



Intention to declare control in respect of Transpower

**Submission on the Commerce
Commission's Position Paper from
Powerco**

27 February 2006

Contents

1	Introduction and Background	3
2	The Commission's Assessment and Inquiry Guidelines of October 2004	3
3	Has the Commission followed the Inquiry Guidelines in its Position Paper?	6
4	Other issues flowing from the Position Paper	10
4.1	Investment incentives, benefits of control and outcomes for consumers	10
4.2	The role of the Electricity Commission in driving efficient investment	12
5	Concluding remarks	14

1 Introduction and Background

1. Powerco welcomes the opportunity to make this submission in response to the Commerce Commission's paper (the Position Paper) setting out its intention to make a declaration of control under Part 4A of the Commerce Act 1986 (the Act), in respect of electricity transmission services supplied by Transpower New Zealand Limited (Transpower).
2. The Position Paper sets out the Commission's reasons for forming an intention to declare control, and invites comments from interested persons to give their views on this intention. In this regard, Powerco does not wish to comment on whether or not the Commission is correct in forming its intention to declare control. Instead, Powerco's submission is limited to commenting on whether the Commission's reasoning and processes are appropriate, especially in the light of earlier commitments made by the Commission with regard to the conduct of post-breach inquiries.
3. This submission is structured as follows:
 - Section 2 describes the Commission's process for conducting post-breach inquiries as set out in the *Commission's Assessment and Inquiry Guidelines* in October 2004 (the Inquiry Guidelines).
 - Section 3 highlights the differences between the Inquiry Guidelines and the approach now adopted by the Commission in its Position Paper.
 - Section 4 identifies other aspects of the Position Paper, where the Commission's analysis is open to challenge.
 - Section 5 sets out concluding comments.

2 The Commission's Assessment and Inquiry Guidelines of October 2004

4. The preface to the Commission's Inquiry Guidelines explains that:

The purpose of this document, the *Assessment and Inquiry Guidelines* (the Guidelines), is to inform interested parties of the Commission's broad process and analytical framework for assessing threshold compliance and for undertaking post-breach inquiries under the targeted control regime. The objective of doing so is to increase certainty and transparency in respect of the Commission's approach to these tasks. (Emphasis added).

5. Powerco concurs that there is considerable merit in maximising the level of certainty and transparency of the regulatory arrangements administered by the Commission. In fact, the issue of regulatory uncertainty has been a matter of concern to Powerco in recent years, and is a recurring theme of the company's submissions to the

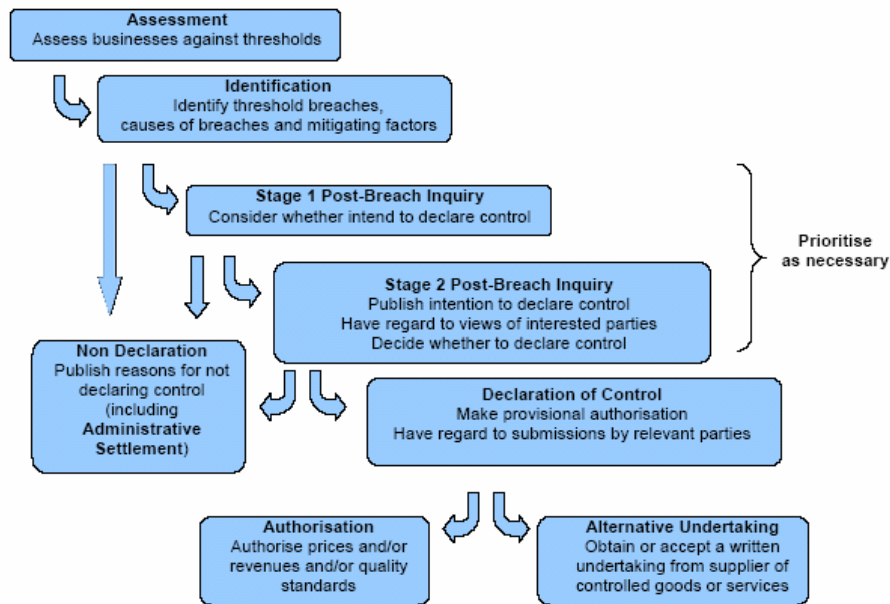
Commission. In fact, Powerco’s submission¹ in relation to the draft Inquiry Guidelines argued that a greater level of certainty was warranted:

It is Powerco’s view that the Draft Guidelines are vague in a number of respects, and therefore do not provide an adequate level of certainty for the lines businesses.

It is also worth recalling that a number of presenters at the Commission’s conference on the Draft Decisions on resetting the price path threshold for electricity lines businesses in November 2003 emphasised the need for certainty in relation to post-breach inquiries. Given this background, it is important to review the Inquiry Guidelines to assess whether the Guidelines have been followed by the Commission in its Position Paper.

6. The Inquiry Guidelines set out the following process in relation to a post-breach inquiry

Figure 1 – Targeted Control Process Steps



7. The Inquiry Guidelines (paragraph 67) explain that a threshold breach would set in train a process that could result, ultimately, in a lines business being subject to a declaration of control. However, the Guidelines note that not all post-breach inquiries need follow the same route. At any stage the Commission could, based on the available evidence and analysis, decide to:

¹ Powerco’s submission on the Draft Inquiry and Assessment Guidelines, 7th August 2003, paragraph 16.

- publish its intention to declare control; or
 - continue to inquire into whether control may be warranted; or
 - resolve the inquiry by entering into an administrative settlement with the lines business; or
 - cease the inquiry and take no other action.
8. When determining whether to declare control of goods or services provided by a lines business, the Inquiry Guidelines (paragraph 82) explain that the Commission must have regard to the purpose statement contained in section 57E of the Act. The overall purpose of the targeted control regime is to promote the efficient operation of electricity transmission and distribution markets for the long-term benefit of consumers.
9. The Inquiry Guidelines further explain (paragraph 86) that in determining the net benefits of control to consumers, the Commission considers that it should judge the behaviour of a lines business that has breached the thresholds against an “efficient prices” standard, which also involves a benchmark of the normal returns to be earned by the business.
10. The concept of the factual and the counterfactual are introduced in paragraph 92 of the Inquiry Guidelines. It explains that this is a comparison between two hypothetical scenarios—one with control and one without—and the Commission must form a view based on pragmatic considerations of each scenario. (emphasis added)
11. The Inquiry Guidelines proceed to explain (paragraph 95) that in the “control”, or factual, scenario prices would, in general, be at the level deemed efficient for a given level of service quality, but with some allowance for the fact that controlled prices may not perfectly reflect efficient prices. That is, controlled prices may be slightly higher than those observed in a (hypothetical) market with effective competition, reflecting slightly higher costs attributable to any adverse efficiency incentive effects of control. In other words, control may not achieve all of the theoretical benefits of efficient prices.
12. It is clear from the Inquiry Guidelines that models would be used to estimate the net benefits to consumers in terms of allocative efficiency, productive efficiency, dynamic efficiency, and transfers to consumers. The Inquiry Guidelines note, in particular, that models are useful to the degree that they focus the parties’ attentions on key assumptions (paragraph 97), by:
- focusing parties’ attentions on verifiable economic arguments;
 - making transparent the values of the key parameters and assumptions in the analysis; and
 - producing quantitative estimates of the results of control.

13. The Inquiry Guidelines identify two broad approaches the Commission could consider in determining efficient prices. The first involves benchmarking the lines business' prices against those of comparable services provided by other lines businesses. The second approach is to construct efficient prices using theoretical models. The Inquiry Guidelines state that these approaches are not mutually exclusive, and the Commission may well use them both, possibly in sequence.
14. The Inquiry Guidelines make two specific commitments in terms of the Commission's analysis:
- In paragraph 89, the Commission states that this form of consumer analysis is similar, in principle, to that used by the Commission in its report to the Minister of Commerce on the control of certain airfield activities, and that the Commission has been using to date in preparing its recommendations to the Minister of Energy as to whether gas pipeline services should be controlled, under Part IV of the Act (the Gas Control Inquiry).
 - In paragraph 146, the Commission proposes to estimate efficient prices, using the building blocks approach, in order to identify evidence of persistent excess profits and/or excessive costs. Evidence of persistent and materially excessive profits and/or costs could lead the Commission towards an intention to declare control, if it were satisfied that control would result in net benefits to consumers.

3 Has the Commission followed the Inquiry Guidelines in its Position Paper?

15. The Position Paper describes the approach taken by the Commission in its assessment of the benefits of imposing control on Transpower in paragraphs 129 and 130 as follows:

The approach taken to develop a "factual" differs from that taken in the recent intention to declare control of Unison Networks Limited (Unison). For the Unison intention, the Commission undertook a "building blocks analysis" to construct a number of possible future price paths (i.e., factual scenarios) to compare with Unison's own projections of its prices over the next few years (i.e., counterfactual scenarios).

In Transpower's case, the Commission does not consider that such a building blocks approach is currently practicable, because it is neither appropriate nor possible at this stage to attempt to construct a factual price path based on an assessment of Transpower's efficient prices going forward.

16. Powerco notes that the approach applied in Transpower's case differs from that foreshadowed in the Inquiry Guidelines. Powerco believes that the Commission has not adequately justified its unexpected departure from the procedures it set out in the Inquiry Guidelines. For instance:

- There is no substantiation by the Commission of its inference that Transpower's investment programme is more complex or less certain than that of any other lines business. On the contrary, it might reasonably be argued that the EGR framework provides a *higher* degree of transparency in relation to Transpower's investment programme. The information available to the Commission through the Grid Upgrade Plans and other documents may readily facilitate the establishment of alternative future investment and price paths (i.e. factual scenarios).
- Table 3 (on page 59 of the Position Paper) sets out a summary of Transpower's own application of the building block approach. That data appears to have been provided by Transpower to substantiate the announced price increase. This data could have been used by the Commission in a building block analysis, in accordance with the approach foreshadowed in the Inquiry Guidelines.

17. Powerco's submission² on the Draft Inquiry Guidelines had cautioned the Commission against using an inconsistent approach in its post-breach inquiries:

The objective of ensuring consistency in the Commission's decisions is not fully considered in the draft guidelines. It should be noted that inconsistent decisions are likely to have an adverse effect on incentives for investment by unduly raising regulatory risk.

Powerco is disappointed that the Commission appears to have taken little account of this observation. As noted below, the issue of regulatory risk is now beginning to be fully recognised in capital markets and reported in the press.

18. The Commission's analysis and reasoning in forming a view that control should be declared over transmission services focuses heavily on Transpower's conduct. It is recognised that "conduct" is one of the three criteria the Commission has said it would typically apply when determining what action to take in response to information indicating a prima facie breach of a statute under which the Commission has an enforcement role.³ However, the Commission's findings in relation to Transpower's conduct should not obviate the need for a building block assessment in accordance with the Inquiry Guidelines.

19. The novel and unexpected approach applied by the Commission in its Position Paper provides a tangible example of heightening regulatory risk. This matter is of relevance and concern to Powerco.

² Powerco's submission on the Draft Inquiry and Assessment Guidelines, 7th August 2003, paragraph 25.

³ Refer to paragraphs 59, 60 and 65 of the Inquiry Guidelines. It is noted that the Commission's discussion of these criteria takes place under the heading of "Prioritisation of Post-Breach Inquiries and Control Declarations".

In this regard it is noteworthy that such concerns are also held in the investment community. For instance, an article appearing recently in the *Dominion Post* reported the reaction of credit rating agency Standard and Poor's to the Commission's approach in the Transpower inquiry. The article stated⁴:

The international credit rating agency criticised the regulatory regime for lines businesses, saying it was characterised by "heightened uncertainty and lack of transparency".

20. An immediate and direct impact associated with this increase in regulatory risk is an increase in the cost of capital, as evidenced by the following excerpt from the *Dominion Post* article cited above:

Ratings agency Standard and Poor's has warned electricity and gas lines businesses they face a weakening of their credit ratings after Government intervention in Transpower's prices.

Standard and Poor's yesterday downgraded the outlook for state-owned national grid operator Transpower from stable to negative...

Standard and Poor's credit rating analyst Justin Davey said the Commerce Commission's recently published reasons for intervening in Transpower "cast serious doubt on Transpower's ability to apply future charges that are sufficient to protect its credit profile should the company continue with its grid upgrade plan".

21. Fitch Ratings has also recognised the heightening of regulatory risk in a recent report and the accompanying media release.⁵

Fitch Ratings today warned that regulatory uncertainty is now a major credit concern for New Zealand's utility sector.

"In recent years the sector has experienced prolonged challenges from regulatory uncertainty, gas supply shortages, uncertainty over future generation capacity and under-investment in transmission," said Carolyn Martin, Regional Head of Fitch's Energy & Utilities team. "These challenges are now heightened, and accordingly Fitch's outlook for the sector continues to be negative," added Ms Martin.

The regulatory regime is now a hybrid of 'light-handed' and interventionist approaches, increasing uncertainty for industry participants. From a credit perspective, the stand-off between Transpower and the regulators is prolonging concerns for the New Zealand electricity sector. Fitch notes from its international experience that under-investment in transmission can have dire effects and tends to occur for two main reasons: bottlenecks in the approval process and uncertainty in recovering costs and earning an adequate return on investment. Both of these factors are evident in NZ.

⁴ Adrian Bathgate, "Credit Warning for Lines Firms", *Dominion Post*, 7 February 2006.

⁵ Fitch Ratings, *New Zealand Utilities: What's the Mix for 2006?* and *Media release: Fitch Ratings- Brisbane/Singapore*, 6 February 2006. Source: <http://www.fitchratings.com.au>

22. A further concern is that the Commission's approach in the Transpower case appears at odds with earlier statements it made regarding the need for the regime to carefully and appropriately consider breaches that may be justified on the basis of costs. Throughout the Commission's consultations on the ELB threshold regime, Powerco expressed concern that the generic thresholds would not reflect the specific forward-looking costs faced by many companies as their assets age, demand grows, and the expectations of consumers for more reliable power supplies increases. In response, the Commission stated:⁶

The Commission considers that lines businesses should regard the declaration of control as an outcome to be avoided where possible. However, given the generic nature of thresholds, the purpose of the regime may not be achieved if lines businesses endeavoured to avoid breaching thresholds under all circumstances or at all costs.

23. The Commission then proceeded to state:

If a lines business breaches a threshold, due to its specific circumstances, the Commission will consider those circumstances, either before the breach is identified, or as part of its post-breach investigation. If the Commission considers that the breach was justified (i.e. the conduct, as revealed upon investigation, was fully consistent with the purpose of Part 4A), then a declaration of control would not follow in respect of that breach.

24. Similarly, the Commission has stated:⁷

From time to time, lines businesses may face significant increases or decreases in uncontrollable costs such as council rates, taxes, and transmission charges. In the absence of a mechanism to account for such events, a lines business could therefore breach the price path threshold because of external and unmanageable cost increases.

25. As noted above, Transpower appears to have sought to provide the Commission with a cost-based explanation of the reasons for the price threshold breaches and proposed price increases (namely, increased investment to maintain and upgrade the network) however, the Commission has not assessed that information using the building block approach referred to in its Inquiry Guidelines.

26. In this context, it is noteworthy that the Commission states that it recognises the need to provide regulatory certainty. For instance, it has stated⁸:

⁶ Commerce Commission, Regulation of Electricity Lines Businesses - Targeted Control Regime: Draft Decision, 23 December 2002, page 19.

⁷ Commerce Commission, Discussion Paper, March 2002, paragraph 53

As discussed in its 6 June 2003 threshold decisions paper, the Commission considers the regulatory objectives may not be achieved if lines businesses were inclined to be unduly cautious or averse to uncertainty about the consequences of their conduct in relation to thresholds.

27. Notwithstanding these statements and commitments, it appears that in Transpower's case, the Commission has proceeded directly to a decision to impose control without properly having regard to matters it previously identified as being relevant to such decisions, and without adhering to processes it set out in its own Inquiry Guidelines.
28. This conduct has resulted in an increase in the level of uncertainty surrounding the regulatory processes administered by the Commission, leading to an increase in the cost of capital, and a diminution of incentives for investment in infrastructure – a matter discussed in further detail in section 4 below.

4 Other issues flowing from the Position Paper

4.1 Investment incentives, benefits of control and outcomes for consumers

29. The need for substantial investment in the transmission grid is widely recognised. For instance, the Electricity Commission has stated:⁹

A key issue facing the Commission is the upgrade and expansion of the transmission system... [The Commission's] role is to enable appropriate transmission investment, which has been limited for some years.

30. Similarly, in a media release dated 6 February 2006, the global credit rating agency Fitch Ratings stated¹⁰:

In recent years the [electricity] sector has experienced prolonged challenges from... under-investment in transmission.

31. Policy makers also recognise the vital role played by infrastructure in ensuring economic growth and prosperity. For instance, in his Statement to Parliament of 14 February 2006, the Prime Minister emphasised the role that infrastructure investment – along with “higher quality regulation” – play in achieving higher productivity, higher business investment, and more innovation across the economy.
32. It is also widely recognised that while regulatory decisions on price controls have potentially significant impacts on prices paid by

⁸ *Regulation of Electricity Lines Businesses: Targeted Control Regime - Draft Assessment and Inquiry Guidelines: Process and Analytical Framework*, 7 August 2003, page 9.

⁹ Electricity Commission, *Statement of Intent 2005–2008*, page 5.

¹⁰ Media release: Fitch Ratings-Brisbane/Singapore-06 February 2006: Source: http://www.fitchratings.com.au/show_featart.asp?rel_id=308

consumers and returns earned by infrastructure owners, they also determine the incentives for on-going investment in regulated infrastructure. Under price control regimes, there are risks to economic welfare arising from regulatory error in establishing price controls.

33. These risks have been highlighted by the Productivity Commission (PC), the Australian Government's principal independent advisory body on micro-economic reform and regulatory policy. The PC's review of Australia's national access regime (which was completed in September 2002) concluded that regulators' decisions should aim to encourage investment in infrastructure, because:

- there is a significant risk that aggressive regulatory decision-making may severely diminish incentives for on-going investment in infrastructure;
- the cost to society as a whole of insufficient infrastructure investment is far greater than the potential cost associated with regulatory decisions that are expressly aimed at providing incentives for on-going investment;
- the information that is available to regulators in their decision-making is, unavoidably, characterised by a high degree of uncertainty; and
- given this uncertainty, and the potential costs to society of overly aggressive regulatory decisions, there is a strong case for regulators' decisions to err in favour of encouraging more, rather than less infrastructure investment.

34. The Commission's intention to declare control in respect of Transpower appears to be aimed at constraining revenues at a time when it is widely recognised that substantial additional investment in the grid is required. Given the nature and tone of the Commission's explanation of its reasons to declare control, there appears to be a significant risk that the resultant price controls may well constrain Transpower from undertaking socially optimal grid investment. Such an outcome, if it were permitted to occur, would be a matter of profound concern to Powerco.

35. In the case of a State-owned enterprise which is constrained by price control from fully recovering costs, the owner may be prepared to accept sub-market rates of return on equity. In the case of privately-owned enterprises however, the imposition, *or threat* of unduly stringent price controls will result in the enterprise facing a capital constraint. Under these conditions, the enterprise will simply be unable to raise the capital required to fund socially optimal infrastructure investments. This outcome would not be in the long term interests of energy consumers.

36. The reasoning underpinning the Commission's intention to declare control conveys to us a significant risk that price controls may well be set at a level that is insufficient to support the funding of socially

optimal investment. This is a matter of prime importance, which the Commission appears, so far, not to have considered in its decision-making.

37. Instead, the Commission argues that a primary benefit of control is to reduce the possibility of over-investment in the transmission grid. Such a proposition seems to be at odds with the widely held view, noted earlier, that New Zealand requires greater investment in transmission. If price control will defer investment, as the Commission postulates, then it might well be reasonable to question whether price control is the appropriate remedy. In any event, it would be necessary for the Commission's decision to evaluate and consider the costs implications if the imposition of control led to socially optimal grid investment being deferred or foregone. The Commission appears not to have considered this important matter.¹¹
38. In fact, Powerco notes that in the Gas Control Inquiry Final Report (of November 2004) the Commission recognised that regulatory risk may deter investment, and that such outcomes would contribute to the indirect **costs** of imposing control. In particular, in paragraph 7.86 the Commission explains:

The Commission's cost benefit analysis assumes that control, if it were imposed, would deter some new investment, resulting in some new customers not being served (termed the 'missing market'). The dynamic inefficiencies that would arise are included in the costs of control in the Commission's modelling.

Given the Commission's approach in relation to the Gas Control Inquiry, Powerco is concerned that in relation to Transpower, the Commission considers that deferral of investment is a **benefit** of control, rather than a cost. It is a matter of concern that the Position Paper does not recognise or explain the apparently contradictory position adopted by the Commission. Powerco cannot accept the Commission's view that price control can be justified on the basis that it will lead to deferral of investment.

4.2 The role of the Electricity Commission in driving efficient investment

39. Paragraph 134 of the Position Paper states:

The Commission considers that, in Transpower's case, benefits from control would arise from ensuring that Transpower's investments and associated price paths are subject to the appropriate regulatory processes to best ensure they are efficient. In the Commission's view, such outcomes are more likely where the regulatory regime is able to operate as intended, and where Transpower does not take actions that may potentially limit the range of viable investment alternatives.

40. The outcomes sought by the Commission are those which are intended to be delivered through Part F of the EGRs. Part F

¹¹ These issues are addressed in more detail in section 4.2 below.

establishes a comprehensive regulatory framework governing transmission investment. As already noted, the Electricity Commission plays a key role in that regulatory framework, by overseeing and facilitating appropriate grid investment.

41. The Electricity Commission itself is presently consulting on proposed changes to the Part F Rules, which are aimed at strengthening the regulatory arrangements governing grid investment. The proposed changes will provide for the Electricity Commission's staged approval and closer oversight of Transpower's investment decisions. It is understood that these changes are intended to ensure that Transpower's investment decisions are subject to the appropriate regulatory processes to best ensure they are efficient; and that Transpower does not take actions that may potentially limit the range of viable investment alternatives.
42. The Electricity Commission's analysis of the benefits expected to flow from the proposed Rule changes identifies the same benefits – namely deferral of investment - as those attributed to the imposition of price control by the Commission. In the separate analyses undertaken by the two Commissions, deferral of investment constitutes the most significant benefit attributed to the different regulatory changes sought by the two Commissions. Interestingly, however, the Electricity Commission's analysis makes no reference to price control, and it certainly contains no suggestions that the realisation of these benefits is contingent on the imposition of price control. Similarly, the Commission's analysis appears to have been undertaken independently of any consideration of the Part F Rules changes being proposed by the Electricity Commission.
43. These observations raise questions as to:
 - whether the remedy – namely, imposition of price control – proposed by the Commission to address perceived limitations in the grid investment governance arrangements is an appropriate one in the circumstances; and
 - whether the Commerce Commission has adequately considered the need for its price control regime to properly recognise the costs of grid investments that are approved separately by the Electricity Commission under the Part F Rules.
44. It is also noted that in paragraph 133 of the Position Paper, the Commission argues that:

There are also downstream efficiency consequences of inefficient or poorly timed investments. Allowing the costs of inefficient investments to flow through into transmission prices will likely result in allocative inefficiencies as well. Even where transmission investments are optimally selected, scheduled and implemented, inefficiencies can still arise where the time profile of prices does not appropriately reflect the timing of the underlying investments. There may be distributional consequences arising from the pricing profile over time; for

instance, where today's consumers pay for investments that result in benefits for future consumers.

45. As already noted, the task of ensuring that investments are efficient is a matter for the Electricity Commission, not the Commerce Commission. Where investments are efficient, the Commission is wrong to argue that price control is necessary in order to ensure that the time profile of prices appropriately reflect the timing of the underlying investments. Any perceived deficiencies in the transmission pricing methodology employed by Transpower could and should be addressed directly, and do not, of themselves provide a justification for the imposition of price control.
46. More broadly, the observations set out above also serve to highlight Powerco's on-going concerns regarding the potential for conflict and inconsistency to arise between the inter-related regulatory jurisdictions of the Electricity Commission and the Commerce Commission. Clearly, there is a need for careful coordination of the regulatory powers and activities of the two Commissions. The above observations highlight the pitfalls associated with the fragmentation of economic regulatory powers across different bodies, and the on-going need for careful coordination to avoid conflict and inconsistency in the implementation of regulatory policy. They also suggest that there would be merit in reforming and rationalising the existing separate institutions into one regulatory body.

5 Concluding remarks

47. The Commission's Position Paper does not follow the Inquiry Guidelines published by the Commission in October 2004, nor does it follow the process precedent established by the Unison inquiry. In particular, the Commission has not adopted a building block approach to assess whether Transpower's prices are inefficiently high. The Commission has argued (erroneously) that there is insufficient information regarding future investment to undertake such analysis. In fact, there is probably more readily available information in relation to Transpower's investment plans than would be available for other lines businesses.
48. Powerco has previously argued that inconsistent approaches in post-breach inquiries by the Commission will unduly raise regulatory risk. This warning is now borne out by capital market reactions and press reports.
49. At a time when there is a widely held recognition that greater investment is required in the grid, the Commission argues that a principal benefit of imposing price control is the deferral of investment. Powerco does not believe that this is necessarily a benefit; on the contrary, it is more likely to impose a substantial cost on New Zealand plc. In fact, in the Gas Control Inquiry the Commission argued that price control may deter investment and that this effect is a **cost** of control. The Commission has not explained its apparent change of approach to this issue in its Position Paper.

50. The reasoning underpinning the Commission's intention to declare control conveys to us a significant risk that price controls may well be set at a level that is insufficient to support the funding of socially optimal investment. This is a matter of prime importance, which the Commission appears, so far, not to have considered in its decision-making.
51. In addition, the Position Paper does not properly consider the Electricity Commission's role in ensuring that Transpower's investment is soundly based. This serves to highlight Powerco's ongoing concerns regarding the potential for conflict and inconsistency to arise between the inter-related regulatory jurisdictions of the Electricity Commission and the Commerce Commission.
52. In the absence of a building block cost analysis, it is not possible for Powerco – or the Commission – to judge whether price control for Transpower is justified. It is therefore imperative that the Commission undertakes the appropriate analysis, in accordance with the Inquiry Guidelines published in October 2004, before reaching any judgment as to whether control is warranted. Powerco looks forward to commenting in detail on the Commission's building block cost analysis and the underlying capital expenditure forecasts adopted by the Commission once this information is made available.