? Do customers of consumer trusts benefit less from regulation than electricity consumers linked to the networks of private companies? This issue can be further complicated by judgements of equity and efficiency and other criteria.
9. The Ministry listed a set of principles of levy setting in its consultation paper "Consultation Regarding Levy of Industry Participants under Section 172ZC of the Electricity Amendment Act 2001", published by the Ministry on 10 July 2003. These principles are listed below. It is also useful for the Ministry to consider the Treasury Guidelines for Setting Charges in the Public Sector, published in December 2002, and the Audit Office Guidelines on Costing and Charging Public Sector Goods and Services, published in May 1989.

**Ministry of Economic Development Principles, July 2003**

**Economic efficiency:** the levy structure should promote efficient market behaviour (or at least not materially detract from it).

**User/causer pays:** where the causes of the costs of providing certain services are identifiable, levies should be structured on a causer pays basis.

**Rationality:** where levies are to recover costs that are allocated to participants or participant classes, there should be a relatively strong logical nexus between the participants to whom a levy is imposed and the costs being recovered through that levy.

**Simplicity:** the levy structure should not create undue transaction costs for the organisation which implements and administers it, or for the participants who must pay it; the levy structure should consist of as many individual levies as necessary to recover the costs in an efficient manner, taking account of all other criteria; and the levy structures should be transparent to industry participants.

**Equity:** users in similar situations should pay similar amounts; and competitive neutrality should be preserved. Within a class of participants the allocation of costs should not competitively advantage one participant over another.

**Comprehensiveness/revenue sufficiency:** the levies (together with other sources of revenue, such as penalty payments) need to be sufficient to recover the costs borne by the organisation collecting the levy.

10. Powerco's comments in this submission are based on the amount that we think it is fair and reasonable for Powerco's gas and electricity consumers to contribute to the development of regulation, while considering the Ministry's principles listed above.

## The regulatory activities to be funded

11. The Ministry has provided the following indicative budget in the Discussion Paper:

**Table 1: Activities to be funded by levy and budgeted total levy spending for each financial year (in \$'000s).**

Sector	2008/09	2009/10	2010/11
<b>Gas</b>			
<ul style="list-style-type: none"> <li>• Input Methodologies</li> <li>• Information Disclosure</li> <li>• Part 5 Price Control (Vector and Powerco)</li> <li>• Default/customised price/quality path</li> </ul>	2,900	1,600	1,600
<b>Electricity</b>			
<ul style="list-style-type: none"> <li>• Input Methodologies</li> <li>• Information Disclosure</li> <li>• Residual administration of Part 4A</li> <li>• Default/customised price/quality path</li> </ul>	7,100	3,400	3,400
<b>Airports</b>			
<ul style="list-style-type: none"> <li>• Input Methodologies</li> <li>• Information Disclosure</li> </ul>	1,300	800	400

### *Electricity*

12. The Ministry has proposed that the levy under Section 53ZE of the Commerce Amendment Act is divided between the companies in each sector (electricity, gas and airports) based on each company's share of total asset valuation. The one exception to this is that the costs of developing the electricity default/customised price quality path will not be levied on the consumer-owned<sup>2</sup> companies who are only subject to information disclosure.
13. Consistent with the Ministry's principle of 'user pays', the costs of regulation should be born by the people who benefit from the regulation; and conversely, where consumers do not benefit from a regulation activity, they should not incur the costs. The Commission has proposed that "only those businesses subject to default/customised price-quality path regulation pay for the costs of that regulation". Powerco agrees in general with this approach.
14. We do note that, although consumer-owned companies are, in the first instance, only subject to information disclosure, they may be subject to the input methodologies through the application of section 54H. Given this, consumer owned companies should, as the Ministry has proposed, be required to contribute to the funding of the development of the input methodologies. Powerco agrees with the Ministry when it states that "as all

<sup>2</sup> As defined in clause 54D of the Commerce Amendment Act 2008.

lines businesses are subject to the other parts of the regulatory regime all businesses should contribute to the costs”.

15. Following this approach, Powerco recommends that any of the Commerce Commission’s costs associated with a consumer-owned electricity distribution company losing its exemption status should also be paid by only the firm involved. For example, if a petition under clause (3) of Section 54H of the Commerce Amendment Act is made, the cost of the Commission’s subsequent investigation should only be born by the consumer-owned company being investigated.

#### *Gas*

16. With respect to gas regulatory activities, the Ministry has proposed that all gas pipeline businesses be charged for all gas regulation activities. Powerco is concerned about the cost of regulation that will fall on a relatively small number of gas consumers. While Powerco’s gas customers may benefit from the development of the gas default/customised price path from 1 July 2012, they have already been subject to the extensive costs of developing the gas Final Authorisation that will apply to 2012. The total cost of developing this regulation has amounted to around \$7.26 million since 2002<sup>4</sup>. The process has also involved extensive work that is likely to contribute to the development of the input methodologies and the default-customised regimes. It is unreasonable to expect Powerco’s gas customers to bear the costs of developing a scheme that they will not benefit from for nearly four years.
17. Powerco recommends that businesses under Part 5 of the Act continue to pay their own costs, and do not contribute to the costs of developing the default/customised price-quality path. The division of funds of the gas process has been occurring administratively since 2005, and it should not be significantly administratively complex to continue an already operational process.

#### *A minimum level of levy*

18. Powerco recommends that all companies pay a minimum amount of levy to cover the fixed costs of administering regulation for a company. Every regulated firm will generate a basic level of administrative cost, and the levy should be set at a level that recovers this cost. In the United Kingdom for example, the Office for Gas and Electricity Markets (Ofgem) has a minimum licence fee payable. This was set at £500 (around NZ\$1,500) in 2005.<sup>5</sup>

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<sup>4</sup> The figure is calculated from the estimated actual revenue in the ‘Control of Natural Gas Services’ in the Budget Appropriations from 2003 to 2008. The total from 1 July 2002 to 30 June 2008 amounts to \$7.26 million.

<sup>5</sup> For information on the principles behind Ofgem’s levy arrangements see: <http://www.ofgem.gov.uk/Licensing/Work/Documents/1/3826-licfeescostrecfeb2002.pdf>

### *A maximum level of levy*

19. Powerco also recommends that there is a cap on the maximum levy a regulated firm should pay. For example, in Italy industry contributions to the Authority for Electricity and Gas (AEEG) can not exceed 0.1% of the licensee's income in the previous financial year, and in Luxembourg the annual levy must not be greater than 0.2% of turnover. In 2007/08 Powerco's levies to the Ministry amounted to over \$1.29 million – more than 1% of Powerco's total revenue for 2007/08 financial year.

### **The division of the levy within the sector**

20. As stated earlier, the costs of a regulatory activity should be divided reasonably between those consumers who benefit from the regulation. In the United Kingdom for example, the electricity and gas distribution network license fees are proportionate to the number of customers of each distribution businesses.
21. The Ministry included using the number of customers served as an option in the Discussion Paper, but stated that this approach is problematic as “distribution businesses [...] would not be comparable to Transpower, whose customers are large generators, large loads, and lines businesses themselves”<sup>6</sup>. The United Kingdom's solution to this issue is for the gas transmission and electricity transmission companies to pay 50% of their sectors total levy.
22. Powerco appreciates that New Zealand's geography and uneven population density leads to significant variations in the proportion of customers to system length and assets in the gas and electricity distribution sectors. Powerco therefore supports the Ministry's proposal where allocation is based on the share of the total valuation of fixed assets.

### **Airports**

23. The Ministry has proposed that “Auckland, Wellington and Christchurch International Airports are all subject to an information disclosure regime, and it is proposed all three airports will fund a levy to pay the cost of the regulation”<sup>7</sup>. Powerco supports this proposal as it is consistent with the approach used for the gas and electricity sectors.

### **Additional comments regarding design of levy regulations**

24. The Ministry has stated that, at this time, it is not consulting on the level of funding or the total amount allocated to each sector. As the Ministry does not provide a consultation timeline for these issues, Powerco provides the comments below on the level of funding in the indicative budget, and the treatment of levies under future price control.

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<sup>6</sup> Paragraph 46, page 10.

<sup>7</sup> Paragraph 66, page 13.

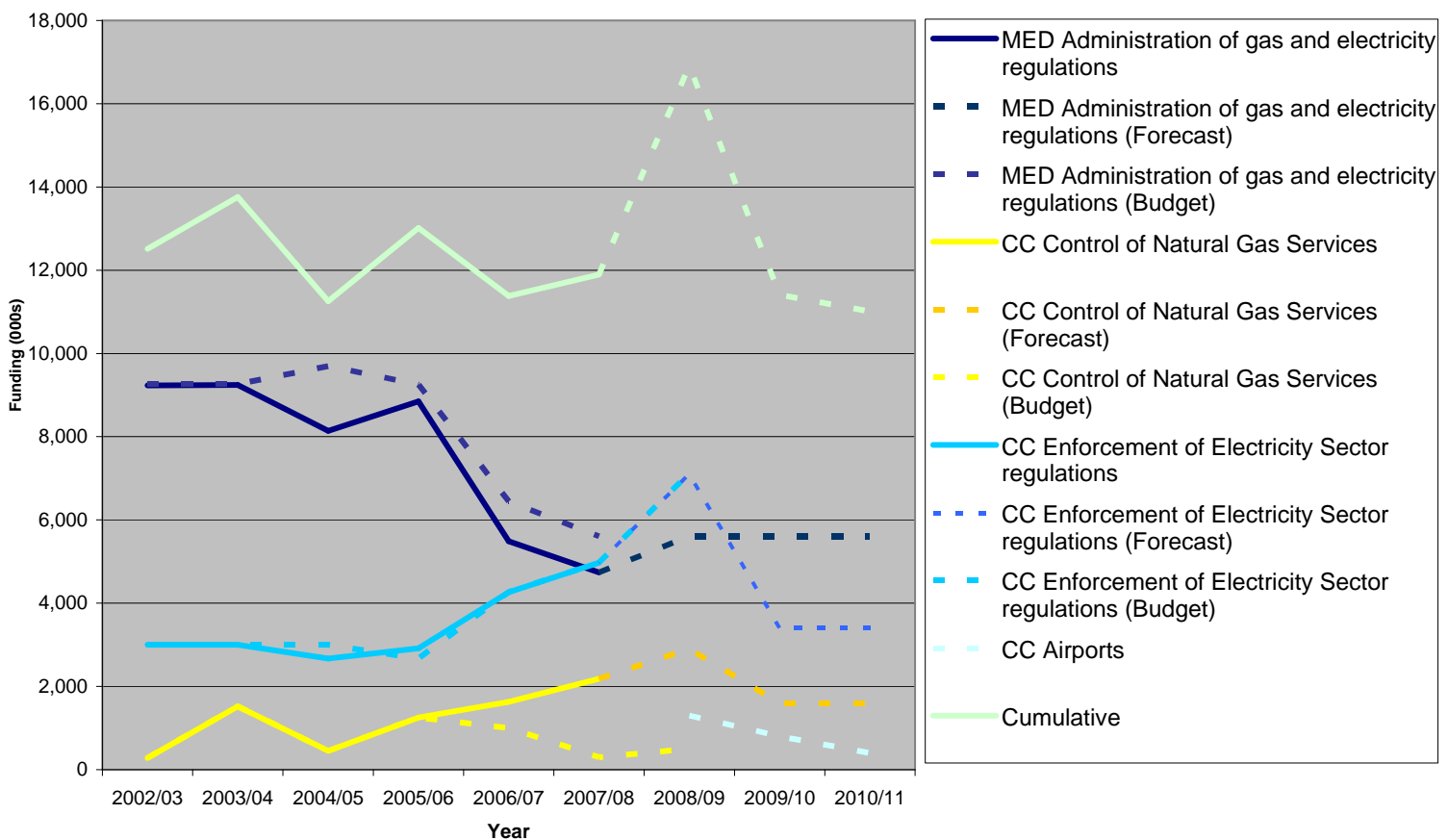
*The level of funding*

25. The Ministry has outlined an indicative budget of \$22.5 million over three years to fund the Commerce Commission’s activity from 2008/09 to 2010/11. This includes \$11.3 million in 2008/09, which is more than three times the Vote Energy appropriation to the Commission in 2007/08.
26. The indicative budget also states that it only lists the key activities of the Commission. Powerco would like the Ministry to clarify if it expects there to be any funding requirements in addition to the indicative budget.

*Change in funding over time*

27. Graph One has been compiled using data from the Vote Energy Budget Appropriations from 2003/04 to 2007/08 and the forecasts in Table 1 of the discussion paper. The graph shows the change in expenditure on the regulation of electricity and gas by the Ministry and the Commerce Commission. It also compares the expenditure budgeted at the beginning of each year with the estimated actual spend towards the end of the year.

**Graph One: Changes in expenditure of electricity and gas regulation over time<sup>8</sup>**



<sup>8</sup> The estimated actual figures in the Budget have been used to show the expenditure of each year to ensure consistency of data used, and there may be minor variations with final expenditure. The MED administration of gas and electricity regulations has been assumed to be constant at the 2008/09 expenditure.

28. The Commerce Commission's funding for enforcing electricity and gas regulation has grown by around 130% in the four years from June 2004 to June 2008. While the combined funding of the Ministry and the Commission for electricity and gas regulation has shown a general decline, the indicative budget in 2008/09 shows a sharp rise in the level of funding.
29. Powerco has a number of concerns. Firstly, it is over five months into the 2008/09 financial year, the year in which over half the total funds are to be spent. Expenditure is also more than three times of the funding level of the year before. Powerco is concerned that it will be challenging to utilise this level of expenditure efficiently in such a short space of time. Work is likely to be delayed, leading to higher costs in later years.
30. This links to an issue of the efficiency of the operational activities of the Commission. Graph One shows that the Ministry has consistently under spent in their administration of gas and electricity regulations. The Commission, in relation to gas regulation, however, has experienced considerable over spend in 2007/08 and 2008/09.
31. The efficiency of Government Ministries, such as MED, is held to account during the Budget process, and by a rigorous Treasury scrutiny process. As the Commerce Commission is funded by industry levies, it is only the Ministry of Economic Development that is able to control increases in the Commission's expenditure. The gas authorisation inquiry illustrates a process where costs dramatically escalated. It is important that this is not repeated in the development of the default/customised price-quality paths.

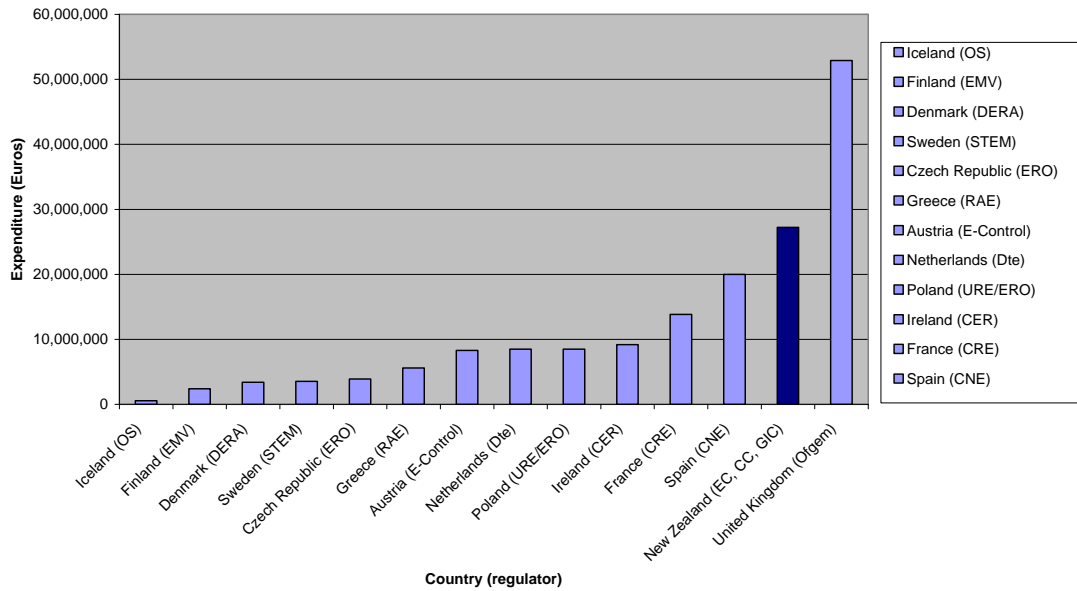
#### *International comparisons*

32. International comparisons of the Commerce Commission's activities in gas and electricity regulation with other countries regulators is difficult due to the unique structure of the Commerce Commission, the Electricity Commission and the Gas Industry Company. The following table provides an illustration of how New Zealand's expenditure on energy regulation in 2007 compares with the expenditure of European Energy regulators in 2004<sup>9</sup>.

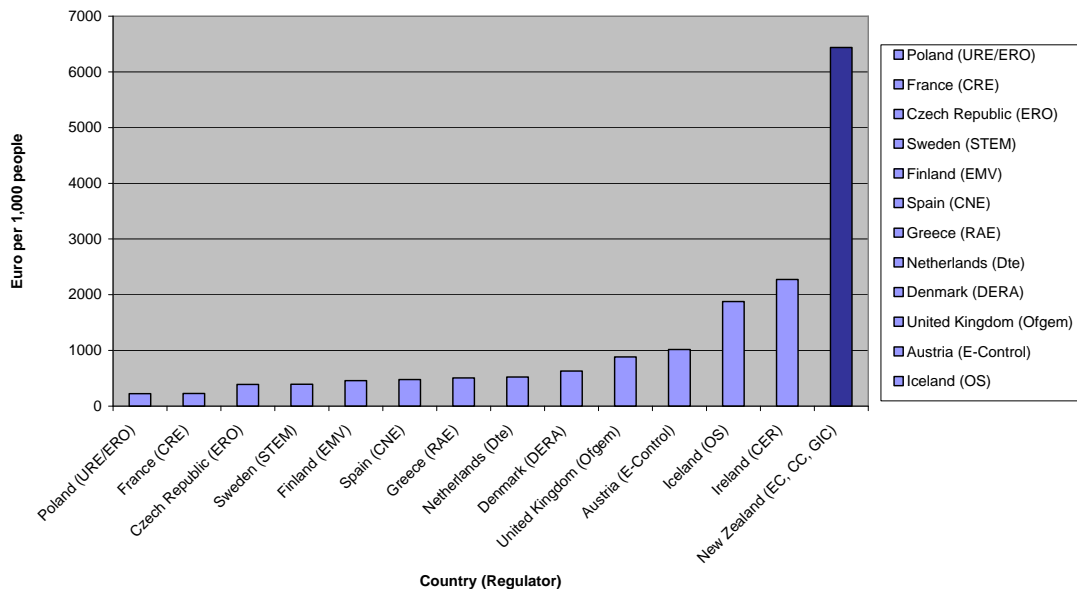
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<sup>9</sup> As the aim is to examine the current level of expenditure, the total in 2007/08 for New Zealand has been used. The New Zealand total is higher than it otherwise might be due to the impacts of inflation. The New Zealand total of \$60,400,007, has been calculated from the Gas Industry Company revenue from levies (\$4,202,007), the estimated actual figures in the 2008 Budget for the Commerce Commission's appropriations for regulating natural gas (\$2,181,000) and electricity regulations (\$4,974,000) and the Electricity Commission's expenditure (\$49,043,000). Graphs 2 and 3 are illustrations, as further analysis is required to break down the functions and costs of each agency to provide a more accurate comparison. The European information is sourced from the Council of European Energy Regulators Regulatory Benchmark Report, 6 December 2005.

**Graph 2: Comparison of total expenditure of European energy regulators in 2004 and New Zealand energy regulators in 2007.**



**Graph 3: Comparison of expenditure per 1,000 people of European energy regulators in 2004 and New Zealand energy regulators in 2007**



33. Graphs two and three illustrate that New Zealand's expenditure on energy regulation is considerably higher than European energy regulators, especially when the population is taken into account.
34. In the United Kingdom there has been growing concern over the cost of regulation. The United Kingdom, HM Treasury published the Hampton report

in April 2005, and its five principles of good practice regulation have become established in UK regulator's minds and most codes of practice. These principles include proportionality and targeting, which both relate to the efficiency of the regulator.

35. To reduce costs, Ofgem, the United Kingdom's equivalent to the Commerce Commission, has self imposed a RPI-3<sup>10</sup> cost reduction regime on itself for five years (ending in April 2010), and its expenditure and operations are regularly reviewed by the UK National Audit Office (NAO).
36. The Commerce Commission is ultimately funded by the electricity and gas consumers it exists to protect. The Commission should lead by example by lowering its own costs to minimise the cost of regulation on energy consumers.

#### *The classification of levy expenditure*

37. In this submission Powerco has argued that the costs of regulation should be born by the consumers who benefit from the regulation. In the past the Ministry has argued that the costs of regulation should not be pass through costs as this does not provide incentives for regulate companies to interact efficiently with the regulator.
38. Powerco believes however, that it has very little control on the Commerce Commission's expenditure. The Authorisation of Powerco's gas services on 31 October 2008 allowed levies under Section 53ZE of the Act to be classed as pass through costs. Powerco recommends electricity regulation also allows levies under Section 53ZE of the Act to be pass through costs.

#### **Levy Collection Arrangements**

39. The Commission recommends that "levies be collected quarterly by the Ministry for Economic Development for both the gas and electricity sectors". Powerco supports this approach.

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<sup>10</sup> The Retail Price Index (RPI) is the United Kingdom equivalent to New Zealand's Consumer Price Index (CPI).

Question	Response
<b>Electricity Lines Businesses Design of Levy</b>	
Do you consider that the proposed allocation of costs for different activities (only lines businesses subject to price-quality regulation pay for the costs of this part of the regime, all lines businesses pay for all other activities) is appropriate?	Yes, the costs of regulation should only be born by the people who benefit from the regulation. This includes the costs of investigations into consumer-owned trusts to be funded by the company being investigated.
If not, what do you consider could be used as a method to allocate costs for different activities, and why?	No comment.
Do you consider that share of valuation of fixed assets (calculated using the methodology required by the Commerce Commission - currently ODV) is a reasonable basis to use to recover costs, within activities?	Yes, it is reasonable. While it is most logical to allocate the levy based on customer numbers, Powerco appreciates that New Zealand's geography and variable population density leads to significant variations in the proportion of customers to system length and assets in the gas and electricity distribution sector. There should be a minimum levy for each company to cover basic administration costs, and a maximum levy for each company based on the percentage of revenue.
If you consider that an alternative basis would be better than share of total valuations of fixed assets, what would this be and why?	No comment.
Do you have any other comments regarding the design of levy regulation for electricity lines businesses?	Please see Powerco's comments on the total expenditure of the Commerce Commission and the treatment of levies as pass through costs in paragraphs 25 to 40.
<b>Gas Pipeline</b>	
Do you consider that the proposed allocation of costs for different activities (all businesses pay for all activities for administrative simplicity) is appropriate?	Powerco is concerned about the cost of regulation that will fall on a relatively small number of gas consumers. While Powerco's gas customers may benefit from the development of the gas default/customised price path from 1 July 2012, they have already been subject to the extensive costs of developing the gas Final Authorisation that will apply to 2012. The total cost of developing this regulation has amounted to around \$7.26 million since 2002 <sup>11</sup> . It is unreasonable to expect Powerco's gas customers to bear the costs of developing a scheme that they will not benefit from for nearly four years.
If not, what do you consider could be used as a method to allocate costs for different activities, and why?	Powerco recommends that businesses under Part 5 continue to pay their own costs, and do not contribute to the costs of developing the default/customised price-quality path. The division of funds of the gas process has been occurring administratively since 2005, and it should not be significantly administratively complex to continue an already operational process.
Do you consider that share of valuation (calculated using the methodology required by the Commerce Commission - currently ODV) should be used as the basis for recovery of the levy?	Yes, it is reasonable. While it is most logical to allocate the levy based on customer numbers, Powerco appreciates that New Zealand's geography and variable population density leads to significant variations in the proportion of customers to system length and assets in the gas and electricity distribution

<sup>11</sup> The figure is calculated from the estimated actual revenue in the 'Control of Natural Gas Services' in the Budget Appropriations from 2003 to 2008. The total from 1 July 2002 to 30 June 2008 amounts to \$7.26 million.

	sector. There should be a minimum levy to cover basic administration costs, and a maximum levy based on the percentage of revenue.
If you consider that an alternative basis would be better than share of total valuation of fixed assets, what would this be and why?	No comment.
Do you have any other comments regarding the design of levy regulations for regulated gas pipeline businesses?	Please see Powerco's comments on the total expenditure of the Commerce Commission and the treatment of levies as pass through costs in paragraphs 25 to 40.
<b>Major International Airports</b>	
Do you consider that the proposed allocation of costs for different activities (all three regulated airports pay for the costs of regulatory activity) is appropriate?	Yes, the approach is consistent with the approach to the electricity sector.
If not, what do you consider could be used as a method to allocate costs for different activities, and why?	No comment.
Do you consider that share of the total valuation of fixed assets used in supplying specified airport services (calculated using the methodology required by the Commerce Commission) should be used as the basis for recovery of the levy?	Yes, the approach is consistent with the approach to the electricity and gas sectors.
If you consider that an alternative basis would be better than share of valuation, what would this be and why?	No comment.
Do you have any other comments regarding the design of levy regulations for regulated international airports?	No comment.
<b>Levy Collection Arrangements</b>	
Do you have any comments on the proposed levy collection arrangements?	Powerco supports the Commission's proposal.