

**Presentation to the 10th Annual Energy Summit
Te Papa Tongarewa Museum of New Zealand
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The Role of Regulation in New Zealand and the Commission's work in the Energy Sector

Introduction

1. Good morning to you all and thank you Mike for your introduction.
2. I note that the theme of this conference is very much forward looking – it is a conference focused on options and strategies for delivering sustainable growth and stability in New Zealand's energy future.
3. I am delighted that the Commerce Commission is considered an important part of such a conference because the Commission does and will play a vital role in promoting and overseeing New Zealand's economic markets including the energy sector.
4. I am going to focus my presentation today on the conference theme and in so doing will set out some of the key aspects of the Commission's role and the work the Commission does. I will set out some of the key aspects of the Commission's current work programme and will look forward to focus on the future.

The Free Market Economy and Energy Sector Growth

5. The Purpose Statement of the Commerce Commission is to promote dynamic and responsive markets so that New Zealanders benefit from competitive prices; better quality and greater choice.
6. The Commission and its staff truly believe in and focus on that Purpose Statement - the Commerce Commission is unashamedly pro-market and operates from the basis that a free market economy is the best way to allocate a country's precious resources, can deliver lower prices, innovative products and greater choice for consumers.
7. The Commission considers that competition underpins the free market economy: As noted last year by the OECD Secretary General Angel Gurría, "greater competition can boost a country's growth and productivity. Conversely, restricting competition harms economic performance and delays development."¹

¹ Angel Gurría, OECD Secretary-General, Presentation of the Competition Assessment Toolkit, June 14, 2007, Mexico City.

8. Competition is a vital ingredient for sustainable growth and stability in New Zealand's energy future. The extent to which markets are competitive will be important for this growth.

Competition's Benefits

9. New Zealand has embraced the market economy model for some decades now but the underpinning of that model – competition – is often taken for granted.
10. US economist Kenneth Train observed that “Competition, in theory, if not always in practice, is nothing short of a miracle.” In a competitive market, each firm tries to make as much profit as possible; each consumer operates in their own self interest and yet, the result is maximum benefit for society.
11. Competition is an elegant process where firms compete on their merits to attract the consumer's dollar. The firms that best meet that demand in terms of price, quality and service are rewarded with higher sales; greater profits; greater returns ... they attract investment and they thrive. It is a watchful endeavour where firms are constantly striving to ensure they are providing the innovation; quality and service that will allow for longevity.
12. The firms that do not best meet customer demand over time are starved of business and eventually go under or disappear – they free up resources for use by more efficient operators.
13. Competitive markets, to a large extent, are self-regulating. The market itself offers the carrots and sticks to encourage optimal outcomes.
14. The most obvious benefit of competition is the pressure exerted by way of lower prices and improved quality, different groups of consumers opt for different offerings dependent on their needs and wants. Competition also encourages productivity by creating incentives to work smarter; to find better ways to do things at least cost – enabling company performance to be measured against competitors. Competition encourages innovation both in the products and services produced and how companies go about producing them. This is always targeted at building or retaining the customer base; making more return; and attracting more local and foreign direct investment.

Competition and Consumer Law

15. For benefits such as these to be delivered however, self-regulation of markets also requires facilitation – facilitation of the competitive process. This facilitation is provided by robust legal frameworks to preserve and promote competition.
16. An economy where there is adequate enforcement of the competition rules is critical for attracting prospective investment as businesses in such markets are then likely to succeed or fail according to their merits.
17. It is the Commerce Commission's role is to promote competition by administering and enforcing New Zealand's legal frameworks. To protect the competitive markets by ensuring that there is adequate enforcement; deterrence; and understanding of competition rules.
18. The Commerce Act is the leading Act designed to preserve competitive markets in New Zealand. It is focused on ensuring that there is no substantial lessening of competition; no misuse of dominant power; no collusive behaviour to the detriment of consumers and competitors; no collusive alliances or "national champion" formation unless the public benefits clearly outweigh the detriments.
19. The Fair Trading and CCCFA are also critical legislation to protect and facilitate the competitive process. Many consider that these Acts are really acts about consumer protection but that is not how the Commission views them, rather the Commission considers this legislation to be vital for the competitive process – Consumers drive competition through their choices. Consumers can only send the right signals to firms if their choices are founded on accurate information – they depend on companies to provide much of that information but companies cannot always be relied on to provide such accuracy.
20. In the past 3 years since I have been at the Commission, several high profile cases have shown how misleading behaviour by firms can disempower consumers, disadvantage competitors and thereby undermine the competitive process. These cases have related to companies operating in many significant sectors of New Zealand's economy - banking; the airline sector; telecommunications; the food and beverage industry. Some cases have involved global businesses operating in the NZ market; others have involved some of NZ's biggest companies. To play their part in the competitive process consumers must be able to trust the information they obtain. The Commission will continue to place a heavy emphasis on its educative; deterrent and enforcement responsibilities under the Fair Trading and CCCF Acts.

The General State of Competition and the Energy Sector

21. The aim of the Commerce Act is to promote competition in markets for the long-term benefit of New Zealand consumers and applies to all sectors of the economy. The Commission is therefore genuinely interested in the state of competition within markets including but not limited to the energy sector.
22. The Commission will investigate complaints and conduct that allegedly substantially lessens competition; or is a misuse of market power to prevent competition or maintain prices at levels higher than might be expected in competitive markets.
23. It is for these reasons that a Part 2 investigation into the national wholesale and retail electricity markets was commenced in 2005.
24. The Commission had received numerous residential and commercial complaints and concerns expressed about electricity generation and retail company profits, customer switching difficulties; and perceived low levels of competitive activity.
25. In theory, effective competition in a market subjects prices to downward pressure over time. In markets with multiple suppliers, high prices can be due to a number of factors – it may be that industry participants are working together to increase or maintain high prices. Alternatively, it may be that firms enjoy substantial degrees of market power and may use that power to prevent competition to keep prices high. There may also be market design issues which are identified as part of the analysis.
26. There has been speculation as to whether electricity prices in New Zealand are at workably competitive levels. Due to the complaints and these concerns the Commission began its investigation.
27. This investigation has required much very detailed, complex data relating to a number of years. The Commission has been disappointed in the quality and availability of this data, particularly the historic data. However, the Commission is appreciative of the efforts of market participants and regulatory bodies for their assistance in filling the information gaps.

28. The Commission does have robust information gathering powers and has used these powers in order to gather the necessary information but nevertheless the ability to obtain the levels and quality of data has been challenging. There are some in the industry that have suggested that the information gathering requests have been excessive. However, it is worth noting that in many jurisdictions around the world much of the data we have gathered for this investigation would be disclosed publicly as a regulatory requirement.
29. The Commission has employed a leading US expert - Professor Frank Wolak, a Stanford University-based economist who has analysed the operation of a number of electricity markets around the world including markets in the US and Australia. A major part of Professor Wolak's work has been focused over the past 20 years on the empirical analysis of market power.
30. Professor Wolak's reports to the Commission will be considered in order to determine whether there are substantial degrees of market power in the wholesale or retail electricity markets or any other competition issues that the Commission should investigate further or take steps to address.
31. The Commission expects Professor Wolak's reports to begin arriving shortly for analysis to complete the investigation.
32. Carrying out such investigations that consider the state of competition in markets is a critical part of the Commission's jurisdiction, particularly in markets that are crucial to the New Zealand economy. By acting on the results of such investigations, the Commission promotes dynamic and responsive markets that can deliver sustainable growth for New Zealand over time.

Regulation and the Energy Sector

33. New Zealand's regulatory approach has maintained the premise that general competition law should constraint the accumulation of market power through consolidation by preventing the abuse of market power and by preventing consolidation that is not in the public interest.
34. There are however firms in vital sectors of the economy that policy makers consider do not face the competitive pressures and self-regulation of competitive markets. They do not have the discipline of the markets to provide information that enables consumers to make accurate choices based on sound information.

35. These are sectors possessing monopoly businesses - such as telecommunications; dairy; airports; electricity and gas. The regimes in each case are different but the objective of regulation is consistent: to deliver the outcomes that would occur if the companies faced competition. "To provide efficient, credible regimes to address the potential exercise of market power in markets where competition is not possible"²
36. The energy sector is considered to be a critical sector for such regulation the world over - possessing "network businesses which are capital-intensive; durable, long-lived and immovable... that make up a large fraction of the economy's productive capital."³
37. In most OECD countries, sector-specific regulation has been in place for many decades and is an acceptable form of market oversight. In New Zealand, by contrast sector specific economic regulation has been a considerably more recent phenomenon. The first real attempts at regulation, outside of early information disclosure, were the passage into law in 2001 of the Telecommunications Act and the amendments in the same year to the Commerce Act with the introduction of Part 4A for electricity lines businesses which established the targeted-control regime and complementary information disclosure regimes.
38. As with other jurisdictions however, New Zealand has still grappled with the questions of how regulatory regimes provide sufficient certainty and timeliness to provide incentives for investment and innovation balanced with delivering the efficiencies sought for the long term benefit of consumers. In Australia, for example, this resulted in the recent national market reforms for electricity and gas which have increased the prescriptive nature of the National Gas Law and National Electricity Law.

Commerce Amendment Bill

39. On Friday 5 September, we followed suit with the Commerce Amendment Bill receiving its third reading. It will likely take effect in October. The Bill obviously has quite some impact on the energy sector and the regulatory frameworks within which parts of that sector work.

² Commerce Committee. (2008). Commentary on the reported back Commerce Amendment Bill;p.1

³ Newbery, David M. 1999. Privatisation, Restructuring, and Regulation of Network Utilities. The MIT Press, Cambridge, Mass; p.27

40. The Commission has to this point worked under its regulatory jurisdiction of the Parts 4, 4A and 5 of the existing Commerce Act 1986. This has included focusing on the threshold reset for electricity lines businesses; developing and *gazetting* requirements for complementary information disclosure; ensuring that post breach inquiries are completed in priority order.
41. A number of parties suggested that we should have delayed particular work streams or simply rolled over the thresholds, for example. However, that is not the approach that an independent regulator with integrity will take. The Commission had a jurisdiction with a particular purpose statement that it was required to work and to ensure that the incentive effects of that regime were enhanced in a timely manner. The Commission could not simply desist from continuing its work programmes on the basis that a Bill might pass.
42. Now planning for the new regimes can really begin to ensure that the work required can be delivered in priority order. Before discussing some of these priorities however, I first wish to make some comments about the new Bill, and what it brings.
43. The Bill does bring a legislative framework for regulation that, in the interests of certainty and timeliness, provides a new level of prescription; and a set of statutory timeframes. These will apply to all interested parties and it will be a challenge for all involved in the regulatory process to meet the prescription and timeframes as set out. Regulated businesses will need to become better equipped and more adept at dealing with the timeframes and requirements of the regulation, just as the Commission will. There will necessarily be more rigour in the regulatory process - extension requests, for example, will be very carefully scrutinised and will require solid justification.
44. The effectiveness of the prescription and timeframes will depend on whether regulated parties acknowledge and take steps to reduce the information asymmetry that can critically constrain a regulator's ability to make timely decisions.

Accountability

45. The Commission in its submissions on the Bill submitted that a balance needed to be struck between the provision of accountability in decision making and timeliness. The Commission noted the availability of judicial review to parties of any decision the Commission made and suggested a limited right of appeal and some clear grounds for appeal (as applied in Australia).

46. Appeal mechanisms have been provided both with respect to determinations of input methodologies and at the stage where the Commission makes end point determinations on customised or individual price-quality path determinations. Measures have been built into the Bill to ensure that these mechanisms cannot be used as a way of gaming the regime or the regulator. This satisfies the Minister of Commerce that there will be sufficient checks and balances to avoid such gaming.⁴
47. The decisions that interested parties make in terms of their use of the accountability mechanisms will still however be vital to the effectiveness and timeliness of the regulatory decisions. While it is important to ensure accountability, potentially multiple levels of review can delay the decision making process substantially.

Regulated Sectors

48. Electricity lines businesses; gas pipelines businesses and the three major international airports are subject to different regimes under the Bill. There are major changes from the existing regimes that the Commission works with. The Commission has commenced preparation to develop the priority workstreams resulting from the Bill.
49. All other sectors that may be subject to future regulation will require an inquiry to have been undertaken that is more streamlined than the existing Part 4 process. The criteria to be met are that there is little or no competition and little or no likelihood of a substantial increase in competition; and there is scope for the exercise of substantial market power, taking into account the effectiveness of any existing regulation or arrangements, including ownership arrangements; and the benefits of regulation must materially exceed the costs.
50. Moreover, the Bill enables a range of regulatory instruments to be put in place which provides far greater flexibility for the Commission when making recommendations resulting from such inquiries. The Commission could singularly recommend information disclosure, for example, or could recommend information disclosure in conjunction with other regulatory forms that are set out in the Bill. It is worth noting that at the heavier end of the range of regulatory instruments - Part 5 price control, although not explicitly retained as an option in the new Bill, could still be recommended as an option under individual price-quality regulation. In every case, the form of regulatory control if breached may result in statutory penalties.

⁴ Hon Lianne Dalziel, Minister of Commerce, Commerce Amendment Bill Second Reading; p.2

51. The new inquiry process is a considerable improvement on the existing inquiry process that involved a two-step “whether to” and then “how to” control process and should be considerably more efficient to administer.

Purpose Statement

52. I also wish to mention the important improvement of the inclusion of a specific purpose statement for economic regulation which will consistently apply to any of the activities the Commission or regulated parties subject to Part 4 undertake. The Minister in introducing the Bill for second reading suggested that the absence of such a purpose statement had provided considerable uncertainty in the past for infrastructure businesses and their investors.
53. The new purpose statement does make it clear that the objective of regulation is the promotion of the long-term benefit of consumers in markets where there is little or no competition and little or no likelihood of a substantial increase in competition.
54. This is to be achieved by promoting outcomes consistent with outcomes produced in competitive markets such that suppliers of regulated goods and services –
- Have incentives to innovate and invest ...
 - incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
 - Share with consumers the benefits of efficiency gains in supply of the regulated goods and services through lower prices; and
 - Are limited in their ability to extract excessive profits.
55. This purpose statement is similar to that currently operating for Part 4A relating to electricity lines businesses. It requires a careful balancing between two key aspects at the heart of economic regulation – the ability to ensure that regulation does not deter investment in infrastructure while ensuring that service providers are pricing and operating efficiently and sharing the gains in efficiency over time; as would occur in competitive markets.

Input Methodologies (Regulatory Principles and Guidelines)

56. One of the fundamental changes in the Bill is the statutory provision for the development of input methodologies to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to regulation or proposed regulation of goods and services.

57. The Bill is designed to ensure that as a priority the Commission will determine input methodologies in sufficient detail so that the material effects can be estimated and that the determinations be completed by 30 June 2010.
58. The Commission has recognized the need for greater transparency and certainty of key inputs into the regulatory decision making process. It was for those reasons that it commenced its cost of capital guidelines consultative process including using leading expert advisers from offshore jurisdictions as well as from within New Zealand.
59. The Commission also confirmed with the Minister of Commerce that it wished to commence the development and planning of such activities as soon as possible, regardless of the regulatory regime it was working under. This has enabled us from the beginning of this year to commence the work to build a team to work on the methodologies. The Commission is confident that we can deliver within the statutory timeframes.
60. It was intended to begin consulting on the principles of regulatory economics as a key input into the development of guidelines for the main inputs (as outlined in the Bill) in August this year. However, as this time drew closer it became clearer that the work that the Commission was developing and the proximity of legislative change would likely influence the draft principles and their context. The Commission therefore indicated that the release of principles for consultation would be delayed but would not affect the timeframes for the other work that we would be carrying out as part of the input methodologies work programme.
61. It is the Commission's intention to release principles for consultation in November/December this year.

Thresholds Regime (Part 4A of the Commerce Act)

62. The Commission had been working to reset the existing price-path and quality thresholds to take effect from 1 April 2009 for all electricity lines businesses. The Bill when it takes effect will change this work programme.
63. The Bill will roll over the existing price-path and quality thresholds for those lines businesses subject to the default price-quality regime under the Act and deem them to be default price-quality paths for a year to 31 March 2010.
64. A number of businesses will, due to their ownership arrangements, be subject to information disclosure only.

65. The Commission will therefore not be resetting the price-path and quality thresholds to take effect in the time frame anticipated under the existing Part 4A regime. However, considerable research into quality-reliability and other matters relevant to the establishment of any default price-quality regulation has been undertaken and the Commission will carefully consider the extent to which such matters can be applied in the consultative process leading to the setting of the first default price-quality paths under the new regime due to take effect on 1 April 2010.

Information Disclosure

66. The Commission has indicated that it would publish performance requirements by the end of September to refine the electricity information disclosure regime that the Commission took over from MED in 2004.
67. Currently the Commission is on track to do this although it may be a few weeks later yet, dependant on the advice with respect to the fit between the new requirements and the Bill. The Bill does include explicit savings provisions for information disclosure but it is the preference of the Commission to ensure that any requirements are consistent with the purpose statement of the Bill.

Process Paper(s)

68. In order to ensure clarity in the transition for interested parties regarding how the Commission will proceed with input methodologies and information disclosure, the Commission is considering the release of process papers for consultation shortly after the Bill has taken effect.

Compliance Assessment and Post Breach Inquiries

69. The Commission intends continuing to conduct its analysis of the annual self-assessment of businesses subject to the existing Part 4A thresholds regime and will continue to conduct inquiries into breaches that the Commission considers require further investigation. This week Commission staff and expert advisers will be visiting two network businesses, subject to post breach inquiries, to understand some of the issues relating to existing breaches further and to assess network practices.
70. The Bill provides transitional arrangements to enable the Commission to continue to complete relevant priority work in this area.

Gas Pipelines

71. The Commission is continuing to complete the control authorisations or accept undertakings for the regulated gas pipelines businesses of Powerco and Vector. It is intended that final decisions will be released in late-October, 2008.
72. The Commission, in April, received a separate offer of undertaking from both Powerco and Vector. An offer of undertaking can be accepted instead of making an authorisation. On 5 September, the Commission issued its preliminary view on each undertaking that each offer should not be accepted. The Commission in its consultative document set out its consideration of the offers and compared the offered price paths with those that may be set under a control authorisation with a price path of CPI-0 (CPI). In the case of each offer considerable benefits to acquirers through reduced prices - \$11.2 million in Vector's case and \$5.8 million in the case of Powerco – would be foregone.
73. Consultation by way of written submissions closes on Thursday 18 September at 5pm.
74. The New Bill does not affect the substance of this work except that there will no longer be a second regulatory period (as contemplated by the Order In Council) through to 2016. The Commission will work on ensuring that there is a smooth transition from the Part 5 regulatory determinations to the new Part 4 default-customised price-quality path regime as part of its future work programme.

The Future

75. I have provided a snap shot of the existing work programme and some of the future implications.
76. However, what might an optimistic future view of the energy sector look like five years hence, when considered within the frame of the Commerce Commission's functions?
77. In the competitive sectors any issues arising from the Commission's current investigations under Part 2 of the Act will have been dealt with or at least well under way to resolution and appropriate incentives put into place to ensure market behaviour more closely aligned to that expected in Competitive Markets. Market participants will clearly understand how the Commission will respond and what their obligations are.

78. In the regulated sectors interested parties will have clear input methodologies and regulatory specifications. Optimistically, I am hopeful that the accountability mechanisms will not be necessary or will be used sparingly so that the regime, built around the input methodologies, can operate with certainty and transparency.
79. Separate Information disclosure requirements will apply to both electricity lines businesses and gas pipelines businesses under the Commerce Act. These will be comprehensive and will include more information relating to quality; consumer engagement and other non-financial performance measures so that a broader range of trend data is available for all interested parties.
80. The Commission will develop summary and analysis and pitch it so that all interested parties have easy access to the key information needed to make relevant decisions about how well suppliers are performing comparatively year on year and relative to peers.
81. Default price-quality regimes will apply for electricity lines businesses and gas pipelines businesses that will establish very clear price-paths including starting prices and quality paths that provide the relevant incentive effects. The interaction with interested parties will be such that few customised proposals will be required, as up front and in the quest for certainty, regulated businesses will see it in their best interest to provide the information, in consultation, necessary to enable the Commission to set relevant individual price and quality paths up front.
82. Working with the Electricity Commission as required the Commerce Commission will be ensuring that the regime it has developed for electricity lines businesses promotes incentives and avoids disincentives so that those businesses can invest in energy efficiency; demand side management and ways of reducing energy losses.
83. The theme of this conference is to deliver sustainable growth and stability in New Zealand's energy future – the Commerce Commission and all interested parties will play a vital role in ensuring that this occurs. The way that the new regime develops and the way that parties operate within the regime will be an important factor in building such a future. This is a challenge for us all and I and the Commission look forward to meeting this challenge.
84. Thank you for your time, this morning.