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BY E-MAIL

Dear Mr Calleja

Commerce Commission's proposed methodology for adjusting starting prices under Subpart 6 of Part 4 of the *Commerce Act 1986*

1. Background

- 1.1 The Commerce Commission has published an 'Update Paper' relating to the methodology it proposes to adopt for the adjustment of starting prices for electricity distribution businesses (**EDBs**) under Part 4 of the *Commerce Act 1986* (the **Commerce Act**).¹
- 1.2 In summary, the Commission proposes to adjust starting prices by comparing the expected profitability of each EDB (assuming the continuation of its current prices) with the expected profitability of each EDB if it is assumed that expenditure, growth and inflation will increase from 2010 levels in accordance with a series of forecasts produced by the Commission. The estimated rates of change in expenditure, growth and inflation are industry-wide forecasts that are based on historic trend information, independent forecasts and (in the case of capex) supplier forecasts.

¹ *2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments, Update Paper*, Commerce Commission, April 2011.

- 1.3 While the 'current' profitability of each EDB (as at disclosure year 2010) will be assessed on the basis of information that is specific to each EDB, the *projected* profitability of each EDB will be assessed against levels of expenditure and demand that are industry-wide forecasts. It is improbable that any EDB's actual expenditure or demand will move in line with the estimates produced by the Commission. In practical terms, this means that EDBs regulated under the default price-quality path (**DPP**) may find that their starting prices are adjusted so as to produce a return on investment that is either not sufficient to fund their anticipated expenditure requirements or in excess of what is required to fund their anticipated expenditure requirements.
- 1.4 The Commission has recognised that the expenditure profiles for individual EDBs can be expected to deviate from the industry-wide estimates the Commission has developed.² However, the Commission contends that EDBs whose expected revenue requirements will not be met under the DPP have the option of applying for a customised price-quality path (**CPP**) to better suit their circumstances.
- 1.5 In view of the manner in which the Commission has developed its industry-wide assumptions, a significant proportion of the 17 EDBs subject to default/customised price-quality regulation may, under the Commission's methodology, need to apply for a CPP to satisfy their anticipated expenditure requirements. For example, if it is assumed that the nominal rate of growth in capex forecast by the Commission (3.3%) is based on an average of the capex that is foreshadowed by EDBs in their asset management plans, it follows that as many as half may have actual capex requirements in excess of this industry-wide forecast.
- 1.6 In light of the above, you have asked us to advise on:
- (a) whether the Commission's methodology satisfies the requirement in section 53P(3)(b) to determine starting prices *'based on the current and projected profitability of each supplier'*; and
 - (b) the extent to which the Commission's methodology, specifically its reliance upon the CPP mechanism, is consistent with the objectives of the provisions of the Commerce Act relating to default/customised price-quality regulation.

² eg. Update Paper, paragraphs X.18, 4.7, 4.34, 4.55.

2. Summary

2.1 In our opinion, the Commission's proposed methodology:

- (a) does not satisfy the requirements of section 53P(3)(b) of the Commerce Act, as it does not take into account the projected profitability of each EDB; and
- (b) is not consistent with the objectives of default/customised price-quality regulation as articulated in section 53K of the Commerce Act.

2.2 We explain each of these conclusions in detail below.

3. The Commission's approach does not satisfy the requirements of section 53P(3)(b) of the Commerce Act

3.1 Section 53P(3) of the Commerce Act provides that starting prices set by the Commission under this section must be either:

- '(a) the prices that applied at the end of the preceding period; or*
- (b) prices, determined by the Commission, that are based on the current and projected profitability of each supplier'.*

3.2 Section 53(3)(b) was inserted into the Commerce Act as a result of a recommendation by the Parliament's Commerce Committee in its review of the Commerce Amendment Bill.³ This recommendation was made in response to a submission made by the Commerce Commission and advice from the Ministry of Economic Development.

3.3 In its submission to the Committee, the Commission stated:

'[38] The Commission is concerned that information asymmetries between the regulator and regulated parties will be exacerbated by placing restrictions on the Commission's information gathering powers when setting default price-quality paths (under clause 53P). These restrictions will have significant implications for setting the initial default price-quality paths for electricity lines and gas pipeline services.

³ Commerce Amendment Bill, Report of the Commerce Committee, July 2008, page 8.

[39] In considering the reset of thresholds for electricity lines businesses under the Act, the Commission has relied on its statutory information gathering powers to supplement information disclosure to obtain the information needed to establish price path and quality thresholds. If the information used to set default paths is limited, there is a significant risk that the default path will be imprecise. This may result in some of the key outcomes in the purpose statement not being achieved (e.g., limiting excessive profits). It may also have the effect of increasing cost and complexity through a significant number of proposals for customised control terms, and as such, the objective of low cost regulation may not be achieved.

*[40] The Commission recommends that it be given flexibility to use a broader range of information and its statutory information gathering powers to set the initial default price-quality paths for electricity lines and gas pipelines services.'*⁴

- 3.4 Commenting on this concern, the Ministry of Economic Development agreed that the Commission should be permitted to use its information gathering powers in setting DPPs, but also recommended that:

*'53P(3)(b) should be clarified to provide that reset default prices for a supplier should be based on its current and projected profitability (but should exclude any recovery of excess profits in the previous regulatory period).'*⁵

- 3.5 The extrinsic material relating to section 53P(3)(b) indicates that the purpose of this section is to require starting prices for a regulated supplier to be re-set on the basis of the current and projected profitability *of the supplier in question*. The Bill was specifically amended to ensure that the Commission could use its information gathering powers to avoid having to set a default path that was *'imprecise'*.

⁴ Commerce Commission's Verbal Submission on the Commerce Amendment Bill, 3 July 2008, page 10.

⁵ Commerce Amendment Bill, Report of the Ministry of Economic Development, 4 July 2008, page 30.

- 3.6 Under the Commission's proposed methodology, an EDB's starting prices will be adjusted by comparing the projected ROI for the EDB (based on its current prices) with the projected ROI if the EDB's revenue and costs escalate in accordance with the Commission's industry-wide assumptions for capex, opex, growth and inflation. This adjustment will involve no comparison between the EDB's projected revenue and *the EDB's* projected expenditure or costs.
- 3.7 The Commission has recognised that the use of industry-wide assumptions introduces uncertainty in the estimation of an EDB's expenditure requirements.⁶ It may be accepted that the future expenditure of an EDB can be expected to differ from any expenditure forecast, regardless of whether the forecast is based on industry-wide assumptions or a supplier-specific forecast of expenditure requirements. However, this does not make the two approaches equally meritorious for the purpose of section 53P(3)(b). Section 53P(3)(b) requires starting price adjustments to be based on the projected profitability of *each regulated supplier*. This necessarily requires a comparison between the supplier's projected revenue and an estimate of *the supplier's* projected costs.
- 3.8 Under the Commission's approach, industry-wide assumptions relating to expenditure and demand are used as a proxy for an estimate of the projected costs of each EDB. In our opinion, this approach does not satisfy the requirements of section 53P(3)(b) of the Commerce Act. The Commission's approach makes no attempt to assess the projected costs of each EDB. In reality, it must be expected that the actual future expenditure of an EDB will vary from the industry-wide assumptions used by the Commission. A methodology which makes no attempt to estimate the projected costs of an EDB cannot, by definition, produce an estimate of that EDB's projected profitability.
- 3.9 It is not enough for starting prices to be determined under a methodology which accommodates a reasonable range of suppliers' circumstances.⁷ Section 53P provides for the re-setting of the starting prices that apply under the DPP established for *each* supplier that is subject to default price-quality regulation in accordance with section 53O of the Act. Every adjustment to the starting prices of a supplier that is subject to default price-quality regulation must conform to the requirements of section 53P(3)(b). The fact that a supplier can instead propose a CPP to better meet its circumstances is irrelevant.

⁶ Update Paper, paragraphs 4.54-4.55.

⁷ Update Paper, paragraph 2.26.

- 3.10 Section 53P requires the Commission to strike a delicate balance in setting starting prices under a DPP. On the one hand, the Commission is expressly forbidden by section 53P(10) from using comparative benchmarking for efficiency. On the other, estimating projected profitability on the basis of a detailed supplier-specific analysis of costs is more akin a CPP proposal.
- 3.11 However, in our opinion, the Commission's methodology fails to strike the necessary balance between these two outcomes. The Commission proposes to assess each EDB's profitability against a series of industry-wide benchmarks for opex and capex, although it contends that there is no benchmarking for efficiency.⁸ However, even if the Commission's methodology does not infringe upon the restriction in section 53P(10), it makes no attempt to assess the projected profitability of any individual EDB. In this respect, the Commission's proposed methodology is flawed. We consider that modifications to this methodology are required if it is to conform to the requirements of section 53P(3)(b).
- 3.12 In our opinion, the approach outlined in the Commission's August 2010 discussion paper was superior to its current approach in terms of its conformity with section 53P(3)(b).⁹ The approach outlined in the August 2010 paper used an ROI 'band' which was designed to account for uncertainties in predicting future expenditure from base year levels. While it might be debatable whether the use of the ROI band, by itself, would be sufficient to satisfy the requirements of section 53P(3)(b), this approach gave at least some recognition to the fact that the costs of individual EDBs would vary over time from the levels of expenditure in the base year.
- 3.13 If the Commission combined the use of its industry-wide forecasts with an ROI 'band', similar to that proposed in its August 2010 discussion paper, it would account for the inevitable variations in actual costs around its industry-wide forecasts. In our opinion, this would go much further towards establishing a proper basis for assessing the projected costs (and therefore the profitability) of each EDB, thereby satisfying the requirements of section 53P(3)(b).

⁸ eg. Update Paper, page 73, footnote 119. This distinction is arguably a fine one, as many of the steps undertaken by the Commission in developing its industry-wide assumptions might form part of an efficiency benchmarking exercise, particularly in relation to the Commission's industry-wide assumptions for opex.

⁹ *Starting Price Adjustments for Default Price-Quality Paths, Discussion Paper*, 5 August 2010.

4. The Commission's approach is not consistent with the objective of default/customised price-quality regulation as articulated in section 53K of the Commerce Act

4.1 Part 4 of the Commerce Act prescribes four different types of regulation that may be applied to a service that is regulated under this Part of the Act:

- (a) information disclosure regulation;
- (b) negotiate/arbitrate regulation;
- (c) default/customised price-quality regulation; and
- (d) individual price-quality regulation.

4.2 The provisions relating to default/customised price-quality regulation are set out in Subpart 6 of Part 4. This form of regulation is applicable to all EDBs that are not 'consumer-owned'.

4.3 Section 53K of the Commerce Act describes the purpose of default/customised price-quality regulation in the following terms:

'The purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances'.

4.4 DPP and CPP regulation are both forms of price-quality regulation. That is, they are two different ways of setting a price-quality path for a regulated supplier. The objectives of this form of regulation are articulated in section 53K, namely:

- (a) to set price-quality paths in '*a relatively low-cost way*'; and
- (b) to allow, at the same time, an opportunity for an individual supplier to have a price-quality path that better meets their circumstances.

4.5 The emphasis on setting price-quality paths in a low cost way is consistent with the extrinsic material relating to the provisions in Subpart 6 of Part 4.

4.6 The provisions of the Commerce Act creating default/customised price-quality regulation were inserted by the *Commerce Amendment Act 2008*. The objectives of this regulatory regime were described in the explanatory note for the proposed legislation in the following terms:

The objectives are to provide for a regulatory regime for businesses not subject to competition that—

- *is credible and coherent, provides sufficient disciplines on firms in markets with natural monopoly characteristics, and provides for incentives to invest in infrastructure:*
- *provides clarity, certainty, transparency, timeliness, and predictability for businesses, and appropriate accountability mechanisms:*
- *is appropriate for New Zealand's small size (with small firms and limited resources).'¹⁰*

4.7 Effect is given to this third objective in the purpose of default/customised price-quality regulation as articulated in section 53K – that is, to provide a relatively low cost way of setting price-quality paths.

4.8 This has been recognised by the Commerce Commission which stated, in the reasons paper accompanying its Input Methodology Determination for EDBs and GDBs:¹¹

*'[2.8.25] Productivity-based approaches to setting price paths are typically much less intrusive and data-intensive than building block approaches, and therefore tend to be less costly. Consequently, using a productivity-based approach to determine DPPs is a key part of tailoring the Part 4 regime to New Zealand's small size, with small suppliers and limited resources (paragraph 1.2.19). However, some regulated suppliers may be disadvantaged by an approach that is based on industry-wide factors, unless supplier-specific factors are explicitly allowed for in the analysis.'*¹²

¹⁰ Commerce Amendment Bill, Explanatory Note, page 16.

¹¹ Decision 710, *Input methodologies applicable to electricity distribution services pursuant to Part 4 of the Commerce Act 1986*, 22 December 2010.

¹² Also see the extract from the Commission's submission to the Commerce Committee in paragraph 3.3 above.

Costs associated with default/customised price-quality regulation

- 4.9 The explanatory note to the amending legislation recognises that an applicant for a CPP will need to incur additional costs, over and above the costs of information disclosure and DPP regulation.¹³
- 4.10 The additional costs incurred by an EDB in order to prepare a CPP application are likely to be substantial. Under the Commission's input methodologies, an applicant for a CPP is required to bear the costs associated with:
- (a) consumer consultation;
 - (b) updating information on asset values and depreciation;
 - (c) updating tax information;
 - (d) providing the detailed information specified in Schedules D and E to the Input Methodologies Determination, including:
 - (i) policies relied on by the EDB;
 - (ii) detailed descriptions of each service category;
 - (iii) detailed descriptions of the EDB's network;
 - (iv) detailed forecasts relating to demand, consumer numbers and generation;
 - (v) detailed information relating to forecast capex, broken down into system growth capex; asset replacement and renewal capex; reliability, safety and environmental capex; and non-system fixed assets capex;
 - (vi) detailed information relating to forecast opex, including self-insurance;
 - (vii) information relating to dealings with related parties; and
 - (viii) assumptions about unit costs and expenditure escalators;
 - (e) providing information on proposed new pass through costs; and
 - (f) providing information on recoverable costs.

¹³ Commerce Amendment Bill, Explanatory Note, page 23.

- 4.11 Under Australia's regime for electricity distribution network regulation, the equivalent to a CPP proposal is a 'regulatory proposal'. The *average* length of the regulatory proposals submitted to the Australian Energy Regulator by distribution network service providers is well in excess of 300 pages, plus attachments (regulatory proposals have been submitted with more than 200 attachments). While there are obviously differences between the regimes in Australia and New Zealand, there are significant common features between a regulatory proposal and a CPP proposal, including detailed breakdowns and justifications of forecast capex, opex and demand. The scale and cost of the exercise involved in collating and verifying this information is likely to be comparable.
- 4.12 The costs involved in assessing a CPP application, involving detailed reviews of opex, capex and demand, will also be material. This has been recognised in the explanatory notes to the amending legislation,¹⁴ and by the Commission itself.¹⁵ The Commission's costs in assessing a CPP proposal are to be borne by the applicant.¹⁶
- 4.13 An indication of the scale and scope of the CPP assessment process can be found in the legislation itself, which provides that:
- (a) an EDB may make a CPP proposal only once in a regulatory period,¹⁷ and only in the annual window specified by the Commission;¹⁸
 - (b) the Commission is given up to 150 working days to make a determination on the CPP proposal (capable of being extended by a further 30 working days);¹⁹ and
 - (c) the Commission is required to consider no more than four CPP applications relating to the same type of regulated service in each year.²⁰
- 4.14 This last requirement was included in the legislation to ensure that the Commission is not '*overwhelmed*' by CPP applications.²¹ While the Commission has foreshadowed that it

¹⁴ Commerce Amendment Bill, Explanatory Note, page 24.

¹⁵ eg. Information Methodology Determination, Reasons Paper, paragraph E10.68.

¹⁶ section 53Y.

¹⁷ section 53Q(3).

¹⁸ section 53Q(2)(b).

¹⁹ sections 53T, 53U.

²⁰ section 53Z.

²¹ Commerce Amendment Bill, Explanatory Note, page 24.

might consider more than four CPP proposals in a year if there has been a 'catastrophic event',²² there has been no other indication of a willingness to consider additional proposals as a result of adjustments to starting prices under the Commission's methodology.

Consistency between the Commission's methodology for starting price adjustments and the objectives of default/customised price-quality regulation

- 4.15 The costs associated with a CPP create an inherent tension between the two objectives of default/customised price-quality regulation articulated in section 53K. The overarching objective of the regime is to create a low cost way to establish price-quality paths. Achieving the second objective (meeting individual circumstances through a CPP) comes at the expense of this overarching objective, since the cost of establishing a price-quality path through a CPP is significantly higher than using a DPP. This risk has been recognised by the Commerce Commission in its submission to Parliament's Commerce Committee on the Commerce Amendment Bill (see paragraph 3.3 above).
- 4.16 To some extent, the legislation itself seeks to mitigate these costs (eg. by obliging the Commission to consider no more than four applications each year). However, despite such measures, the costs involved in obtaining a CPP are likely to be substantial. The tension between the two objectives articulated in section 53K will be exacerbated if there is a proliferation in the number of CPP proposals.
- 4.17 A regulatory regime which encourages CPP proposals will, by definition, undermine the objective of the default/customised price-quality regulation framework by increasing the overall cost of establishing price-quality paths. The regulatory framework clearly recognises that EDBs should have access to a CPP if this is necessary to accommodate their circumstances. However, it is implicit in the objectives of this regime that the use of CPPs *should be limited*.
- 4.18 In effect, the Commission's methodology assumes that any EDB whose anticipated expenditure requirements will not be met by the Commission's industry-wide assumptions can apply for a CPP. A significant proportion of the 17 EDBs that are subject to default/customised price-quality regulation may have such a need.

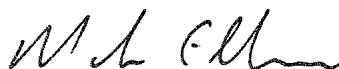
²² e.g. Information Methodology Determination, Reasons Paper, paragraph K1.14.

- 4.19 In our opinion, such a methodology is not consistent with the objective of the default/customised price-quality framework as articulated in section 53K of the Act. There are, in broad terms, two reasons for this conclusion.
- 4.20 First, the Commission's methodology assumes that any EDB that is dissatisfied with the levels of expenditure provided under the Commission's industry-wide assumptions can apply for a CPP with relative ease. In our opinion, this assumption is incorrect. The legislation limits the number of occasions on which a CPP may be sought and requires the Commission to consider no more than four in each year. The costs of preparing a CPP proposal are likely to be substantial.
- 4.21 Secondly, the Commission's methodology encourages the proliferation of CPPs by making this the sole mechanism through which an EDB, whose anticipated costs exceed the Commission's industry-wide benchmarks, can earn sufficient revenue to fund its anticipated expenditure requirements. Such an outcome is at odds with the objective of a regime which was designed to establish price-quality paths in a low cost way. In relying on the CPP mechanism to this extent, the Commission has, in our opinion, given the CPP mechanism a role which it was not intended to perform.

Please do not hesitate to contact Justin Oliver on +61 7 3119 6332 if you wish to discuss the above.

Yours faithfully

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