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Dear Keston

Input methodologies: threshold for changing IMs and the creation of new IMs

We welcome the opportunity to submit on the Commerce Commission's "preliminary view" that: (i) there is no specific statutory threshold for changing the IMs as part of the IM review; and (ii) the Commission cannot create an IM on a matter not covered by a published IM as part of the IM review. We apologise for the slight delay in our submission this was an oversight on our part and trust that given the importance of this review for our business you will consider it.

The focus of our submission is on whether it would be desirable for the Commission to establish a set of thresholds for changing the IMs, what such thresholds could look like, and the approach the Commission should adopt if it is unable to establish new IMs.

Thresholds for changing the IMs

In our view, the Commission is more or less correct that "there is no specific statutory threshold for changing the IMs as part of the IM review", subject to the following caveats:

> *Any changes made to the IMs must be consistent with the purpose of the IMs in section 52R "to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part" and the purpose of Part 4 in section 52A of to "… promote the long-term benefit of consumers … "*

- Section 52X states that "If the Commission proposes to amend an input methodology by making a material change, section 52V applies as if the amendment were a new input methodology".

While the Commerce Act does not contain a "specific statutory threshold", this does not preclude the Commission from adopting its own threshold or thresholds, if it considers that this would help promote the purposes in section 52A and/or 52R.

We reiterate our recommendation that "the Commission should pause at this point to better establish … a coherent and clear policy governing IM change processes and thresholds: this will simplify and enhance the value of the statutory review and improve the ability of the IMs to promote the purpose of sections 52A and 52R".[1]

The Commission has, by way of precedent, adopted thresholds for when a DPP or IPP may be reconsidered, consisting of the following four circumstances:

- A catastrophic event
- A change event
- An error, and
- The provision of false and misleading information.

These are a (deliberately) very narrow set of circumstances, and mean there is a very high threshold that needs to be crossed before the Commission will re-open a DPP or IPP:[2]

> *An important feature of Part 4 of the Act (as amended), particularly for the input methodologies, is promoting certainty for suppliers and consumers. The Commission considers that amendments to the determinations should therefore be generally avoided, and where an amendment is required, be made as infrequently as possible.*

Thresholds could enhance regulatory certainty and help promote incentives to invest

We share the Commission's view on the importance of regulatory certainty and predictability e.g.:

> *It is well established in the international economics literature that frequent changes to the regulatory approach taken can lead to a lack of regulatory predictability (often referred to as regulatory uncertainty) which can in turn harm investment incentives. This can be particularly true for regulated industries where the assets are sunk and long-lived, as is the case for many telecommunications assets. The "sunkness" of the assets makes it difficult for the regulated firm to exit the market should those rules change, while their long-lived nature means that their costs must be recovered over multiple regulatory periods. The risk of unpredictable changes in the regulatory environment can harm regulated firms' investment incentives. For example, it might lead to a reluctance of regulated firms to invest in the first place, or lead to socially sub-optimal investment behaviour such as under-investment, investment delay or sequential investment when an immediate or single large investment might be preferable from a social welfare perspective. A lack of predictability can also affect confidence and investment incentives more broadly, not just those of regulated firms.*[3]

We also agree that the Commission "should give weight to choices that provide greater regulatory predictability".[4]

We are of the view that regulatory predictability or certainty can be enhanced by adopting thresholds that need to be satisfied before the Commission would make changes to the IMs.

We reiterate that

> *"… the section 52R purpose, and likely the section 52A purpose, will be undermined if the threshold for review and change adopted by the Commission is incorrect or unclear. For example, if the Commission:*

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[1] Transpower, Input Methodologies: scoping the statutory review, 31 March 2015, page 1.
[2] Commerce Commission, Process for amendments and clarifications of Part 4 determinations, 8 March 2011, para 4.
[3] Commerce Commission, Draft pricing review determination for Chorus' unbundled copper local loop service, draft determination, 2 December 2014, paragraph 130.
[4] Commerce Commission, Draft pricing review determination for Chorus' unbundled copper local loop service, draft determination, 2 December 2014, paragraph 126.

- *too readily changes, or entertains change, for value shifting aspects of the IMs then this heightens investment risk for suppliers and consumers*
- *without good reason, dismisses or avoids timely consideration of non-value-shifting improvements proposed by suppliers (and potentially consumers)*
- *has no clear and consistently applied policy and procedures governing when and how it will review different aspects of IMs and the threshold it will apply to change".*[5]

What possible thresholds for amending the IMs could look like

The thresholds need not, and should not, be high for matters that are unlikely to be controversial, or for which there is broad agreement. We have previously noted this could include: (i) error correction and drafting clarifications, (ii) changes to improve the operation of the IMs (accepting that if there are value or substantial price path impacts that implementation may need to be deferred until the next reset),[6] and (iii) any other non-contentious changes that do not have negative impacts on any stakeholders.[7]

This is consistent with the Commission's position that, when considering a request for amendment of an IM, it "will take into account … whether the amendment is material and hence must be the subject of consultation with interested parties" and "whether the amendment is likely to be contentious".[8]

At the next tier, we would include changes which could create win-wins for consumers and regulated suppliers, which could include: (i) new mechanisms (e.g. IRIS) and the refinement of existing provisions (e.g. catastrophic event provisions); and (ii) changes to improve the operation of the IMs.[9]

We consider, though, that regulatory certainty would be enhanced by adopting a relatively high burden of proof that amending the IMs would better promote the purpose in section 52A for matters which substantially change the individual IMs, create winners and losers between regulated suppliers and consumers (e.g. changes to the RAB and WACC IMs, including WACC percentile) and are likely to be controversial.

In general terms, we consider that the threshold for change to the IMs should be highest where:

- the IM has been reviewed (particularly if the IM has been recently reviewed), including by way of Judicial Review and/or Merit Appeal
- substantial amendment to the IM would be required
- the changes are likely to be contentious
- the changes have the potential to create winners and losers (and result in wealth transfers)
- there is uncertainty surrounding the potential costs and benefits – this may include where there hasn't been sufficient time to determine whether the existing IM is working well or not
- there is asymmetric risk between the potential benefits and costs; and
- the changes could undermine incentives to invest, innovate and/or improve efficiency.

Discretionary use of a "materially better" test

While the "materially better" threshold was put in place specifically as a threshold for Merit Appeals, there is nothing preventing the Commission from adopting this as a threshold for substantive

[5] Transpower, Input Methodologies: scoping the statutory review, 31 March 2015, page 2.
[6] Transpower, Input Methodologies: scoping the statutory review, 31 March 2015, page 2.
[7] Transpower, Further work on the Cost of Capital Input Methodologies: Request for further information, 1 May 2014, Table 4.
[8] Commerce Commission, Process for amendments and clarifications of Part 4 determinations, 8 March 2011, para 15.
[9] Transpower, Input Methodologies: scoping the statutory review, 31 March 2015, page 2.

changes to the IMs, if it was satisfied this would better promote the purposes in section 52A and/or 52R.

We agree with PricewaterhouseCoopers that applying a "materially better" threshold to changes to the IMs would help promote regulatory certainty.[10]

The Commission states, in response to PricewaterhouseCoopers, that "Our view is that the materially better threshold does not apply in respect of changes to IMs as a result of the s 52Y review. That threshold is specifically for the IM appeals regime. The s52Y process, which the Commission is following in reviewing the IMs, does not contain a materiality threshold".[11]

Our understanding of PricewaterhouseCoopers submission is that they are advocating that the Commission use its discretion to apply a "materially better" threshold, not that the Commission is legally required to apply such a threshold. We have similarly argued for application of a "materially better" threshold for contentious IM amendments. We argue this because we believe it would directly promote the s52R purpose and indirectly promote the s52A purpose (not because we think there is an explicit statutory obligation to do so).[12]

Implicit thresholds?

It appears that the Commission has adopted implicit thresholds as part of the statutory IMs review. For example, the Commission has stated that "substantial changes of the current input methodologies are unlikely to be desirable, particularly in light of the purpose of input methodologies in section 52R".[13]

We infer from this that the threshold the Commission is setting for substantial changes is high, but the Commission is silent on what that threshold is. At the very least, such statements imply the status quo has some form of 'incumbency advantage'.

We support the Commission's proposal to develop a decision making framework as part of the scoping stage for the statutory review. It would be helpful if this work clarified any such thresholds and made the decision-making framework transparent. For example, would the Commission make substantial changes if a regulated party could demonstrate the change would be "materially better" or would the threshold for change be higher (or lower) than this?

Creation of an IM on a matter not covered by a published IM

The Commission has not stated why it does not consider it can introduce new IMs as part of the IM review. That omission has hampered our response to the Commission's statements and proposition on the matter.

Our understanding is that the Commission considers that under s 52V the Commission had until 31 December 2010 to determine any IMs for electricity and gas lines services (apart from Transpower's Capex IM).[14]

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[10] PricewaterhouseCoopers, Response to the Commerce Commission on the IM Letter on the proposed scope, timing and focus for the review of input methodologies, 31 March 2015, paragraphs 38 and 39.
[11] Commerce Commission, Input methodologies review: Invitation to contribute to problem definition, 16 June 2016, paragraph 42.
[12] Transpower, Further work on the Cost of Capital Input Methodologies: Request for further information, 1 May 2014, Table 4.
[13] Commerce Commission, Open letter on our proposed scope, timing and focus for the review of input methodologies, 27 February 2015, paragraph 28.
[14] Letter from the Commerce Commission to ENA, Clarification on SPA IM, 20 July 2012.

Section 52U states that "The Commission must determine input methodologies for the goods or services regulated under subparts 9 to 11 no later than 30 June 2010". The Minister granted an extension of 6 months, in accordance with s 52U(2), to 31 December 2010.

The Act is silent on when the Commission can determine additional or new IMs, and does not include any explicit exclusion on new IMs. Section 52V details the process the Commission must follow for determining IMs, including new IMs, and but does not include any limits on timing.

If it was the legislative intent that the Commission would be precluded from adding new IMs, after the section 52U(1) requirement had been meet, it would have been a simple drafting addition for the legislation to have explicitly excluded this.

It is quite possible the IMs review could identify there are problems with the operation of Part 4, that are not adequately addressed by the existing IMs, and would be best introduced by the introduction of new IMs. If the Commission were precluded from introducing new IMs, in such circumstances, it would undermine the purposes in sections 52A and 52R, and the value of the IMs review.

If there are situations where the Commission was unable to create a new IM but considered it helpful to provide clarity of the policy and/or methodology it expected to apply then it could establish guidelines. There are parallels to this approach with the Guidelines the Commission has set out for mergers and acquisitions etc. While the Commission would not be bound by such Guidelines in the way that it is for IMs they could help enhance regulatory certainty - particularly if the Commission had consistently applied the Guidelines on multiple occasions.

If the Commission's preliminary view is correct, we consider it should also advise the Minister that it would be appropriate to amend the Commerce Act to remove the artificial constraint on establishment of new IMs. We cannot think of any sound policy reason for precluding the Commission from establishing new IMs.

Please let me know if you have any questions or would like to discuss any of the points made in this submission.

Yours sincerely

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