

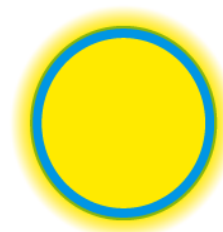
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POWERCO



Dear Keston

REVIEW OF INPUT METHODOLOGIES: RESPONSE TO THE COMMERCE COMMISSION'S OPEN LETTER

Thank you for the opportunity to provide our views on the matters identified in the Commerce Commission's "open letter" dated 27 February 2015.

The matters raised by the Commission for comment are:

- A proposal to complete the review of all Input Methodologies by December 2016 (whereas the current expectation is for decisions to be made on the Input Methodologies review in December 2017);
- Some preliminary thoughts on how the Commission might focus the Input Methodologies review; and
- Some suggested key topics which would be the focus of the review.

We comment on each of these matters below. We also offer some preliminary thoughts on the process for any review.

Timing of the Input Methodologies Review

Powerco's strong preference is to retain the December 2017 timing for issuing reviewed Input Methodologies. There are several reasons for this.

First, the Input Methodologies review is a serious event. It is a full review of the "rule book" that will regulate industry participants for a further 7 years. For that reason industry participants and investors take the Input Methodologies review very seriously.

There is a widespread expectation amongst industry participants and investors that the review will occur in 2017 (an expectation reinforced during the recent WACC percentile review). Changing the timing of the Input Methodologies review would defeat expectations that have been in place for a number of years and be a significant regulatory surprise.

As the Commission is aware, the experience of establishing the Input Methodologies has had a few unexpected turns, including the length of the merit review process and the out-of-cycle WACC percentile review. To enhance the reputation of the Part 4 regime we should be focusing on predictable regulation going forward.

Changing the timing of such a significant event as the Input Methodologies review detracts from the predictability, and reputation, of the Part 4 regime.

Second, the Commerce Act anticipates that pricing periods and Input Methodologies review periods would be on different cycles (5 and 7 years respectively). This differential cycle places a discipline on the Commission and the industry to discuss the rule book outside the context of a particular price reset, makes price resets more predictable, and improves certainty and confidence in the regime. In this regard the different cycles can be seen as substituting for the differing roles of the AEMC and the AER in Australia.

If the Input Methodologies review timetable is brought forward this will be the second time in two years that the Commission has proposed departing from the basic framework of the reviews (the first being the out-of-cycle WACC review prior to the EDB DPP reset). Such an approach runs contrary to the important principles of regulatory predictability and certainty.

We are conscious that the Commission was motivated by regulatory certainty in raising the possibility of bringing for the Input Methodologies review. However this view of certainty is grounded in the Commission's desire to review the Input Methodologies before major price setting decisions. We hope we have explained why that is not the expectations established by Part 4, and will not enhance regulatory predictability or certainty long term.

Our third reason for preferring that the Commission retain the December 2017 timing is that the December 2017 timeframe allows sufficient time for a robust and thoroughgoing review.

The initial areas of focus suggested by the Commission already flag some potentially significant changes to discuss. These include the potential move to revenue control, avoiding the current distortions flowing from use of short term spot interest rates, reviewing substantive components of the WACC setting methodology and considering how to factor in the risk of disruptive new technologies. We should take the time to work through these issues thoroughly, identify a good evidence base, and build as much of a consensus around changes as possible. If the Commission structures its review now around a December 2016 deadline there is a good prospect that we will not do the issues justice.

For these same reasons, when targeting December 2017 decisions we can see there is a good argument for starting the review this year.

Focusing the review

When the review proceeds, we agree with the Commission's starting points that:

- formally, all Input Methodologies are reviewed; but
- the Commission can and should identify areas of focus; and
- if the Input Methodologies are generating outcomes that are consistent with the section 52A purpose, then they should remain unchanged.

We would add that the Commission should identify areas where sets of issues need to be considered together and be alive to how that influences the focus and conduct of the review. An example is the WACC Input Methodology, where a holistic approach should be taken to the set of interrelated judgments involved in calculating the WACC.

Areas of focus

The Commission noted in its open letter an initial list of focus areas. This is a mix of issues the Commission wants to explore (in particular, form of control) and loose ends from the merit review and other processes. We do not disagree with any of the suggested issues of focus.

In the limited time available we have not comprehensively reviewed the Input Methodologies, looked out over the period to which the reviewed Input Methodologies will influence regulation, and identified all desirable changes.

At a high level we suggest it is worth reviewing the Commission's approach to the cost of debt used in the WACC calculation (both the risk free rate and the debt premium). The current use of 5 year spot rates exposes the regulatory regime and the regulated entities to avoidable volatility and is driving inefficient commercial responses. Australia has recently changed its approach, to better align with the position in the UK and the US.

Process for the review

This is also an opportunity to consider the best way to conduct an Input Methodologies review. There is an opportunity to collaborate on which issues to prioritise in the review, and the best way to engage on each issue (which may be different issue by issue).

We recognise that the Commission's open letter is a good start to a collaborative approach. The question is where to from here. Exchanging documents (draft papers from the Commission, submissions from affected parties) is not necessarily an optimal way to build a consensus on the agenda of issues, and to work through those issues.

We suggest the Commission consider using a working group to encourage a collaborative approach and build consensus where possible. This could potentially be similar to groups established by the ENA to work through key issues, albeit with a cross-sector character where appropriate.

If you would like to discuss any part of this submission, please contact Richard Fletcher (richard.fletcher@powerco.co.nz , tel. 021 730 348) in the first instance.

Yours sincerely

A handwritten signature in black ink, consisting of a large, stylized loop followed by a series of smaller, connected strokes.

Nigel Barbour
Chief Executive