

## **Presentation to Electricity Networks Association (ENA), Icon Room, Te Papa**

**October 12, 2007**

### **“The Role of the Commission in Regulation”**

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#### **Introduction**

1. Warren, Alan, Members of ENA, Ladies and Gentlemen. Good morning and thank you for the invitation to speak to your AGM today.
2. First, I wish to apologise on behalf of the Commission Chair. Paula would like to have attended the AGM but she will be on her way to an OECD regulators’ conference in Europe.
3. Today I am going to spend some time and talk about:
  - The Commerce Commission’s regulatory role, and how it fits with competition policy more generally; and
  - The targeted control regime and complementary information disclosure regimes.
4. I will then briefly discuss recent relevant decisions and their context. Most specifically, in this regard, I will discuss the:
  - Unison Networks Supreme Court decision with respect to the initial and revised price path thresholds set by the Commission;
  - The Transpower draft decision not to declare control and to accept new thresholds; and
  - The draft decision for the control of gas pipeline services and its relevance to electricity lines businesses.
5. I then wish to discuss the proposed change to ODV disclosures for information disclosure purposes, the reasons and implications.
6. Finally I will discuss the immediate priority steps for the Threshold reset and Information Disclosure work programmes on the Commission’s regulatory agenda for 2007/08. I do this to signal generally when resources will need to be brought to bear for your business in order to engage in these key programmes.

## **The Commission's Regulatory Role and how that fits with Competition.**

7. The Commission is unashamedly pro-market. We recognise the benefits that competition brings to an economy and we adhere to the view that a free market economy is the best way to allocate a country's precious and finite resources, and can deliver lower prices, innovative products and services and greatest choice for consumers. In other words competition underpins a market economy.
8. That competition does provide this outcome has been recognised around the world and does underpin the restructuring, privatisation of state-owned assets during the 1980s and 1990s, and complementary regulation of such assets.
9. Competition is an elegant process but is often taken for granted or trivialised. What are some general observations one can make about a workably competitive market?
  - Firms compete on their merits to attract the consumer dollar;
  - Those that best meet consumer demand in terms of quality of product or service and price are rewarded with higher sales and greater profits;
  - Those firms attract capital for investment and they thrive;
  - The firms that are not a success are eventually starved of business and do not succeed. They often go under;
  - Resources in the economy are thereby freed up for use by more efficient operators.
10. Competitive markets are to a large extent self-regulating.
11. Competition itself creates the incentives and disincentives that virtuously enable the free market to prevail and evolve over time.
12. The most obvious example is that competition creates pressure on the prices at which goods or services can be sold. It places disincentives on the ability to price outside of the competition.
13. Competition also creates incentives to raise quality because consumers demand it.
14. In other words consumers as a whole control the market by the way they vote for quality and price.

15. Competition also creates incentives to work smarter and be more productive - Produce more for less. A company's performance may then be measured against its competitors and/or comparators. Competition also enables companies to innovate. R&D outcomes – new technologies; new products; better ways of doing – all enable companies that act quickly to take advantage of their competitors for periods of time as each tries to think up new ways of out-thinking each other that improves products, services and efficiency and most importantly benefits their bottom lines.
16. A competition-focused economy not only provides these benefits and signals but, due to the returns achieved, likely attracts further direct investment whether local or global.
17. However such an economy does need rules in order to operate. These legal frameworks facilitate competition – they aid the facilitative process. The Commerce Act is designed primarily to preserve and promote competition in markets. The Fair Trading Act and Credit Contract Consumer Finance Act also promote competition in New Zealand.
18. Some see the latter legislation as being about consumer protection. The Commission however, sees such legislation as being primarily protections for the competitive process.
19. Consumers drive competition through their choices but consumers can only send the right signals to firms if their choices are founded on accurate information. Information is another key underpinning of competitive markets. Consumers depend, in the end, on companies sending the right information. However, there are circumstances in which companies cannot be relied upon to accurately provide that information.
20. Misleading behaviour by individual firms dis-empowers consumers, can disadvantage competitors and ultimately if allowed unchecked undermines the competitive process. This is why enforcement of the Fair Trading and CCFA legislation is such a high priority for the Commission.
21. You are probably bemused as to why I have discussed this context? Let me explain.

## **Regulation**

22. Clearly competitive pressure does not affect your sector. Your businesses, like many other infrastructural or utility service providers, are natural monopolies largely due to the nature and scope of the investment required to establish, maintain and improve the utility service. This effectively eliminates the likely scope for competition to prevail.

23. A successful market economy however needs world class infrastructural services in order to enable the competitive sectors to perform - New Zealand's economic success relies on such services. The services your businesses provide are also critical for consumers every day lives.
24. It is this critical importance that requires policy makers to impose regulation where no self-regulation exists. The purpose, regardless of the nature of regulatory regime, is clear: it is to deliver the outcomes that would occur if your businesses faced competition.
25. So what would your business face in a workably competitive market? I noted at the outset what the key observable elements of a self-regulating competitive market are. It is these elements that regulation, over time, is looking to replicate to the greatest extent possible.
26. Your businesses:
- meeting consumer demand;
  - providing efficient quality service as sought by consumers at the efficient prices consumer's are prepared to pay;
  - providing clear, accurate information to enable consumers to make decisions, including the actual costs to supply and maintain quality service; and reflecting a reasonable rate of return to support on-going investment.
27. The regulator implements the regulatory regime to ensure that over time the above occur whilst also ensuring that the monopoly business has sufficient returns to support ongoing investment. The regulator then seeks to hold the regulated business accountable for ensuring that the ongoing investment is efficient, is well-planned and does actually take place. It will be that investment which the business will be expecting to charge to customers.
28. Regulation, therefore, boiled down is simply the substitution of the self-regulating elements of a competitive market.

## **The Elements**

29. Let us focus on the elements again. These are the critically important elements that all of us in this room should be focused on getting right:
- Sufficient information to enable consumer choice;
  - Engagement with consumers to ensure that consumer choices are understood;
  - Quality service, productively and efficiency supplied; and
  - The appropriate incentives and disincentives to invest, price and provide quality service and the commensurate accountability for those pricing, investment and quality decisions.

30. The Commission's job as regulator therefore is to conduct a critical balancing act on behalf of New Zealand consumers and the wider New Zealand economy, to ensure regulated businesses are accountable for the decisions they make. The regulated businesses themselves must focus on their key challenge of providing services that underpin the New Zealand economy in a way that enables the potential of New Zealand's economy to be recognised and the informed signals of consumers to be received.
31. The Commission, like the world cup referee, must apply the rules as they determine them to be, in the knowledge that if they are not well-received or understood, then, unlike the world cup referee, the Commission will be held accountable both reputationally and judicially.
32. It cannot be forgotten that monopolies are regulated in all developed countries. How New Zealand chooses to regulate monopoly businesses and how regulated businesses in this small market economy choose to engage will have important consequences for New Zealand's international competitiveness.

### **Targeted Control and Information Disclosure**

33. Currently New Zealand operates a relatively light-handed, by international standards, regulatory regime that in the context of New Zealand's small market economy makes considerable sense. This was on the basis that the cost of carrying out full bottom up building blocks control for 28 electricity lines businesses would be exorbitant in terms of time, money and resources.
34. The regime consists of price and quality thresholds and complementary information disclosure.
35. The threshold regime has the overall purpose – 57E:

*To promote the efficient operation of markets directly related to the provision of electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers –*

- (a) *are limited in their ability to extract excessive profits; and*
- (b) *face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- (c) *shares the benefit of efficiency gains with consumers, including through lower prices.*

36. The complementary regime for information disclosure has as its purpose – 57T:
- To promote the efficient operation of markets directly related to the provision of electricity distribution and transmission services by ensuring that large lines owners make publicly available reliable and timely information about the operation and behaviour of those businesses so that a wide range of people are informed about such factors as profits, costs, asset values, price (including terms and conditions of supply), quality, security, and reliability of supply of those businesses.*
37. These two purpose statements effectively and virtuously replicate the elements of regulation that you would expect to find in a workably competitive market.
38. “Targeted” aims for minimum cost effective regulation over time.
39. Suppliers are limited in their ability to extract excessive profits over time.
40. Suppliers face strong incentives to improve efficiency and provide services that reflects consumer demand over time; and
41. Suppliers share the benefits of efficiency gains with consumers, including through lower prices over time.
42. I deliberately reiterate “over time”.  
It is recognised in the purpose statement that such steps be for the “long-term benefits of consumers” and to “promote the efficient operation of markets”. These are long-term purposes.
43. In order to promote the efficient operation of markets the Commission must balance the key considerations outlined in the purpose statement at 57E, including sufficient returns to support ongoing investment.
44. The expectation is that these incentives are best established by:
- Setting price and quality paths that look forward, to the extent that available information enables the Commission to do so.
  - The application of many regulatory periods.
  - Focusing on efficiency outcomes.
  - Avoiding unwarranted price shocks.
45. Information disclosure should provide not just transparent information for consumers to understand how their businesses are performing but also to inform the Commission in the setting of price and quality paths over the long term and to support the inquiry elements of the Commission’s work.

46. The regime is designed to continue to encourage businesses by incentive mechanisms to continue to do more to meet the 57E requirements over time. The reset will not involve a simple continue of the current price and quality thresholds and no refinement.
47. Can the New Zealand economy continue to rely on no worse reliability than the measures set in the existing thresholds? Can the New Zealand economy continue to carry the vast range of reliability performance that the data appears to indicate? What other elements of service should network businesses be measured on and held accountable for over time?
48. As the regime gets more robust, based of greater and hopefully better quality data, businesses can expect more pressure over time to improve efficiency, in terms of quality of service and pricing. For some businesses and their owners this may be a significant challenge.
49. One of the key means by which many companies can become more efficient is by seriously considering joint ways of delivering service. This could be achieved by management contracts, or joint ventures with committed and engaged boards and management. One of the quickest and proven ways to achieve this may be by merging businesses or even acquiring, or conversely selling businesses.
50. The Commission has been surprised that more synergies to enable efficiency have not been realised over the past 3-4 years.

### **What does the Reset require of Lines Businesses?**

51. *Engagement*  
The outcome of the price and quality reset and the extent to which the Commission strikes the appropriate balance will be largely reliant on the quality of information provided and the way that businesses engage. Up front, early engagement that does not involve iterative information requests or clarifications will be important.
52. *Justification*  
Where there are business specific circumstances that the Commission should be considering when setting the price and quality thresholds, is there sufficient justifying information to support the circumstances being argued for by the business? Are the assumptions and methodologies provided to support the data, first time?
53. I will discuss the programmes going forward a little later.

## **Recent Decisions relating to Regulatory Matters**

### ***Unison Supreme Court Decision [2007]NZSC74; 10 September 2007.***

54. The first decision I wish to briefly discuss is the Supreme Court's decision involving an appeal from the Court of Appeal by Unison Networks Limited.
55. This is an important result for all lines businesses in that had Unison been successful it may have created considerably more uncertainty than any business has encountered to date with respect to the regime.
56. In the Commission's view, fortunately, the Supreme Court accepted the Commission's arguments as to the purpose and construction of the price path threshold.
57. The Court noted that the Commerce Act contemplates the Commission fashioning thresholds that it judges as appropriate to further the broad economic section 57E objectives, having considered submissions from interested parties. The thresholds must be relevant in that they contribute to the administration of the targeted control regime.
58. It is not necessary for a threshold to do more than identify potential candidates for control on a general, rather than specific enterprise basis. It is then at the final stage of the process, when examining a particular business, that the Commission is obliged to take into account all aspects of the statutory purpose that section 57E covers. Prior to then, thresholds may legitimately be steps on the way which, in isolation, are not necessarily indicative of section 57E concerns.

### ***Transpower Draft Decisions on Reasons for Not Declaring Control and Resetting Transpower's Thresholds 5 October 2007***

59. Last Friday the Commission released its draft decision and is currently seeking submissions from interested parties on this document and the proposed administrative settlement proposal from Transpower Limited.
60. The most striking feature of Transpower's proposal is that rather than continue with a price path threshold as previously established. Three separate thresholds dealing with revenue, capital expenditure (non-Part F expenditure), and a new system operator threshold are proposed.
61. The regulatory period would run through to 30 June 2011.

61. The new revenue [transmission (revenue requirement)] threshold proposed requires Transpower to demonstrate that it has applied a set of principles in deriving its annual revenue requirement. It is proposed that the threshold will apply through to 30 June 2011. A base operational expenditure value is set that the Commission agrees with subject to submissions and this base value will be indexed annually using a CPI-X formula. The 'X' factor is proposed to be 0. The base value and X factor have been considered by the Commission's external advisers and their views taken account of in the Commission's draft decision.
62. Transpower further proposes using a one-year post tax nominal WACC of 7.2% for 2006/07; 7.7% in 2007/08 and 7.8% for the remainder of the proposed regulatory period through to 2011 (during this period the Corporate tax rate will have fallen to 30%).
63. The proposed non-Part F Capital Expenditure Threshold will apply for one year until 30 June 2008. The Commission will reset that threshold on an annual basis in accordance with a set of reset principles proposed by Transpower, should Transpower propose non-Part F capex. This arrangement would continue until such time as the EC had developed sufficient capacity and arrangements to oversee such expenditure.
64. The third threshold is designed to ensure compliance with the system operator provider agreement in place between the Electricity Commission and Transpower during the regulatory period.
65. A fourth threshold, the current quality threshold will be maintained at least until such time as alternate service reporting obligations have been established. We do note though that both the Commerce Commission and Electricity Commission have limited jurisdiction to enforce Transpower's delivery of service quality.
66. The outcome, should the proposal be accepted, is that the 19% price increase announced in December 2005 for the 2006/07 pricing year has reduced to 10.2%. As the full 19% was rebated, the revenue that this price increase generates if accepted will be applied against the EV accounts and form part of the 30 June 2007 balance.
67. The 13% price increase forecast for the 2007/08 year has been reduced to 8.1%, subject to final approval pending the outcome of consultation. Again, any gains arising from the price increases will dealt with in the EV accounts to form part of the balance as at 30 June 2007.
68. Prices based on the annual revenue requirement from 2009 -2011 will be constrained by the thresholds and building block components outlined above.

69. The Commission's preliminary view is that acceptance of the settlement offer will provide an acceptable solution for the provision of efficient transmission services over time.
70. There are some key preliminary decisions in principle that it is worth noting:
- The level of WACC adjusts over the period. They are Transpower's proposed estimates in order to run an efficient system.
  - Only approved assets once commissioned can be entered into the RAB. This will be on a depreciated historic cost basis. The preliminary view is that this methodology provides cash flow advantages and reduces regulatory risk at a time when very significant scale of investment has been proposed.
  - Tax is calculated using a tax payable approach (with the addition of an interest tax shield).
71. The draft decision and the administrative settlement proposal received by Transpower have been considered in the context of the current *Assessment and Inquiry Guidelines* dated October 2004 and the *Framework for considering Administrative Settlement offers* determined as part of the decision process for not declaring control on Unison Networks Limited release on 11 May this year.
72. ***Submissions on the Commission's draft decision are due on Friday, 9 November.***

***Draft Decisions for the Authorisation for Control of the Supply of Natural Gas Distribution Services of Powerco and Vector Ltd***

73. This draft decision has taken a considerable amount of time and expense to get to this point and I do not intend to rehearse the history that has led to the release of this draft decision. Rather, I wish to draw your attention to some of the key findings and some of the key principles that have been applied to underpin the draft decisions made to date.
74. Firstly the Commission has applied the concept of Financial Capital Maintenance (FCM) or NPV = 0 on an ex ante basis to determine the terms in the draft Authorisation decision. The efficient level of allowed revenue has been determined applying building blocks analysis consistent with FCM. The Commission is mindful of the need to maintain incentives to invest.
75. FCM is applied for information disclosure purposes and is recognised as the best method of balancing the trade off s between the various regulatory principles. The regulated businesses' financial capital is maintained in present value terms and the NPV of net pre-financing cash flow is intended to be 0 on an ex ante basis.

76. Post-tax nominal WACC of 9.14% has been applied for the 06/07 year. From 1 October 2008 WACC is set at 9.33%. Both of these are equivalent to the 75<sup>th</sup> percentile range, the latter is adjusted to recognise the reduction in corporate tax rate.
77. The regulatory asset bases were revalued as at June 2005 using ODV methodology and specific replacement costs and multipliers for each business recognising the business specific circumstances of each. In each case this has resulted in substantial revaluation gains. These will be treated as income for the purpose of price setting over the regulatory period. This is again consistent with FCM.
78. The order-in-council period runs right through to September 2016. The Regulatory control regime will consist of an initial seven-year control period through to 30 June 2012 and an additional four-year period following on.
79. Revenues from over-charging during the Provisional Authorisation will be recovered over the period through to 30 June 2016 to minimise the future price shocks as much as possible.
80. P<sub>0</sub> adjustments of 42% on average in the case of Powerco and 15% on average in the case of Vector are proposed for the remainder of the 2008 year – anticipated to be from 1 April 2008.
81. Then a glide path of CPI-X set at 2% is proposed in the draft decision for the regulatory period through to 30 June 2012.
82. The key conclusion is that on our preliminary findings and without further information to the contrary, both Powerco and Vector are making significant excess returns from the supply of their controlled gas distribution services despite the average price reductions of 9% in Powerco's case and 9.5% in the case of Vector.
83. Finally I wish to note that one of the most significant issues that the Commission faced as it has attempted to develop its draft decisions has been the lack of supporting information that justifies the claims being made by the regulated businesses. This is particularly the case with respect to forecast of capital and operating expenditure.
86. The Commission will not allow capital or operating expenditure that is not justified. This has especially impacted on Powerco and is a major reason for the draft decision including a higher P<sub>0</sub> adjustment for Powerco.

87. The Commission requires information to clearly support claims, including clear articulated assumptions and methodologies supporting such data. Lines business's making claims with respect to their own position for the forthcoming threshold reset can only expect claims to be heeded if there is robust supporting information available when the claim is made.
88. *Submissions are sought from interested parties by 12 November 2007, at 12 midday.*

**Review of the Information Disclosure Regime and the Update of ODV valuations proposed for 31 March 2008.**

89. Late last month the Commission released a brief update paper on its review of the information disclosure regime and proposed to change the date for the next full ODV revaluation by one year as at 31 March 2009. We sought submissions on that proposal by end of business today.
90. Regrettably the Commission did not set out clear reasons as part of that communication. I now wish to explain the logic behind the proposal we are making. We have consequently, following requests, extended the deadline for submissions to the close of business, Friday 19 October.
91. Many will recall that in April 2006 a number of final decisions with respect to the Information Disclosure regime were made with respect to Asset valuation.
- Full ODV valuations would only be required every five years, following a next full ODV valuation which the Commission mooted would be 31 March 2008. The reason for the first valuation being 4 years on was so as to take account of those valuations in the threshold reset process.
  - Valuations in intervening years would be indexed using CPI and capital expenditure would be rolled in at cost.
  - Consultation on a new ODV handbook would take place in advance of the first full ODV valuation.
92. The Commission, in April 2006, also proposed that in full ODV valuation years there would be a number of adjustments to the rolled forward asset base. A number of industry submissions on this proposal drew particular attention to the differences between the replacement costs of modern equivalent assets based on an assumption of a significant scale of construction, and the costs of undertaking incremental capital expenditure that accommodated associated costs to cover such issues as traffic management, live maintenance, duct access and so on.

93. On the other hand, a number of interested parties indicated at the time that the Commission should stick with the March 2004 ODV valuation and simply roll it forward at indexed historic cost. The key underlying concern expressed by these parties was that the differences between the full ODV valuation and incremental costs roll in on an indexed historic basis might result in substantial potential write downs with no corresponding recognition of the devaluation or expense.
94. The Commission considers that the approach proposed will not disadvantage lines businesses as we move forward to the reset. It will not involve writing down the value of any capital expenditure incurred during the current regulatory period.
95. The Commission recognises the differences that may arise between replacement costs based on ODV principles and efficiently incurred capital expenditure. We also recognise that where businesses may not be permitted to recover efficiently incurred investment; there may be consequential disincentives for future investment. The Commission mindful of this does consider that the FCM principle should continue to be applied for information disclosure purposes; we are still considering how this will be achieved and will look to consult with interested parties.
96. In late-November, the Commission will be releasing its draft information requirements package. This will include proposals for reconciling full ODV valuations with valuations rolled forward in intervening years based on actual capital expenditures and CPI indexation. The submissions of interested parties have been taken in relation to the Commission's earlier proposals.
97. The package will also set out the Commission's proposals for calculating the ROI indicator, and how any differences between ODV-based replacement costs and incremental-based capital expenditures could be addressed, in a manner consistent with the underlying principle of financial capital maintenance.
98. The Commission proposes deferring the ODV handbook update until the financial year 2008/09.
99. The process for updating the ODV Handbook will provide an appropriate opportunity to seek evidence on the level of differences between ODV-based and incremental-based replacement costs. Practically however, the consultation will be lengthy and complex and will be informed to some degree by industry's views on the process for reconciling full ODV valuations with the roll forward valuations which will only be consulted on following the release of the November package.
100. The Commission does recognise that postponing the ODV handbook update will mean that updated ODV valuations will not be available for the 2009 threshold reset.

101. In its September 2007 update the Commission signalled that it proposes that any valuations used in the reset be based on rolling forward the March 2004 ODV valuations through the addition of actual capital expenditure, indexed by the CPI.
102. However, the Commission intends consulting on this proposal as part of its wider threshold reset consultation process (in order to provide the full context). An initial discussion paper on the reset is due out before the end of this year.
103. As noted earlier, while the majority of the businesses have in the past supported continuing to use ODV for valuing network assets, a number of lines businesses have consistently supported using indexed historic cost going forward.
104. The Commission acknowledges that its proposals for ODV reconciliations may not necessarily be the most cost-effective way of applying the financial capital maintenance concept in the context of information disclosure.
105. Hence, while the Commission intends releasing draft information disclosure requirements prepared on the assumption that ODV will continue to be applied going forward, the Commission will be open to considering changing the valuation approach. Consultation on the proposal mentioned above during the threshold reset will include consideration of this issue and the Commission looks forward to submissions on this matter as a result, at that time.

### **Threshold Reset**

106. I wish to finish by indicating that engagement on the reset will be starting in earnest in late-November. At that time a major discussion paper will be released along with a number of supporting consultant's reports. This will likely include discussions relating to:
  - Should similar network characteristics be recognised to provide meaningful starting comparisons?
  - Reliability and how to refine the quality thresholds.
  - Is there a discernible relationship between prices charged and the quality of service provided?
  - How should price quality trade offs be accounted for – should it be instead of or in addition to a quality threshold?
  - Is there sufficient information to support consideration of service quality performance?
  - What incentives might such a consideration entail?
  - Pricing and mechanisms for efficient investment.
  - the state of networks, asset profiles and asset management – what forward investment should be taken accounted of? What improvements might be made to AMP requirements, if any?

107. The s.98 information provided by the businesses has assisted greatly in enabling the consultancy studies to be embarked upon to support the discussion paper. The Commission is grateful for the efforts of most of the businesses in meeting the Commission's requests.
108. Dependant, of course, on the nature of the information we receive. It is the Commission's intention, as much as possible, to construct forward-looking thresholds that take account of supported prospective information. Efficiency will be a major consideration. The result will be further refinements to the existing thresholds for the next regulatory period.
109. Thank you for your attention. I am happy to answer any questions.