

24 August 2011

Matthew Lewer
Regulation Branch
Commerce Commission
PO Box 2351
Wellington

Email: regulation.branch@comcom.govt.nz

Dear Mr Lewer,

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

QIC is an Australian institutional funds manager with A\$60.2 billion of funds under management. One of our investments is a 58% interest in New Zealand electricity and gas distributor Powerco. In this context, we have attached our submission to your 2010-2015 Default Price-Quality Path for Electricity Distribution, (P0) Draft Decisions Paper. We note the Commission's intention to publish all submissions on its website, and have accordingly supplied an electronic copy of our submission in an accessible form to facilitate this.

We would be pleased to discuss further with you any of the points raised in our submission. In the first instance, please contact:

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Yours faithfully,



William Scott
Principal

Dynamic Investment Solutions

Global
Infrastructure

QIC

QIC Submission to the New Zealand Commerce Commission

Response to 2010-2015 Default Price-
Quality Path for Electricity Distribution --
Draft Decisions Paper

August 2011



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Summary

QIC Global Infrastructure is pleased to make a submission to the Commerce Commission in relation to its 2011-2015 Default Price-Quality Path for Electricity Distribution Draft Decisions Paper (issued July 2011). QIC Global Infrastructure, on behalf of its clients, is a significant investor in infrastructure assets in New Zealand, Australia, and globally and, in particular, holds a 58% interest in New Zealand electricity distribution company Powerco.

QIC Global Infrastructure's views on the Draft Decisions Paper are:

- The Commerce Amendment Act in principle provides a solid and internationally competitive framework for regulating prices in the electricity and gas distribution sectors, and should enable New Zealand regulated businesses to compete for international capital on an equal footing with regulated businesses in other jurisdictions.
- The implementation of the Commerce Amendment Act needs to fulfil the promises of that framework for a regulatory process that is fair, predictable and transparent.
- The Commission's Draft Decisions Paper falls short of this target in some crucial areas.
 - The Commission has introduced important changes with wide-ranging effects late in the consultation process and with limited explanation of them. In particular, the Commission's approach to discounting cashflows is unusual, not consistent with its own or international precedent, but significantly affects the P0 outcome. The Commission does not appear to have appreciated either the magnitude of the effects of this change on its decision, nor the consequences of such an unconventional approach for capital providers' assessments of NZ regulatory risk.
 - The Commission has introduced a raft of new forecasts to the process without regard to the irreducible uncertainty associated with these forecasts – a "false precision" problem. In particular, the Commission's process for forecasting growth of revenues and expenditure relies on growth forecasts for population, GDP and electricity demand that are highly uncertain; the Commission appears not to have been duly cautious that significant errors in the inputs might create significant errors in the output starting price adjustment.

We ask that the Commission rectifies these shortcomings in two ways. Firstly, by deferring application of its 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 a proper consultation on an important change and would be consistent with good regulatory practice. Secondly, the errors arising from false precision could be mitigated by implementing an RoI band concept as mooted in the Commission's August 2010 paper on starting price adjustments.

QIC Global Infrastructure, on behalf of our clients, intends to be a long term investor in the New Zealand electricity and gas distribution sectors; a full implementation of the fair, predictable and transparent regulatory regime set out in the Commerce Amendment Act would encourage other investors to also commit long-term to investment in New Zealand's electricity and gas infrastructure.

Background

QIC Global Infrastructure is a business division of QIC Limited, a leading institutional funds manager with A\$60.2 billion in funds under management as at 30 June 2011. QIC Global Infrastructure is a dedicated infrastructure team specialised in sourcing, investing and managing infrastructure investments globally. We have successfully invested and committed over A\$6 billion of our clients' infrastructure allocation into a global portfolio of 14 infrastructure investments over 12 geographies. QIC Global Infrastructure has a long-term interest in the lower-risk 'core' infrastructure represented by regulated utilities and has made the following investments in regulated utilities:

- Powerco in New Zealand (2008) – 58% interest; and
- Thames Water in the United Kingdom (2006) – 8.7% interest.

Our major clients are Australian public sector superannuation funds. These clients are and will continue to be a significant source of investment in infrastructure.

At the time of our investment in Powerco, the Commerce Amendment Act was in the process of being made law. We viewed the framework that the Commerce Amendment Act provided for regulation in New Zealand as a major improvement in the certainty and transparency of the regulatory regime.

The Act's requirements to provide for the development of Input Methodologies prior to decisions and for transparency and consultation in the regulatory decision-making processes represent a valuable addition to New Zealand's approach to regulation. The Purpose Statement enshrined in the Act provides a useful interpretative guide to the Act for regulators, regulated businesses and investors. As an investor, we appreciate that any good regulatory regime must balance the interests of consumers and owners of regulated assets to ensure a sustainable development of the industry, provide adequate incentives for investment and efficiency to owners, give appropriate pricing signals to consumers, and share the benefits of efficiency with them.

However, we have become concerned that the positive elements of the framework provided by the Act may not be fully evident in the Commission's July 2011 Draft Decisions Paper. The paper has several troubling aspects:

- Lack of Transparency: the Commission has changed its approach from that signalled in April 2011 on important components and introduced new concepts only at the draft decisions stage. The extent of discussion of the changes does not accord with the impact of the decisions on the regulated entities.
- False Precision: the Commission's new methodology relies heavily on forecasts of the future to justify why, despite Powerco's current profitability falling short of the Commission's allowable return¹, the Commission still believes a downward adjustment of prices is necessary. The uncertainty inherent in the forecasts means that they cannot bear the burden of proof necessary to justify such an adjustment. We believe that an RoI band approach (as discussed by the Commission in August 2010 but not developed in April 2011) may provide an effective solution to this problem of uncertainty.

These concerns are discussed separately in the following sections.

¹ Powerco Submission on Default Price-Quality Path Draft Decisions Paper, August 2011, para 68-69.

Transparency

Providers of capital to regulated utilities, both debt and equity, are keenly aware of the importance of regulation to the outlook for their investments. As such, any investment decision in the sector will involve careful scrutiny of the regulator's decisions and decision-making process, looking for both outward statements of intent, and insight into the processes that led to the decisions. Where relevant, investors will take into account precedent and consistency within the jurisdiction in question and in other similar jurisdictions. A history of surprises from regulators will raise investors' perceptions of jurisdictional regulatory risk and thereby increase the return required by investors.

Therefore, the Commission must appreciate that its interpretation of principles, decisions, and the processes surrounding them, are a key input in investors' assessment of the risks in investing in New Zealand electricity distribution infrastructure. Decisions that are inconsistent with rational expectations, formed by consideration of precedent both in New Zealand and overseas, are likely to result in an increase in perceived New Zealand regulatory risk by capital providers. This is particularly true if the regulator does not provide careful justification or investors perceive that the regulator is not aware of the effects of the change on the regulated business. An increase in perceived regulatory risk will increase the rate of return required for debt and equity investments in the NZ regulated assets, to the detriment of consumers and system reliability.

In this context, the Commission's repeated assertions² that errors in the default price path decision can be rectified at little cost by the affected companies applying for a CPP seems incorrect on a number of levels. As Powerco's submission notes³, applying for a CPP is likely to be an expensive and time-consuming commitment, and (given likely timeframe for a decision) may not rectify a defective DPP decision until an EDB has been on an inappropriate price path for several years⁴. Additionally, errors in the DPP decision will have a knock-on effect on capital providers' perceptions of the regulatory risk inherent in a CPP process. A rationally risk-averse decision-maker will evaluate the risk of a CPP application, taking into account the Commission's behaviour in the recent DPP process. A DPP process that has provided significant surprises will make it more difficult for EDBs to convince capital providers that a CPP will produce a positive risk-adjusted outcome. The regulatory risk premium will rise and force up the cost of capital in the NZ electricity distribution sector, lowering incentives for investment and increasing prices to consumers.

Given this, the Commission's introduction of changes to the timing of discounting of cashflows⁵ is troubling. This single aspect of the Commission's draft decision is one of the most influential on the outcome, but the Commission did not consider that it required more than one paragraph of explanation to justify. This lack of explanation is particularly surprising in light of the change that the proposed approach represents, both to prior New Zealand regulatory practice and practice in other jurisdictions such as Australia and the UK. We know of no other regulator that uses the unusual combination of timings for different cashflow types that the Commission has chosen in its draft decision. While this does not mean that the Commission's approach is not appropriate, the Commission should have expected that the change would constitute a surprise to the sector and that its introduction near the end of a consultation process would induce a shock in capital providers' assessment of regulatory risk. This shock in perceived regulatory interpretation is an outcome that a transparent regulatory regime should seek to minimise.

The Commission can avert this negative outcome by not implementing the change to the timing of discounting of cashflows in this decision and instead commit to a thorough consultation on this issue prior to the 2015 DPP decision. This would signal to capital providers that a change may be coming, would allow for a proper consultation process during which the views of the Commission and relevant stakeholders could converge, and would show capital providers that change in the New Zealand regulatory system is considered and predictable.

² Commerce Commission, 2010-2015 Default Price-Quality Path -- Draft Decisions Paper, July 2011, paras 1.49, 1.52, 3.40.

³ Powerco Submission on Default Price-Quality Path Draft Decisions Paper, August 2011, para 8.3

⁴ Ibid., footnote 3

⁵ Commerce Commission, 2010-2015 Default Price-Quality Path -- Draft Decisions Paper, July 2011, para 2.29

More generally, the Commission should evaluate the difference between its views and the legitimate expectations of EDBs and their capital providers, and, where that difference is large, seek a convergence of views over time (potentially over more than one decision).

False Precision

The Commission's process relies on forecasts of future population growth, economic growth and electricity demand at a regional level. This submission does not consider the question of whether the specific forecasts the Commission has used are appropriate or unbiased; instead we believe that the Commission has neglected to consider the consequences of the errors inherent in any forecasting process on the outcome of the DPP process.

Forecasts of population, economic growth and electricity demand at a regional level are likely to have a very high degree of error; that is, there is a wide band of plausible outcomes around the point forecast. As Powerco notes, the Electricity Authority's own estimate of the band of plausible outcomes for 2015 electricity demand is 10%⁶; the NZIER report accompanying the Powerco submission cites errors in CPI forecasts of $\pm 0.5\%$ ⁷ and provides charts illustrating that national-level GDP growth consensus forecasts are regularly a percentage point or more away from actual outcomes even over periods as short as one year⁸.

The Commission's draft decision paper does not attempt to consider or quantify the potential forecast error and how errors could affect the PO outcome. Forecast error is, in effect, ignored and forecasts are treated as precise outcomes. Wide bands of plausible outcomes in forecasts means that companies that could plausibly have the same outcome could have quite different point forecasts and therefore receive quite different PO outcomes. In effect, it makes a significant part of the PO outcome dependent on random errors embedded in the forecasts.

This is a particularly unfortunate outcome for EDBs, like Powerco, who have received a significant price reduction despite having current profitability levels being below those consistent with the Commission's WACC⁹. In this case, the Commission's process places such heavy reliance on error-prone forecasts of growth that the known, certain current profitability has effectively been ignored.

A better approach would be to weigh evidence proportionate to its level of certainty; this would accord a much higher weight to current profitability outcomes than to uncertain forecasts of potential future profitability. An RoI band approach (as discussed in the Commission's August 2010 discussion paper) would help achieve this better outcome if the width of the bands reflected the level of uncertainty in forecasts used as inputs.

⁶ Powerco Submission on Default Price-Quality Path Draft Decisions Paper, August 2011, para 116.

⁷ Forecast of PPI and LCI, and Uncertainty of Forecast, NZIER, 18th August 2011, Table 1

⁸ Ibid., Figure 1

⁹ Powerco Submission on Default Price-Quality Path Draft Decisions Paper, August 2011, para 135.

Conclusion

QIC Global Infrastructure remains positive about the regulatory processes created by the Commerce Amendment Act and by much of the consultation process the Commerce Commission has engaged in to determine the Input Methodologies.

However, the Commission's July 2011 Draft Decisions Paper falls short of the target set by the Commerce Amendment Act in some crucial areas. Specifically:

- The Commission has introduced important changes with wide-ranging effects late in the consultation process and with limited explanation; and
- The Commission has introduced a raft of new forecasts to the process without regard to the inherent uncertainty associated with these forecasts – a “false precision” problem.

We ask that the Commission rectifies these shortcomings in two ways. Firstly, by deferring application of its 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 a proper consultation on an important change and would be consistent with good regulatory practice. Secondly, the errors arising from false precision could be mitigated by implementing an RoI band concept as mooted in the Commission's August 2010 paper on starting price adjustments.