

Matthew Lewer
Regulation Branch
Commerce Commission
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New Zealand

Submitted by email to: regulation.branch@comcom.govt.nz

24 August 2011

Dear Mr Lewer

Submission on 2010-2015 Default Price-Quality Path for Electricity Distribution, (P₀) Draft Decision Paper

Brookfield Asset Management Inc. (Brookfield) is a global asset manager focused on property, renewable power and infrastructure assets with approximately US\$150 billion of assets under management. A publicly listed, Brookfield managed fund, Brookfield Infrastructure Partners L.P. (NYSE:BIP and TSX:BIP.UN), is the co-owner of Powerco (42%). BIP's business consists of the ownership and operation of utilities, transport and energy, and timber assets in North and South America, Australasia and Europe.

As co-owner of Powerco, and generally as investors in New Zealand's regulated infrastructure, we have serious concerns with the approach that the Commission has taken with the development of its Draft Decisions Paper.

Brookfield was genuinely pleased with the introduction of the Commerce Amendment Bill in 2008. The Bill introduced the default and optional price-quality paths for electricity distribution businesses and required the Commission to develop and publish generic input methodologies covering aspects of the regulatory decision making process, such as the cost of capital, valuation of assets, pricing methodologies, and so forth. The framework introduced by the Bill has a number of characteristics that should provide additional certainty for investment, including:

- the requirement to develop input methodologies that would be consistently applied so that regulatory outcomes could be predicted with a reasonable degree of accuracy;
- provision for merits appeals against final decisions on input methodologies; and
- a regulatory purpose statement, which specifically requires that investors should have incentives to innovate and invest.

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The purpose statement is a critical part of the regulatory framework. It establishes the need for the Commission to make decisions which balance the long-term benefit of customers, with the need for incentives to invest:

52 This Part provides for the regulation of price and quality of goods and services in markets where there is little or no competition and no likelihood of a substantial increase in competition.

52A ...The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets so that suppliers of regulated goods or services:

- Have incentives to innovate and invest, including in replacement, upgraded and new assets; and*
- Have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- Share with consumers the benefits of efficiency gains in the supply of all or any regulated goods or services including through lower prices; and*
- Are limited in their ability to extract excessive profits*

We are concerned that aspects of the approach and process adopted by the Commission in arriving at the current draft decision draw into question whether the objectives of the purpose statement will be met in practice.

Prior to the current draft decision, the Commission has followed a well-structured process with its development of the Input Methodologies and the setting of the initial Default Price Path. However, a lack of procedural fairness and predictability in the Commission's consultation process around the P₀ draft decision is creating uncertainty and disincentives to investment that are contrary to the objectives of the Commerce Act.

The process around the P₀ draft decision falls short of the Commission's usual well-structured process in two important respects:

1. The introduction of important changes to calculations late in the consultation process with limited explanation. The financial model used for the draft decision departed from previous work published by the Commission in a way that significantly impacts on the outcome for Powerco. In particular, the Commission's approach to discounting cashflows is unusual, not consistent with its own or international precedent, but significantly affects the outcome. Internationally, regulators routinely consult on the financial model and finalise its design *before* it is used in regulatory decisions. This provides transparency and predictability to the process.
2. The introduction and acceptance of new forecasts of growth in population and energy demand without regard to the inherent uncertainty associated with forecasting. This uncertainty means that a significant error could be made in setting starting price adjustments if no margin of safety is allowed for forecasting error. In moving away from the rate of return band concept (as outlined in the Commissions' August 2010 Discussion Paper on Starting Price Adjustments), the Commission has moved away from providing a margin of safety and is taking an approach which places undue reliance on the accuracy of forecasts.

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These late changes in the process means that the draft outcome for Powerco is a significant price reduction of 9.2%, which is a far greater reduction than could reasonably have been predicted from the discussion documents and models previously published by the Commission. From an owner's perspective this unexpected unfavorable outcome creates a "regulatory shock" which directly destroys the value of our investment. In fact, the draft decision is the second regulatory shock that we have endured in this process, the first being the Commission's earlier decision to move away from the rate of return band.

The risk profile for investments in infrastructure and utility assets is generally considered to be positioned between that of a bond and equity shares. By investing in utilities, investors expect to earn a moderate return in exchange for taking what they perceive to be a moderate amount of risk. The investment rationale is that utilities provide for stable, predictable cash flows, which are nonetheless subject to volume, operational and regulatory risks.

Regulatory shocks, such as the Commission's draft P_0 decision, destroy the perception of stability and substantially increase the level of risk. Any business that can face an immediate 9.2% reduction in revenue from an unpredictable event cannot be considered to have a moderate level of risk. The proposed price reduction is particularly unexpected given that Powerco's regulatory return on investment is currently *below* the level considered acceptable by the Commission. In fact, there appears to be a fundamental disconnect between an assessment of Powerco's performance using the Commission's input methodologies, and its draft price decision, which ostensibly uses the same methodologies.

All commercial investments decisions involve weighing up an expected rate of return against a perceived level of risk. A higher level of risk means a higher hurdle rate for investment. This is true in all sectors, including regulated infrastructure. Regulatory risk is the risk that returns will be diminished or asset value will be eroded through unfavourable changes in the regulatory approach or unfavourable regulatory decisions. It follows therefore that uncertainty, and therefore the perception of regulatory risk, is increased by a lack of transparency and predictability in the regulatory process. Increased risk means an increase in the hurdle rate for investment, an increased cost that is ultimately borne by the consumer. By introducing uncertainty and unpredictability into its process the Commission will ultimately increase costs to consumers.

The process followed by the Commission in arriving at the draft P_0 decision cannot be viewed as consistent with the objectives of the Act in that it will not promote the long-term benefits of consumers, nor will it incentivise investment and innovation.

The Commission should align its final decision with the objectives of the Act by:

1. Deferring application of the new discounting approach for this decision and instead consulting on appropriate discounting techniques prior to the next Default Price-Quality Path in 2015. This would allow for proper consultation on an important change and would be consistent with good regulatory practice.
2. Provide a margin of safety to account for forecasting error by implementing the rate of return band concept as outlined in the Commission's August 2010 Paper on Starting Price Adjustments.

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If required, we would be pleased to elaborate on any of the points raised above. In the first instance, please contact:

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Yours faithfully

A handwritten signature in black ink, appearing to read 'Sam Pollock', written in a cursive style.

Sam Pollock
Senior Managing Partner
Brookfield Infrastructure Group