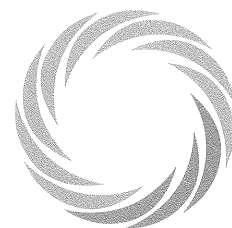


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Submission on Intention to Declare Control of Transpower

This submission is in response to the Commerce Commission's report (the Report) on its intention to declare control of the goods and services supplied by Transpower New Zealand Ltd.¹ We wish to raise five issues that arise in the Report that have relevance to the application of the targeted control regime to electricity distribution businesses as well as to Transpower. These issues are:

- The Commission should not rely on views of prospective behaviour
- The need to consider potential costs as well as benefits from control.
- Who is accountable for what under the targeted control regime?
- Is it possible to raise threshold prices without being controlled?
- The need to maintain integrity of the consultation process.

The Commission is acting prematurely by basing conclusions on views of prospective behaviour

The Commission does not appear to have a convincing case that Transpower is earning excessive profits, rather it's assessment of Transpower's breach appears to rely in part on the Commission's view of Transpower's prospective behaviour, i.e. comments by Transpower that transmission prices will need to increase by 13% per annum over the next few years to fund the Grid upgrade.

While the Commission clearly has access to more detailed information than Unison, analysis of pricing information that we have received from Transpower shows that Transpower's current (and previous) price increases have conformed to a building block approach.² Furthermore, the approach employed by Transpower to set revenues, to the extent it incorporates a well maintained EVA adjustment, provides for a correction factor should Transpower's estimates of revenues, costs, cost of capital or average asset base be wrong. This suggests that excessive earnings are not present and potential excessive earnings are subject to a control and correction mechanism.

¹ The full title of this report is "Regulation of Electricity Liens Businesses, Targeted Control Regime, Intention to Declare Control, Transpower New Zealand Ltd", by the Commerce Commission, 31 January 2006, and updated 16 February 2006. All references are to the updated version.

² Schedule K of Transpower's 2006 pricing booklet, Transpower's website.

Unison is unable to confirm that the capital expenditure driving the \$230 million increase in average ODRC of AC network assets includes any expenditure that is unapproved when approval is 'required'. Similarly, Unison is unable to verify that the overheads costs, which have increased by \$15.3 million (as allocated to AC customers), following increases of \$20.9 million and \$22.2 million in the two preceding years, are efficient. Should both these items prove to be bona fide then it is unclear where the excess earnings arise.

Furthermore, the extent to which Transpower is "pre-funding" investment in the Grid is unclear. Based on the information available to Unison, subject to the bona fides of the capital expenditure included in the asset base, Transpower only appears to be recovering that portion of investments undertaken that contributes additional depreciation (return of capital) and recovering a rate of return on the investment (return on capital).

The Commission has expressed concern that Transpower has publicly disclosed that transmission prices may be subject to further increases as the impact of additional investments roll into its asset base over the next few years. However, based on their view that transmission investment is required, it seems reasonable that recipients of the potentially higher charges are put on notice, albeit that such increases might be subject to approval by the Electricity Commission of some or all of the investments. The Commerce Commission need not respond directly to comments of future potential price increases now. It can and should wait until these are more than prospective and indicative statements become reality. If Transpower increases prices in the future, beyond a level supportable by a building block analysis and based on bona fide levels of asset expenditure (and other inputs), the Commission can reassess Transpower's actions and impose control then, if deemed necessary.

Recommendation

That the Commission should not rely on prospective behaviour in its reasoning for control decisions as it has the power to investigate manifest behaviours as and when they occur.

Need to consider potential costs as well as benefits from control

The Report ascribes up to \$675 million³ (in net present value terms) as potential benefits of control from reduced excess profits and improved timing and choice of transmission investments, but ascribes \$0 as potential indirect costs of control.

This approach assumes the regulatory decision making process will always be more efficient than that undertaken by the supplier (in this case Transpower) but the Report is silent on any justification for this view, and silent on why there was no account taken of potential error on the part of the regulator. Unison considers this position implausible.

Indeed, if regulatory processes could be relied upon to improve private decision-making in the manner assumed in the Report, New Zealand's economy could be boosted by placing all goods and services under control where they are supplied in markets in which competition is found to be limited in some way. The performance of

³ This assumes the amounts on page 11 of the Report of \$36 million, \$234 million and \$405 million are additive.

centrally planned economies relative to market economies throughout the last century provides telling evidence that this assumption is not supported in practice.

Furthermore, the particular set of regulatory decision-making processes that the Commission is relying upon to be more efficient than Transpower's decision-making processes include:

- The involvement of two regulatory bodies, the Electricity Commission and the Commerce Commission, with no formal guidance as to how their respective decisions will relate to each other. For example, it is not clear whether or not investments approved by the Electricity Commission would be considered "excluded services" or not by the Commerce Commission, and if not whether they would be accepted as part of a Commerce Commission building block analysis. The Report does not even provide a method for determining such decisions (e.g. paragraph 84 raises questions rather than provides guidance).
- The absence of a Memorandum of Understanding between the two Commissions, as requested by Government in October 2004 in the Government Policy Statement (GPS, paragraph 107) on how they propose to coordinate their respective roles.
- The requirement on the Electricity Commission to give effect to the objectives and outcomes set out in the GPS. The GPS is able to be changed by Government without the scrutiny of Parliament and thus these objectives and outcomes can be changed to reflect the political requirements of the day without the checks and balances of Parliament.
- The stage in the industry's development that requires very substantial investment in transmission or alternatives to transmission, or some combination of these. The timing and sequencing of the optimal set of investments is complex and requires intimate knowledge of the options, their practical out-working, and the extent to which other parties (e.g. generators) will commit to feasible alternatives. It is not at all clear that either of the Commissions has a comparative advantage over Transpower in identifying the most efficient path forward.

Unison considers it improbable that this convoluted and (at least formally) uncoordinated set of regulatory decision-making processes will approximate an optimal set of investment decisions. Rather, in Unison's view the Commerce Commission should be placing a high probability on substantial regulatory error from these processes.

Similar issues of potential regulatory error in decision-making under control also arise with respect to electricity distribution businesses (although they are less convoluted as they do not involve the Electricity Commission or the Minister of Energy).

Recommendation

That the Commerce Commission recognise the probability and magnitude of regulatory error in its estimates of indirect costs of control.

Who is accountable for what under the targeted control regime?

One of the strengths of a market economy is that the ownership of property rights includes the right to develop, maintain or dispose of property⁴ and the owner bears the economic rewards or losses from taking these actions. Thus accountability for the efficient use of resources is internalised within the concept of ownership, as an owner has the rights to use its property as it sees fit, and on the other hand bears the economic consequences of doing so. Thus a business that correctly forecasts increased demand for its services and invests and successfully markets itself to pick up that demand does well, but a firm that mis-reads customer demand does poorly.

The report cites one of the reasons for intending to declare control as being “... *the Commission considers that, by ensuring Transpower is subject to the regulatory framework intended by the Government and Parliament, significant benefits would arise from a reduced prospect of inefficient transmission investment and inefficient pricing decisions.*” (Page 6 of the Report).

Thus the logic appears to be that control would ensure investment and pricing decisions will be made in a more efficient manner than if left with the owner, Transpower. However, there is no discussion of the implications for accountability of imposing control and thereby truncating Transpower's property rights and its ability to operate its business, and how those implications may affect the efficiency and effectiveness of the transmission service over time.

For example, who would be accountable if control went ahead, if the regulatory decision-making process concluded that expansion of the transmission system north of Whakamaru should be delayed by 3 years, but that decision led to higher electricity prices and brown-outs?

It is not at all clear how this simple question of accountability for the delivery of the transmission service would be answered, as it appears there are four entities (Transpower, the Commerce and Electricity Commissions, and the Minister of Energy) that would be partially accountable, but none completely (and by implication therefore no one).

The Commerce Commission is able to shift and clarify accountabilities in a significant way by the manner in which it implements the targeted control regime. For example, clarification as to how the two Commissions intend to coordinate their activities and the boundaries of those activities would be very helpful. It could also clarify the method it intends to use to test the reasonableness of prices, and (assuming it includes a cost building block approach) the processes it will use to populate that method and if necessary adjust the supplier's information as regards projected costs and output volumes. These steps would go some way to improving the allocations of accountability for the various steps in the regulatory decision-making process.

In the absence of a clearer view as to which party is accountable for what aspects in the regulatory process, the only certainty is that in the case of service failure the customer will be unable to identify which entity is accountable for the problem. Such confusion of accountabilities is the antithesis of the purpose statement of the targeted

⁴ Such rights are of course subject to restrictions related, for example, to encroaching on others property or safety (e.g. as set out in the Resource Management Act and health and safety legislation) and protecting the competitive process (as set out in the Commerce Act).

control regime, *“to promote the efficient operation of markets directly related to electricity distribution and transmission services...”*

Recommendation

That the Commission clarifies the various accountabilities in the regulatory decision-making process when an entity is controlled under the targeted control regime, and provides reasons for why that set of accountabilities are considered to be an efficient way to coordinate the supply of electricity transmission and distribution services (i.e. how they are consistent with the purpose of the targeted control regime).

Is it possible to raise threshold prices without control?

One feature common to the two instances in which the Commission has declared an intention to control goods and services under the targeted control regime (i.e. Unison and Transpower) is that the business faced a very large increase in its capital investment programme, it wished to raise prices above its price thresholds to provide an adequate return on that investment, but was unable to amend the price thresholds to take account of the investment without breach and the significant impact of investigation.

The process to date in both cases has not provided any tests or criteria that an electricity lines business could use to determine what level of increase to the price thresholds would be permissible. The Commission has not provided any method for making such decisions. Thus, at this stage it appears the only way a business can achieve an increase in average prices above those set by the thresholds is to be investigated and subject to potential control.

In terms of a life cycle for a capital intensive infrastructure business this outcome is pernicious. It drives these businesses to defer large capital expenditure projects for as long as possible, in order to defer the point at which they are subjected to potential control.

Further, it means that the regulatory constraints are the tightest at the point in time at which the business needs to attract additional capital to fund the increased capital expenditure. This, coupled with the uncertainty as to how the Commission will determine acceptable prices under control, raises significantly the cost of capital to the business (the recent lowering of Transpower's credit rating is an example of this).

Put another way, the regulatory regime is placing the most regulatory pressure and uncertainty on firms at the point in their cycles when they most need certainty and clear parameters in order to attract capital at reasonable cost.

This approach to the implementation of the targeted control regime will not deliver efficient outcomes. Unfortunately, the practical realities of this will take a number of years to become apparent (e.g. through degraded service levels and the inability of the electricity system to cope with growth).

Recommendation

That the Commission develops guidelines as to the method that lines businesses could use to apply for a change in threshold prices while avoiding investigation and potential control.

Need to maintain integrity of consultation process

The consultation timetable for the Report is very short and does not include the Commission's normal conference procedures.

Unison is surprised by this truncation in time and the omission of this procedural step given the very significant nature of the decision being considered. This approach may have arisen from a sense of importance in progressing this decision speedily.

However, in Unison's view the speed and integrity of the overall process is unlikely to be served by truncating the consultation process. The recent need for the Electricity Commission to re-consult on the pricing methodology to apply to Transpower is an example of procedural haste leading to a slowing of overall progress.

Recommendation

That the Commission maintains reasonable time and its usual procedural steps (inclusive of conferences) when consulting on whether or not to control the goods and services of an electricity distribution or transmission provider.

We would be happy to expand on these issues if you wish.

Yours sincerely

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

Ken Sutherland
Chief Executive
Unison Networks Ltd