POWERCO SUBMISSION 1

IN RESPONSE TO DRAFT INPUT METHODOLOGY AND INFORMATION DISCLOSURE DETERMINATIONS

9 August 2010

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A: INTRODUCTION

1 Powerco Limited (*Powerco*) welcomes the opportunity to make this submission on aspects of the Commerce Commission's June 2010 input methodology and information disclosure draft determinations and reasons papers for EDBs and GPBs (the *Draft Decisions*). Specifically, this submission – *Powerco Submission 1* - sets out Powerco's response on the following draft input methodologies:

1.1 Part D: cost allocation;

1.2 Part E: regulatory tax;

1.3 Part F: pricing methodologies; and

1.4 Part G: rules and processes.

2 In addition, our submission sets out Powerco's views on the overall regulatory framework and our view on matters that should be, but have not, been set out in an input methodology.

3 Powerco has engaged Mr Balchin of PricewaterhouseCoopers (*PwC*) to provide expert response to tax aspects of the Commission's Draft Decisions and accompanying expert reports. Mr Balchin's report dated 9 August 2010 and headed "Establishing the initial taxation asset base" (*PwC Report 1*) is attached to our submission.

4 Our submission should be read in conjunction with (and is intended to be complementary to) the submissions and accompanying reports from the Electricity Networks Association (*ENA*) dated 9 August 2010 on aspects of the Commission's Draft Decisions – *ENA Submissions 1-5*. Powerco supports and adopts the points made in ENA Submissions 1-5.

5 For the avoidance of doubt, all prior Powerco submissions, together with all accompanying expert evidence and referenced documents, form part of the record for the purpose of section 52Z of the Commerce Act 1986 (*Commerce Act*).

6 During the consultation process to date, Powerco has referred in its submissions to various additional documents (including submissions) from other regulatory contexts – in particular the Gas Authorisation process in 2007 and 2008. Again, for the avoidance of doubt, we expressly incorporate those additional documents into the record for the input methodologies consultation process, and rely on their content in this process. A complete list of the additional documents so far referred to by Powerco is at Appendix 1 to our submission. To date we have proceeded on the basis that the Commission has ready access to all of the documents referred to, so we have not attached copies of the documents to this or our earlier submissions. However, we are happy to provide copies to the Commission if needed.

7 All references in this submission to specific paragraphs in the Commission's Draft Decisions relate to the EDB Draft Reasons Paper (June 2010) unless otherwise stated.

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B: EXECUTIVE SUMMARY

9 Powerco welcomes the positive progress made by the Commission in several key areas of its Draft Decisions applicable to Electricity Distribution Businesses (EDBs) and Gas Pipeline Businesses (GPBs). Notable among the input methodologies covered by this submission, the draft cost allocation input methodology is broadly sensible, and the proposed Incremental Rolling Incentive Scheme in the draft rules and processes input methodology is a useful mechanism for carrying forward efficiency gains and thereby improving the incentives for regulated suppliers to achieve those efficiency gains.

10 However, in a number of core respects the Draft Decisions do not yet comprise a reasonable, comprehensive, certain and fit for purpose price/quality control regime. A primary focus of the consultation to date to determine the Part 4 input methodologies has been on the key asset valuation and cost of capital input methodologies. Powerco agrees that it has been appropriate for the Commission to devote a considerable amount of time and energy to the development of these key methodologies, but we are concerned that such a focus may have come at the expense of the quality and inclusion of other important methodologies such as those covered in this submission.

11 While a number of instances exist, the issue that is of most concern to Powerco is the Commission's failure to include in its draft input methodologies its proposed method for calculating starting price adjustments under the Default Price Path (DPP). Four days ago the Commission released its "Starting Price Adjustments for Default Price-Quality Paths Discussion Paper" (5 August 2010) which sets out the Commission's preliminary views on its method for calculating starting price adjustments, but given the timing, EDBs have clearly not had an opportunity to review, analyse and understand how the Commission proposes that the draft input methodologies will apply in this context. In any event, we disagree with the Commission's draft decision to treat the starting price adjustment as falling outside the ambit of input methodologies. Powerco supports the ENA's recent letter to the Commission which makes it clear that as a matter of law the starting price adjustment must be made pursuant to an input methodology.[1] The overall effect of not doing so is to reduce the certainty and predictability of the new regulatory regime.

12 Powerco takes this opportunity in the first of its submissions to emphasise to the Commission the importance of the input methodologies (and overall regulatory regime applicable to EDBs and GPBs) in creating a regulatory environment where businesses have strong incentives to invest as necessary in New Zealand's electricity and gas infrastructure, a vital part of the New Zealand economy. In Powerco's experience, the certainty and predictability of the regulatory regime is a key issue for debt and equity investors in regulated entities and funding from such sources is necessary for suppliers such as Powerco to be able to make the appropriate investment decisions. Large scale investment capital is globally mobile and will be attracted elsewhere in the absence of a certain, predictable and principle based regulatory regime.

[1] ENA *"Letter to Mark Berry, Commerce Commission"* (23 July 2010).

13 Powerco encourages the Commission to be consistent in its decision-making, and also to be cognisant of the fact that it is setting input methodologies that will have far-reaching implications in the real world. If the Commission does not place sufficient importance on incentives to invest, the potential for investment capital to flow out of the electricity and gas industries (with an inevitable degradation of infrastructure) will become a reality.

14 The emphasis in the Part 4 purpose statement on the workable competition standard, the *long term* benefit of consumers and the importance of incentives to invest(sub paragraph (a)) strongly implies the primary need is to ensure quality services are provided over time - such that sub paragraphs (b) to (d) of the section 52A purpose statement may also be achieved. While the Commission must seek to strike a balance between the interests of consumers and suppliers, the implications of a regulatory regime which does not encourage efficient investment will be especially damaging to the broader economy. There is a real asymmetry of risk associated with regulatory settings which discourage investment and those that encourage over-investment in essential infrastructure. This is reason enough for the Commission to err on the side of caution and to give primacy to incentives to invest – particularly for those input methodologies where the workable competition standard itself does not specify a single outcome.

15 With this in mind, much remains to be done between now and 31 December 2010 when the Commission must have determined all of the input methodologies applicable to EDBs and GPBs under the Commerce Act.

16 In addition to those issues identified above, the following major issues arise for Powerco from the Draft Decisions applicable to the input methodologies covered by this submission (and more generally):

Regulatory framework

16.1 Powerco disagrees with the Commission's interpretation of the workable competition standard in the context of economic regulation under Part 4 of the Commerce Act. Workable competition exists in the purpose statement to supply an objective standard – a knowable and (relatively) certain reference point by which the Commission is to make its regulatory decisions. In the Draft Decisions, the Commission draws support from its interpretation of workable competition for an inappropriately subjective and discretionary approach to decision-making – an approach which allows inconsistent and unpredictable decisions and undermines the confidence and incentives for investors to put their capital into the electricity lines and gas pipelines industries;

16.2 the Commission is yet to give its view on the definitions of "electricity lines services" and "gas pipelines services". This creates uncertainty for EDBs and GPBs as these definitions should demarcate the boundaries for the assets subject to price control or not, yet the statutory definition is open to differing interpretations;

Regulatory tax

16.3 with one important exception, the Commission's draft regulatory tax input methodology is broadly reasonable, although several implementation issues need to be addressed. Powerco's remaining (and fundamental) concern is

with the Commission's draft decision to determine the initial taxation asset base (*TAB*) at each firm's actual TAB, thereby including past acquisition premiums in the TAB. This is in stark contrast to the Commission's decision to exclude acquisition premiums from the regulatory tax asset value of future acquisitions and amounts to patently inconsistent and unprincipled decision-making by the Commission;

Rules and processes

16.4 the Commission's proposed efficiency sharing mechanism – the Incremental Rolling Incentive Scheme – should also apply to the DPP to provide certainty and an appropriate methodology to ensure efficiency gains are appropriately shared under the DPP. Additionally, business should be permitted to keep efficiency gains for a period of 10 years, rather than the Commission's proposed 5 year period; and

16.5 the Commission's proposed approach to avoided transmission charges under which EDBs will have to seek the Commission's approval to include such charges as a Recoverable Cost is problematic. The Commission does not specify the approval process and nor does it say what happens if the Commission does not approve the avoided transmission charge as a Recoverable Cost. We agree with the ENA that this approach is inconsistent with the requirement that the input methodologies provide businesses with certainty of the material effects of the Commission's approach.

C: REGULATORY FRAMEWORK

17 During the consultation process to date, a substantial amount of effort has already been made to properly characterise the boundaries of workable competition, as the defining standard that underpins the Part 4 regulatory framework. At this juncture, it appears that the Commission and parties can all agree that, first and foremost, Part 4 regulation must promote outcomes consistent with the outcomes produced in workably competitive markets (the *workable competition standard*). Yet, from Powerco's perspective, there remain fundamental differences in view as to what the workable competition standard actually implies and how the Commission proposes to apply the standard to the specific input methodologies it sets.

18 The "workable competition" standard outcome in a natural monopoly situation in practice, means that the monopoly, in the long term, does not earn rents and the returns it makes are those that would be earned by a firm operating in a workably competitive market. There are two main drivers of returns where this is relevant (apart from the level of capital expenditure and efficient operating costs, both of which are tested by the regulator): the first is the cost of capital. Powerco will argue (and we believe the Commission accepts) that the return on equity and cost of debt (as well as gearing) is very much the result of workable competition in the global equity and debt markets within which capital is raised by regulated suppliers. The second is the value of the regulatory asset base. And we correctly argue that the ODV asset value is the cost that a new entrant would (and does) face in a workably competitive market.

19 Powerco disagrees with the Commission's interpretation of the workable competition standard in the context of economic regulation under Part 4 of the Commerce Act.

20 As Powerco has consistently submitted, workable competition exists in the purpose statement to supply an objective standard – a knowable and (relatively) certain reference point by which the Commission is to make its regulatory decisions. The inverse interpretation – that workable competition in a regulatory context is elastic and allows for any number of variable outcomes (the interpretation favoured by the Commission in its Draft Decisions)– is unacceptably vague, and is not what the legislation intends.

21 Another key area in which Powerco disagrees with the Commission is in the approach to subparagraph (a) of the section 52A purpose statement – incentives to innovate and invest. The legislative history of Part 4 and the structure of the purpose statement strongly indicate that the promotion of incentives to invest is to be given primacy over the other subparagraphs of the purpose statement. Yet, the Commission's approach to setting input methodologies fails to do this.

22 Overall, the Commission's interpretation of the regulatory framework encourages subjective, inconsistent and unpredictable decision-making – an approach which discourages investment in the electricity lines and gas pipelines industries. Below we elaborate on these issues and also discuss other matters relating to the Commission's interpretation of the regulatory framework.

23 Previous expert reports prepared for Powerco by Mr Balchin of PwC and submitted to the Commission during the input methodologies consultation process to date also

address many of the economic issues discussed below. Mr Balchin will address these issues further in the context of Powerco's submission on the draft asset valuation input methodology in particular.

(1) THE PART 4 PURPOSE STATEMENT

Where Powerco and the Commission agree

24 Powerco agrees with the Commission's basic interpretation of the section 52A purpose statement:

24.1 the central purpose is to promote the long term benefit of consumers in markets where there is little or no competition and little or no likelihood of a substantial increase in competition; and

24.2 the central purpose is to be achieved by promoting outcomes consistent with outcomes produced in workably competitive markets, such that subparagraphs (a) to (d) occur.

25 Powerco also agrees that sub paragraphs (a) to (d) have an operative role - in setting input methodologies which promote outcomes consistent with outcomes produced in workably competitive markets, the Commission must seek to ensure that (a) to (d) also occur. This is non-contentious.

26 We note that the Commission has adopted the term "regulatory objectives" to describe sub paragraphs (a) to (d). We caution the Commission against this. While the use of such descriptive language may make discussion of the input methodologies in relation to the purpose statement easier, there is a real risk that the Commission is seen to be elevating (a) to (d) to be the primary means of promoting the central purpose of Part 4 – which is clearly incorrect. The central purpose is to be achieved first and foremost by promoting outcomes consistent with outcomes produced in workably competitive markets.

First point of departure: the primacy of incentives to invest

27 As discussed in ENA Submission 1, Powerco submits that in situations where the workable competition standard points to a range of possible methodologies (rather than a single methodology as in the asset valuation context), then in exercising judgement about the promotion of (a) to (d), the Commission must give primacy to the promotion of incentives to invest under sub paragraph (a).[2]

28 It was clearly Parliament's intent that this would be the case. The Part 4 regulatory reform, and sub paragraph (a) in particular, were directed at ensuring that the Commission placed more weight on incentivising investment than it had done in the past. The explanatory note to the Commerce Amendment Bill 2008 states that "the primary focus of the Bill is to fundamentally reform the regulatory control provisions of the Act", and that an objective was to "provide specifically for incentives to invest in infrastructure".

29 Strong evidence that lawmakers are seeking a change in regulatory behaviour from the Commission includes the following:

[2] However, Powerco wishes to make it clear that the Commission is only permitted to engage in such a judgement where the workable competition standard does not provide clear guidance. As we have consistently submitted, in the context of setting the opening RAB the workable competition standard implies a single valuation outcome – to set the opening RAB by reference to the replacement costs facing a new entrant.

29.1 the Government's economic policy statement to the Commission of 7 August 2006 clearly outlines its objective to incentivise regulated businesses to invest in infrastructure for the long-term benefit of consumers; and

29.2 the Minister's press statement on the introduction of the Commerce Amendment Bill on 13 March 2008 asserted that the Bill would provide better incentives for investment.[3] The then current Minister of Commerce's speech on the Commerce Amendment Bill said, when discussing the purpose statement, that:[4]

> The purpose is "to promote the long-term benefit of consumers in markets ... by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services - (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets". I do not think we should ignore the fact that that is No.1 of a series of four tests against which those outcomes are being measured.
>
> …
>
> **Starting with the incentives to innovate and to invest is really sending a signal about how important it is not to forget that future needs are just as important when we are looking at a non-competitive market ...** I think we **have the order right**, and that sends a very good signal.
>
> [Our emphasis]

30 In Powerco's view, the reference by the Minister of Commerce to "having the order right" reflects the fact that in the version of the purpose statement originally proposed by the MED, the incentives to invest limb was listed at sub clause (d), fourth in a serious of four tests.[5]

31 The primacy of objective (a) is also required by the Part 4 purpose statement itself. The primary purpose is to promote "long-term benefit", which necessarily requires an emphasis on investment to ensure services are provided in the long term, such that (b) to (d) can also be achieved.

32 Finally, it is worth noting that the current government has also emphasised the need to improve the investment environment in New Zealand, for example:

32.1 the National Party's Infrastructure Election Policy stated:

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[3] Hon David Parker *"Bill gives better incentives for infrastructure investment"* (13 March 2008), http://beehive.govt.nz/release/bill+gives+better+incentives+infrastructure+investment.

[4] 649 NZPD 18541 (2 September 2008).

[5] MED *"Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document"* (April 2007), page 28.

> National has a comprehensive infrastructure plan to ensure a step change in New Zealand infrastructure investment and reduce development delays. We believe that developing New Zealand's infrastructure is essential to getting us through this downturn and on to a path to stronger economic growth.

32.2 since being elected, National has reaffirmed its commitment to providing investment incentives:[6]

> We are introducing a series of measures to remove barriers that have prevented New Zealand becoming more competitive and achieving higher productivity growth ... We are boosting infrastructure investment through a 20-year national infrastructure plan, reform of the Resource Management Act and adding $8.6 billion in new capital projects over the next six years.

32.3 further, the National Infrastructure Plan 2010 specifies that "improving the regulatory environment to facilitate the private sector's investment in infrastructure" is an integral part of the Government's approach to infrastructure development in New Zealand.[7]

Second point of departure: workable competition

33 The real point of departure between Powerco and the Commission is in the understanding of what the concept of workable competition means in a regulatory context. The Commission's interpretation of workable competition has a defining bearing on its exercise in setting the input methodologies, as illustrated below. However, in Powerco's view, the Commission's interpretation is wrong as a matter of economics and of law.

Commission's approach

34 In the Draft Decisions, the Commission adopts a very wide concept of workable competition. As we discuss below, the markets that the Commission uses for its analysis are at the outer margins of what may be considered an acceptable level of competition. Indeed, they stretch the concept of workable competition beyond its ordinary meaning. Markets which are characterised by long-lived specialised assets, economies of scope and a limited number of suppliers and/or consumers[8] are not markets that would typically be described as workably competitive.

35 The Commission then identifies a large range of short term outcomes it considers are consistent with those produced in workably competitive markets. This reflects the Commission's reasoning that outcomes associated with long-term equilibrium are not a defining feature of workably competitive markets. This is a key aspect of the Commission's reasoning which Powerco disputes (in fact, outcomes associated

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[6] Bill English *"Crown accounts show need for economic action"* (5 December 2008), http://www.beehive.govt.nz/release/crown+accounts+show+need+economic+action.

[7] New Zealand Government *"National Infrastructure Plan"* (March 2010), page 3.

[8] Commerce Commission *"Input Methodologies Electricity Distribution Services Draft Reasons Paper"* (June 2010), paragraph 4.2.36.

with long term equilibrium are precisely the outcomes that the Commission should be seeking to promote). The Commission promotes these short term outcomes to ensure that (a) to (d) occur.

36 The sum of this approach is that the Commission has asserted a relatively unconstrained discretion to set whatever input methodologies it prefers. This distorts the meaning of the purpose statement, and undermines the objective standard and accountability that the workable competition concept was meant to import into the Part 4 regulatory context.

37 The high level of discretion that the Commission has afforded itself is most visible in its focus on short term outcomes in pursuit of subparagraphs (a) to (d). The Commission states that, in selecting which outcomes to promote, it is "guided by" (a) to (d).[9] Throughout the input methodologies draft decisions, the Commission's focus on weighing the range of outcomes mandated by subsections (a) to (d) - which are often in conflict with each other and between which there is a degree of mutual exclusivity – has rendered the standard of workable competition in the purpose statement somewhat meaningless. Powerco submits that it is unlikely that Parliament envisaged such a broad concept of workable competition, which is so indeterminate as to admit of many variable outcomes. It is also unlikely in a context of broader regulatory harmonisation between Australia and New Zealand that Parliament intended the Commission to adopt an interpretation of workable competition so clearly different to the standard interpretation in Australia.

38 It is clear that Parliament's main objective in providing for a specific purpose statement for Part 4 was to overcome the uncertainty that had undermined the previous regulatory regimes applying to EDBs and GPBs. The explanatory note to the Commerce Amendment Bill 2008 included among the reasons for the (then proposed) amendments to Part 4 of the Commerce Act that (i) the absence of a specific purpose statement for Part 4 up until then had led to dispute and uncertainty, and that (ii) there was uncertainty about the rules governing regulatory decisions (such as the cost of capital).

39 Powerco submits that the Commission's interpretation of workable competition in its Draft Decisions is directly inconsistent with the intention of Parliament to create certainty by the inclusion of an objective and certain purpose statement to guide regulatory decision making.

Workable competition in a regulatory context

40 Powerco maintains its submission that workable competition in the regulatory context is a more specific and objective standard than the Commission suggests.

41 Workable competition needs to be construed in the context of what Part 4 is doing – for EDBs and GPBs it is imposing price control and information disclosure by force of law on private entities. In this context, workable competition is intended to supply an objective standard to guide regulatory decision making and to hold the Commission to account.

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[9] Commerce Commission *"Input Methodologies Electricity Distribution Services Draft Reasons Paper"* (June 2010), paragraph 2.7.4.

42 The concept of workable competition in a regulatory context must be clearly distinguished from the concept as it applies in a competition law context. As Mr Balchin has previously advised the Commission:[10]

> a central feature of the concept of a workably competitive market is that such a market would contain (dynamic) forces that constrain each firm's pricing, output and other decisions… The direction to which these dynamic forces would be expected to push the outcomes of a market is the long run equilibrium to which I have referred. While markets may take a period to get back to this long run equilibrium, may pass straight through or be affected by other events along the way (such as changes to tastes or unexpected technological changes), the character and direction of the forces within the market – which is to encourage response to profits and thereby competing away economic rents and heading towards the position where further expansion or new entry would make only normal returns – is the constant.
>
> …**the typical objective in anti-trust is to attempt to judge the magnitude of these dynamic forces and hence the constraints on firms. The Commission's purpose is quite different – it is required to form a view about the outcome that a workably competitive market would produce**… [emphasis added]

43 The task for the Commission is therefore not to promote or replicate the dynamic forces of workably competitive markets in the regulated markets, but to promote outcomes that are consistent with outcomes produced in workably competitive markets. The Commission's discussion of the role of economic regulation appears to recognise this, and is best encapsulated in Alfred Khan's statement that:[11]

> the single most widely accepted rule for the governance of regulated industries is regulate them in such a way as to produce the **same results** as would be produced by effective competition, if it were feasible. [emphasis added]

44 In considering how best to promote outcomes that are consistent with outcomes produced in workably competitive markets, the Commission must adopt the approach that is most likely to deliver those outcomes. In Powerco's view, regulation based on the short term fluctuations in workably competitive markets is far less likely to deliver workably competitive market outcomes than regulation which is based on the balanced long run equilibrium position.

45 In Powerco's view, setting input methodologies based on the long run equilibrium of workably competitive markets would:

45.1 fairly reflect the intention of Parliament to create a new regulatory regime which has certainty as a fundamental objective;

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[10] Jeff Balchin, PwC, "*Commerce Commission Review of Input Methodologies: Cross-Submission (Prepared for Powerco)*" (October 2009), page 8.

[11] A. Khan, *The Economics of Regulation, Principles and Institutions*, Volume I Economic Principles, MIT Press, Cambridge MA, p 17.

45.2 provide the objective standard required by the workable competition concept in a regulatory context and by Part 4 of the Commerce Act; and

45.3 be the approach that is most likely to promote outcomes consistent with those produced in workably competitive markets such that (a) to (d) occur.

46 The real constant in workably competitive markets is the presence of dynamic forces which push the market towards long run equilibrium. This means that, as a general proposition, workably competitive markets have an inherent tendency to return to the equilibrium state over time. It is in this state that the desirable outcomes typically associated with workably competitive markets are most fully realised. The Commission comes very close to realising this in paragraph 4.3.9 of its Draft Decisions when it states that "The promotion of outcomes consistent with outcomes produced in workably competitive market outcomes [sic], as required under Part 4, will tend to move market participants closer towards 'efficient' outcomes *over time*".

47 Powerco reiterates that the Commission's NPV=0 principle is predicated on the long run equilibrium position. In workably competitive markets, the long run equilibrium is the point at which new investments (either by a hypothetical new entrant or incumbent) make normal returns. As we have previously noted, the accepted approach to cost allocation is also predicated on the long run equilibrium in a workably competitive market.[12] There is a quite obvious inconsistency in the way that the Commission claims to formulate regulation based on the NPV=0 principle, yet continues to reject the use of the long run equilibrium position in its decision making.

48 In rejecting setting methodologies that are based on the objective and consistent long run equilibrium standard, the Commission has resorted to subjective decision-making (framed as "discretion" and "judgement") that is inherent in a focus on a broad range of short term outcomes. This is plainly illogical when it is the particular outcomes associated with the equilibrium state that will best promote workably competitive market outcomes such that (a) to (d) occur.

49 Such a subjective approach by the Commission undermines the certainty of the regulatory regime as it encourages inconsistent and unpredictable decision-making. The legislative history of Part 4 makes it clear that the section 52A purpose statement was included specifically to provide an objective standard for regulatory decision-making. The Commission's subjective approach will serve only to discourage private investment in the electricity lines and gas pipelines industries.

The Commission has mischaracterised workably competitive markets

50 Even if the Commission's emphasis on the short term outcomes of workably competitive markets were correct (which Powerco denies), the Commission's interpretation of the workable competition standard itself is unorthodox.

[12] Powerco *"Cross Submission Following Input Methodologies Conference"* (15 October 2009), paragraph 38.

51 The markets that the Commission uses for its analysis are, as the Commission explicitly states, characterised by:[13]

51.1 long-lived specialised investments (sunk costs);

51.2 the prevalence of economies of scope; and

51.3 limited numbers of suppliers and/or consumers.

52 These markets can barely be characterised as workably competitive. It is illogical for a regulator to be guided by outcomes in markets that barely meet the workable competition standard. Rather, given that competition is held by economists as a means to an end – with that end being to promote the 'long term interests of consumers' – logic would suggest that the best guidance to the Commission would come from the better functioning competitive markets.

The Commission continues to mischaracterise HNE test

53 In previous submissions, Powerco has submitted that long run prices in a workably competitive market are set by the cost structure of a new entrant.[14] In long-term equilibrium, prices will be at a level whereby there is no incentive for net entry or exit from that market. The condition for no net entry or exit is that a new entrant into the market at that time would earn only normal returns. This will occur when the prices in the market reflect the costs faced by the new entrant. The appropriate inquiry for a market that is not workably competitive, therefore, is to investigate the cost structure of a hypothetical new entrant into that market.

54 Under the workable competition standard, input methodologies should therefore be set by reference to the costs of a hypothetical new entrant – the hypothetical new entrant test (*HNET*).

55 The Commission continues to reject the use of the HNET as the reference point for setting input methodologies, suggesting that the application of the HNET would give incumbents an absolute cost advantage over a new entrant. In doing so, the Commission continues to suffer from a number of misconceptions and make resulting errors.

56 It is important to understand that the HNET standard is justified by alternative 'thought experiments'. As noted above, it is the point to which the process of entry and exit directs workably competitive markets. It is also the outcome that is predicted to hold at all times in a perfectly contestable market. Accordingly, when the Commission interprets the HNET standard and contestability theory as one and the same it is in error. Turning to the points the Commission has made:[15]

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[13] Commerce Commission *"Input Methodologies Electricity Distribution Services Draft Reasons Paper"* (June 2010), paragraph 4.2.36.

[14] Powerco *"Cross-Submission Following Input Methodologies Conference"* (15 October 2009), paragraphs 11-23.

[15] Commerce Commission *"Input Methodologies Electricity Distribution Services Draft Reasons Paper"* (June 2010); Commerce Commission *"Input Methodologies Gas Pipeline Services Draft Reasons Paper"* (June 2010).

56.1 paragraph 2.7.16 – barriers to entry give the incumbent an absolute cost advantage over a new entrant – the HNET standard assumes that there are no barriers to entry, either that sufficient time has passed for excess returns to be competed away (and that the barriers are sufficiently low that the market is workably competitive) or that there are no barriers at all (the perfect contestability thought experiment). We further address this issue below.

56.2 paragraphs 4.3.78 (EDB Draft Reasons) and 4.3.78 (GPB Draft Reasons) – an incumbent will respond to a credible threat of entry by dropping prices to a floor defined by its variable costs – the Commission is focusing on the flux of competitive interaction rather than the end state to which competition ultimately is directing the market. Prices cannot be held below replacement cost forever in order to deter entry, because to do so will make any new investment unprofitable.

56.3 paragraphs 4.3.80 (EDB Draft Reasons) 4.3.55 (GPB Draft Reasons) – entry is feasible only if the new entrant could supply the entire market demand at a cost lower than the incumbent – the Commission's thought experiment suffers from serious error. The incentive for new entry will depend upon the *price* that is being charged by an incumbent, not its *cost* structure. In workably competitive markets, if one incumbent happens upon a cheap resource that is not available to any competitors, then this benefit will be retained by the incumbent – there is no reason whatsoever that an incumbent would be expected to set much lower prices than a competitor could ever match and pass the lucky find on to customers through lower prices. Lastly, the assumption that the new entrant can supply the whole market is equivalent to saying that the new entrant is able to realise all of the economies of scale and scope of the incumbent (and indeed, more), which surely is not an assumption that should trouble the Commission.

56.4 paragraphs 4.3.81 (EDB Draft Reasons) and 4.3.56 (GPB Draft Reasons) – an absolute cost advantage arises where replacement costs are rising, and the total costs of an incumbent needed to meet market demand may be lower than those of a new entrant – this statement appears to be a dangerous step by the Commission back to its previous view that it 'knows' the level at which it would need to set a regulatory asset value in order to ensure that past investments earn a normal return over their lives (and presumably it has in mind 'depreciated historical cost'). The incumbent's unrecovered costs will depend upon what it has spent in the past and the time profile of its cash flows since that time. As has been demonstrated to the Commission, if an infrastructure owner had historically set efficient prices for the use of its services, then the unrecovered cost of its investment almost certainly would be higher than the depreciated historical cost. It is also plausible that it would exceed the value derived by a HNET valuation, even if construction costs are rising at a faster rate than CPI inflation. It is highly inappropriate for the Commission to hypothesise about whether a HNET valuation may give rise to windfall gains in the absence of producing any evidence in support of this.

- *The relevance of the fact that real world entry is unlikely*

57 The Commission continues to be concerned that there are high barriers to entry to the markets in question, and so entry is unlikely. As Powerco has previously submitted, it is difficult to comprehend the point being made here. To state the

obvious, the contestable market standard does not assert that regulated markets are contestable. The lack of competition and contestability is the very reason for regulation. Rather, in a regulatory context the contestability standard asks what the outcomes would be if the market were workably competitive. While this is a hypothetical question, it is the question required by section 52A.

58 Further, the contestable market standard does not argue that the Commission should allow the incumbent to price up to the real world threat of new entry. This, of course, would be too permissive. In fact, the contestable market standard requires the reverse. It assumes the threat of entry meets the onerous contestability standard, and then asks what pricing outcomes would be expected.

59 In this way the contestable market standard provides the most conservative (i.e. biased towards understating price) estimate of the price that would be observed in a workably competitive market. It assumes that a new entrant in such a hypothetical market could displace the incumbent completely and serve the whole market and reap all available economies of scale and scope. Accordingly, the contestable market standard should be seen as providing a lower bound estimate of the price that would be observed in a workably competitive market.

60 Powerco maintains its submission that the ODV methods provide the best estimate of the asset value that would be observed in a perfectly contestable market at any point in time, and hence provides a lower bound estimate of the price that would be observed at any point in time. The logic behind ODV is as follows:

60.1 in equilibrium, the market price would be such that a hypothetical new entrant would just recover the cost of acquiring and constructing new assets if it entered the market and completely displaced the incumbent; and

60.2 the value of the 'old' assets in this situation would be equal to the acquisition and construction cost of the new assets, less any difference between the cost of providing the service using the old assets as compared to using the new assets (that is, reflecting the higher operating and maintenance and asset renewal costs that are likely with old assets). ODV provides an estimate of the value that 'old' assets would have in these circumstances.

(2) THE REGULATED SERVICE

61 A core aspect of the regulatory framework for electricity that the Commission has not focussed on so far is defining the scope of the regulated "electricity lines service" and "gas pipeline services".

62 Powerco supplies a range of electricity related services, some of which in our view do not fall within the scope of the regulated electricity lines service as defined under section 54C of the Commerce Act, and some of which do fall within the scope of the regulated electricity lines service. Whether Powerco is correct in its assessment as to whether these services are regulated or unregulated has obvious implications for the makeup of the regulatory asset base, composition of allowable revenue, allocation of common costs and related inputs. It has equally significant implications for Powerco's commercial decisions as to whether or not it will invest in these services if they are/are not to fall under price control.

63 Powerco submits that there is a need for upfront certainty about what services are, and are not, regulated. We appreciate that the Commission has been reluctant in the past (for example during the 2009 DPP process) to expand on the meaning of electricity lines services, and that the Commission has expected EDBs to form their own view. Powerco has done that. However, as a very practical matter we do not want to make decisions on regulatory compliance and then find out after the fact that the Commission is of a different view. That dynamic is one that EDBs, GPB and the Commission have an interest in avoiding for the sake of long term regulatory certainty and stability.

64 In any case, providing upfront certainty is a core element in the Part 4 regime. Powerco submits that the Commission is obliged by sections 52R and 52T(2) of the Commerce Act (discussed further below) to provide regulated suppliers such as Powerco with sufficient certainty on the scope of the regulated service so that we are reasonably able to estimate the material effects of the methodology on our business. The Commission's failure to define the scope of the regulated service directly cuts across this statutory requirement. For example, for the asset valuation input methodology defining which assets are and are not included in the RAB is fundamental.

65 Assets associated with load management provide a good example of where clearer direction of what is covered by the regulated "electricity lines service" is needed. Currently the ripple propagation plant is within the RAB but ripple relays at consumer premises are not.

What are "electricity lines services"?

66 Section 54C(1) defines "electricity lines services" as the "conveyance of electricity by line in New Zealand". "Line" is defined in section 54C(4) by reference to its definition in the Electricity Act 1992, and this in turn requires analysis of the meaning of "works", "fittings", "electrical installation", "electrical appliance" and "point of supply". Broadly, these definitions exclude from electricity lines services the conveyance of electricity beyond the point of supply (the boundary of a property at which exclusive fittings enter that property) or by electrical installation or electrical appliance.

67 In addition, section 54C(2) lists a number of services that expressly are not "electricity lines services" (despite each involving a conveyance activity), and generally excludes small lines businesses.

68 Outside of these express exemptions, the temptation is to equate all services provided by an electricity lines business as electricity lines services. However, in Powerco's view this is incorrect. Powerco submits that the emphasis on "conveyance" (the act of transporting) suggests a focus on services that are a necessary component of conveyance, rather than complementary to (and capable of being supplied in isolation of) conveyance.

69 There is also an important policy overlay as to what amounts to an electricity lines service and is therefore regulated. Section 52A makes clear that the focus of Part 4 regulation is markets where there is little or no competition and little or no likelihood of a substantial increase in competition. Powerco submits that contestable services – that is, services that could efficiently be provided by any business, not just an electricity lines business (including services somehow related or complementary to the conveyance of electricity by line) should not fall within the regulated service.

70 This view finds support in the services excluded from regulation under the previous Part 4A thresholds regulatory regime that applied to regulation of large electricity lines businesses. For example, the Electricity Distribution Thresholds Notice 2004 defined "excluded services" which did not have to be included in the price path assessment as being, among other things, services where there was workable or effective competition (see definition of "excluded services" in the Commerce Act (Electricity Distribution Thresholds) Notice 2004, and relevant discussion in the Commission's Decisions Papers under that regime).

71 It also finds support in the Electricity Information Disclosure Requirements (31 October 2008 Handbook), in which various expenses, revenues, assets and liabilities are allocated between "Line" (regulated) and "Other" (unregulated) businesses, essentially on the basis of whether the activities in question are natural monopoly lines business activities, or contestable (or potentially contestable) activities.

72 The issue is illustrated by two examples of services that Powerco is considering providing. The first is expanding its fault call-centre to receive phone calls directly from customers (rather than from retailers, which is the current level of service). This expanded service is not essential to the conveyance of electricity by line – although a number of EDBs currently provide this service and treat it as regulated, the conveyance is not hindered by the absence of the service. Second, ripple-receiver relays allow the control of a network's loading by switching off consumers' permanently wired appliances at times when demand is high. Their operation may not be essential to the conveyance of electricity, because they are located on the consumer side of the network, but they are integral to network operations. It is clear from s 54Q of the Act that Parliament intended that the Commission should not disincentivise EDBs from investing in such demand-side management services by regulating them.

73 The question is further complicated by the report of the Commerce Select Committee on the Electricity Industry Bill recommending that the costs and assets

used in the delivery of alternative power systems for remote consumers be included within the regulatory regime.

74 The Commission has proposed requiring an Independent Engineer to decide if assets should be excluded from the RAB if they do not provide electricity lines services/gas line services. It is difficult to ascertain how the Independent Engineer will be able to undertake this without additional direction from the Regulator.

75 The issue for Powerco is not whether the Commission agrees or disagrees with our analysis. What is important is that there is a clear line in the sand. There are numerous other examples of services that Powerco provides and considers may fall outside the definition of electricity lines and gas pipelines services. For the purposes of both regulatory compliance and investment decisions, there needs to be a process by which regulated suppliers can ascertain the boundary between regulated and unregulated services.

76 With this in mind, Powerco submits that the Commission should put in place a process for receiving and making decisions on "status queries" from suppliers in relation to particular services. Electricity lines and gas pipelines businesses could use this process to get certainty on the Commission's views upfront about whether a service is regulated in borderline cases or where the costs of finding out later that the Commission takes a different view are too great.

(3) THE PURPOSE OF INPUT METHODOLOGIES: REGULATORY CERTAINTY

77 Input methodologies must provide regulatory certainty. The purpose statement for input methodologies (section 52R) provides:

> The purpose of input methodologies is 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.

78 The Commission appears to believe that the process of determining an input methodology in itself will meet the purpose of input methodologies. Powerco submits that this takes an overly narrow view of section 52R. Certainty requires the actual regulatory rules to be known in advance. In Powerco's experience, this level of certainty and predictability in the regulatory regime is a key issue for debt and equity investors in regulated entities and funding from such sources is essential for suppliers such as Powerco to be able to make the appropriate investment decisions. Thus, where the Commission has been provided with some discretion under the Act in relation to setting the input methodologies (for example, in those circumstances where the workable competition standard does not of itself effectively determine the appropriate input methodology), this discretion must necessarily be exercised so as to promote rather than undermine the purpose, policy and objects of the Act.

79 Further, the approach of the regulator (the regulatory practice) when setting input methodologies will have a significant impact on sector expectations of future decision-making and, therefore, the certainty and predictability of the regime. If the regulator adopts, or appears to adopt, an inconsistent, arbitrary or outcome-driven approach, there will be considerable uncertainty (and perceptions of regulatory risk) around how the Commission will behave when the input methodologies are next set (or applied). The Commission must be cognisant of the effect its approach to setting the input methodologies will have on perceptions of respect for historical investment, attracting future investment and the availability and cost of capital (including debt).

80 Accordingly, the Commission's approach to input methodologies is fundamental to the promotion of the purposes, policy and intent of Part 4. Parliament has recognised that regulatory certainty is critical to promote investment in regulated industries. In particular, a methodology or approach to regulation that creates uncertainty will not meet objective (a) of the Part 4 purpose statement.

81 The intent to provide certainty is clearly recorded in the explanatory note of the Commerce Amendment Bill 2008, which states that an objective of the Bill is to "improve clarity, certainty, timeliness, and predictability for businesses".

82 The Cabinet Paper on the Review of Parts 4 and 4A of the Commerce Act also acknowledges that regulatory certainty is a pre-requisite for the objective of providing specifically for incentives to invest in infrastructure.[16]

83 The then Minister of Commerce, during debate on the Commerce Amendment Bill, emphasised that a key purpose of regulatory reform was to enhance certainty for regulated businesses, with promotion of incentives to invest being a paramount consideration:

> The overarching objective of this bill is to provide for efficient and cost-effective regulation of the price and quality of key goods and services that are not subject to competition, and to do so **in a way** that promotes greater certainty, and **incentives to invest and innovate for regulated businesses**.[17]
>
> …
>
> The third area that I want to spend just a little bit of time on is the question of appeals on input methodologies. It has not been a controversial area, but it has been **an approach we have adopted to try to achieve a purpose. The purpose is certainty, in an area where the previous law has not allowed for certainty in investment decisions.**[18] [Our emphasis]

84 In Powerco's view, the Draft Decisions raise concerns as to whether the Commission is following good regulatory practice (and therefore promoting regulatory certainty). A key concern for Powerco (as elaborated also in ENA Submission 1) is that the Commission is seeking to reserve a broad discretion for itself when determining input methodologies, despite clear guidance under the Part 4 purpose statement, and despite the importance of promoting predictability and certainty (a broad discretion has the contrary effect).

85 We have included an overview of good regulatory practice as Appendix 2 to our submission. In our view, the principles of consistency, predictability, proportionality and transparency are key principles which the Commission should ensure are followed.

86 This is further reflected in section 52T(2) of the Act which states that:

> (2) Every input methodology must, as far as is reasonably practicable,—
>
> (a) set out the matters listed in subsection (1) in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier; and

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[16] Cabinet Paper *"Review of Parts 4 and 4A of the Commerce Act"* (13 September 2006), paragraph 19.

[17] 649 NZPD 18313 (2 September 2008).

[18] 649 NZPD 18541(2 September 2008).

(b) set out how the Commission intends to apply the input methodology to particular types of goods or services; and

(c) be consistent with the other input methodologies that relate to the same type of goods or services.

87 Powerco submits that the Commission has not provided the specified level of detail in a number of important respects.

88 A primary example of this is the Commission's failure to include in its draft input methodologies the method for calculating the starting price adjustment under the DPP. That is, while the Draft Decisions specify a number of the inputs whose only purpose is to permit a starting price adjustment to be calculated, there is no guidance in the Draft Decisions about how these inputs will be combined to determine that adjustment. While there has been high-level discussion about how a starting price adjustment might be effected in light of the particular guidance of Part 4 in the parallel consultation on the DPP, the correct position for this method is in the input methodologies. That said, no final conclusions on this matter were reached in the parallel DPP consultation. Related to this, regulated suppliers have no way of knowing, for instance, how merger and acquisition efficiency gains will be treated within any starting price adjustment.

89 Powerco submits that if the Commission is going to set an initial level of average prices (that is, make a *P_0 adjustment*), the method for this should be prescribed within the rules and processes input methodology. We note that the method for setting the initial level of average prices falls naturally within the 'specification and definition of prices' limb of the rules and processes input methodology (the pricing methodology is an alternative option, but this traditionally encapsulates how to turn allowed revenues into prices, not P_0 adjustments). The fact that the Commission is proposing an efficiency sharing mechanism (*ESM*) for CPP applications (its Incremental Rolling Incentive Scheme (*IRIS*)) as part of the rules and processes input methodology, which is a method that addresses how the average price level should be determined, means that it is reasonable for regulated suppliers to expect any P_0 adjustment that is to be made would be included within this input methodology.

90 Other examples of matters that the Commission has failed to adequately specify in its draft input methodologies (by deferring the issue to another process) include:

90.1 what level of information must be provided to allow a stranded asset to continue to be depreciated over its remaining life. The Commission's draft decision is that where an asset is stranded or expected to become stranded, EDBs may retain the asset in the RAB and continue to depreciate the asset over its remaining life. However, this will not necessarily apply to asset stranding where the loss is due to an event that appears to be beyond an EDB's control unless the EDB has taken active measures to address stranding risks. It is unclear what kind of measures and level of supporting information will be required. The Commission states that it will consult on the detailed information requirements as part of the information disclosure process, however in Powerco's view this should form part of the asset valuation input methodology to provide regulated suppliers with the necessary level of certainty; and

90.2 the process and criteria for allowing charges from new investment contracts or avoided transmission charges to be “Recoverable costs”. In clause 3.2.4(2) of the EDB Draft Determination the Commission has stated that approval “must be sought in accordance with a process specified in a DPP Determination”. Again, to provide adequate certainty for regulated suppliers, Powerco submits that the process should be specified up front in the rules and processes input methodology (we discuss this in more detail in Part G of our Submission).

D: COST ALLOCATION

91 Powerco generally supports the Commission's draft cost allocation input methodology, which allows regulated suppliers to adopt cost allocators that are the most suitable given their particular circumstances. We support the Commission's use of principles to provide flexibility in implementation (rather than more prescriptive rules).

92 The ENA Submission 2 addresses a range of issues with the draft cost allocation input methodology where improvements need to be made to ensure that the draft cost allocation input methodology meets the statutory requirements for clarity and does not unduly deter investment in other services. Powerco supports and adopts the submissions made by the ENA in this regard.

93 In particular, Powerco submits that the simplest (and, therefore, materially best) way to ensure the legislative requirements are met is for the Commission to make no allocations of shared cost between a supplier's regulated and unregulated businesses.

94 If the Commission nevertheless proceeds with its draft cost allocation input methodology, we agree with the ENA that:

94.1 for the draft cost allocation input methodology to meet the requirements of the Act it must specify that cost allocations made by an EDB consistent with the methodology will be the allocations used by the Commission when setting price paths (for both DPPs and CPPs);

94.2 for the draft cost allocation input methodology to meet the requirements of the Act there should be an associated rule or process that specifies a mechanism for the sharing of merger and efficiency gains. The IRIS that the Commission proposes for CPPs would, with some modifications, be suitable for this purpose;

94.3 a methodology that is materially better at meeting the requirements of the Act would include further improvements to the Cost Allocation Methodology Screening Criteria (*CAMSC*), including (as elaborated in ENA Submission 2) –

(a) the revenue materiality threshold in the CAMSC should be set at 20% to reduce the likelihood of allocations occurring where the costs of the allocation outweigh the likely impact on regulated prices;

(b) a further step should be introduced into the CAMSC to make the process cost effective (through fewer applications of the optional variation): unregulated business units should be excluded from the cost allocation process if they contribute less than 10% of total gross profit;

(c) the treatment of arms length transactions should be made optional because in practice it might not always be possible to accurately identify the costs associated with a particular transaction; and

(d) the Commission should adopt a two-year (24 month) averaging period for determining 'current relationships', being the previous two information disclosure years, unless the regulated supplier determines that more recent data is appropriate and is prepared to incur the additional costs that would entail.

Point (2) – Sharing of merger and efficiency gains

95 As to point (2), above, and as foreshadowed in Part C of our submission, Powerco considers that the details of how merger and acquisition efficiency gains will be treated within any starting price adjustment should be prescribed within the rules and processes input methodology as part of any ESM (rather than left to the DPP process). This is important due to the large degree of certainty needed before a transaction takes place.

96 The Commission's draft decision[19] is that after a merger or acquisition, EDBs will be required to continue to report actual costs as part of information disclosure. EDBs will not be required to prepare information on expected efficiencies. The treatment of efficiency savings will be decided as part of starting price adjustments or the reset of the CPP at the next price review.

97 The Commission has noted that the same rationale for an ESM exists for firms regulated under a DPP as it does under a CPP, and Powerco presumes that the Commission would like to devise an ESM for the DPP that provides materially the same result as the IRIS that has been proposed for the CPP. The Commission's reason for not addressing this matter is the additional perceived complexity of designing an ESM where there is a DPP, with this complexity arising from the absence under a DPP of explicit forecasts for operating expenditure.

98 In Powerco's view, the complexity that the Commission perceives to be associated with designing an ESM in the context of a DPP is overstated, particularly in relation to gains related to mergers and acquisitions. Mergers or acquisitions will be discreet events and few in number, but with the potential to deliver substantial gains for the New Zealand economy and electricity consumers in particular. In relation to mergers or acquisitions, the desired outcome is to permit the regulated charges for the merged businesses to continue to reflect the allowance for operating expenditure that the separate businesses would have received if the merger or acquisition had not occurred, and for this approach to be continued for period that, in Powerco's view, would span two reviews of the DPP price caps. It is not difficult to conceive of plausible methods for deriving a reasonable 'without case' for operating expenditure, particularly given that the process of determining the X factor under the DPP regime will require estimates of actual and forecast productivity growth and input prices for the industry.

99 Finally, Powerco notes that the Commission should specify which forecasts it will use to determine efficiency gains, and how it will combine the regulated and unregulated business forecasts.

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[19] Commerce Commission *"Input Methodologies Electricity Distribution Services Draft Reasons Paper"* (June 2010), paragraphs 3.3.40-3.3.45.

100 Other matters of substance regarding an appropriate mechanism for the sharing of merger and efficiency gains are discussed in Part G of our Submission (relating to the rules and processes input methodology).

E: REGULATORY TAX

101 Powerco refers to and endorses ENA Submission 3 on the Commission's regulatory tax proposals. Subject to the important qualification addressed below, the Commission's draft regulatory tax input methodology seems broadly reasonable. In particular, Powerco supports the Commission's decision to set the opening deferred tax balance to zero.

102 We also strongly support the ENA's submissions on the various tax implementation issues that arise from the Commission's Draft Decisions. Those submissions are aimed at making the EDB and GPB draft determinations a more accurate translation of the Commission's draft regulatory tax input methodology. As it stands, the draft determinations suffer from some specific implementation issues which would benefit from correction in line with ENA's submissions.

Initial regulatory tax asset value

103 However, Powerco continues to have a fundamental concern with the Commission's draft decision to determine the initial taxation asset base (*TAB*) at each firm's actual TAB (albeit now capped at its RAB). Permitting the TAB to be set above the RAB is a fundamental inconsistency within the regime, and the Commission's acceptance of the arguments that Powerco has made over the last six years is acknowledged. However, the Commission's decision to use each firm's actual TAB as the opening regulatory TAB irrespective of whether transactions occur results in a fundamental inconsistency of treatment between entities that have been the subject of an asset sale or amalgamation in the past and those that have not. It also implies a fundamental inconsistency between the treatment of future and past transactions.

104 The Commission states at paragraphs 5.4.7 and 5.4.12 of the EDB Draft Decisions:

> 5.4.7 To implement the proposed modified deferred tax approach, suppliers will need to calculate regulatory tax depreciation by applying tax depreciation rules specified by the IRD to the regulatory tax asset value of their investments. In the event of future asset acquisitions, the Commission considers that, like the RAB value, the regulatory tax asset value of the acquired assets should remain unchanged (i.e. not be adjusted to reflect the transaction price, which is how the IRD would recognise the tax asset value in most cases).
>
> 5.4.12 The Commission considers that an appropriate starting point for establishing the initial regulatory tax asset value is to use the equivalent actual tax book value for the same assets as recognised by the IRD.

105 Powerco supports the Commission's decision to exclude sales premiums from the regulatory tax asset value of future acquisitions. As the Commission has recognised in its Draft Decisions, this approach allows suppliers to retain the net tax benefits of acquisitions but also bear any subsequent costs, while at the same time

ensuring that excessive profits and incentives to pay a significant premium over RAB are limited by ignoring any acquisition premium.[20]

106 However, the Commission has then determined to include the acquisition premiums for historical acquisitions in the initial regulatory tax asset value. This is in stark contrast to the Commission's decision to exclude acquisition premiums from the regulatory tax asset value of future acquisitions.

107 In Powerco's view, the same reasons set out as to why not to include acquisition premiums from future transactions apply to the tax treatment of past acquisitions, and we are unclear why the Commission considers that a different approach should be taken in these circumstances. No reasons are provided in the Draft Decisions for this fundamental inconsistency, and in Powerco's view, no sound reasons exist.

108 In addition, the Commission's approach to past acquisitions will create an inconsistency of treatment across businesses and will also result in a different regulated price being set for two businesses whose only difference is that one had had a change of ownership during its life. The outcome whereby a change in ownership would result in a different price is not consistent with any of the interpretations of the outcome of a competitive market that have been placed before the Commission. In particular:

108.1 Under our view as to how the outcome of a competitive market should be interpreted, the Commission must have regard to the long run equilibrium conditions in a competitive market, under which the price reflects the cost structure of a new entrant into that hypothetical market. Thus, the tax situation of the incumbent firm – including whether it has been the subject of an acquisition – would not affect the market price.

108.2 The Commission's experts emphasised the short term flux of competitive markets and de-emphasised the importance of long run equilibrium conditions. However, even when the short term perturbations of such markets is considered, there is nothing to suggest that different firms may charge different prices depending only upon whether they have been subject to a historical acquisition.

109 The Commission's experts also emphasised the importance of long term contracts for markets in which there are economies of scale and scope and irreversible investments. The experts then concluded that the terms under such contracts need not reflect current market events but rather the historically agreed contract terms, and proposed this as an alternative view of the outcome of a competitive market. While Powerco disagrees that this is the outcome of a competitive market, even under the experts' thought experiment, there is no suggestion that the price would differ depending upon whether the particular asset had been subject to an acquisition. This is because the initial price under such a contract was described as being set competitively, and so would gravitate towards a price that reflects the cost of a new facility (indeed, such contracts presumably would only be written for a new

[20] Commerce Commission *"Input Methodologies Electricity Distribution Services Draft Reasons Paper"* (June 2010), paragraph 5.4.8.

facility). Thereafter the price would continue under the contract terms – there was nothing in the experts' reports to suggest that the price would be reviewed if an acquisition takes place as such a contractual provision would be highly unusual.

110 We refer the Commission to PwC Report 1 for further analysis of this issue. Mr Balchin of PwC concludes as follows:[21]

> I conclude that the effect whereby a historical transaction would result in a firm being required to set lower prices than an otherwise identical firm that had not been the subject of such a transaction is not consistent with any of the versions of the outcome of a competitive market that have been placed before the Commission. In particular such an outcome:
>
> - would not be observed in a workably competitive market that is in long run equilibrium, as the prices in such a market would reflect the cost structure of a new entrant into that hypothetical market rather than the circumstances of the incumbents;
>
> - would not be observed if the focus was upon the short term dynamics of a workably competitive market as such dynamics reflect forward looking demand and costs; and
>
> - would not be observed in an arrangement that is governed by a long term contract – the initial price in such a contract would reflect the situation of a new facility at that time, and thereafter a change to the tax the entity pays that results from a change in ownership would only affect the price if this was included into the contract, which would be unexpected.
>
> The method for setting the initial taxation asset base for regulatory purposes that would not contradict these outcomes of a competitive market is to set that value in a manner that ignores (or undoes) the effects of past transactions, which I expect would be a straightforward exercise.

111 Powerco has previously questioned the Commission's inconsistent tax treatment of historic and future transactions. Unfortunately, the Commission has provided no explanation for their decision. The only possible basis Powerco can envisage is that the Commission considers it is too hard to calculate past acquisition premiums so that they can be removed from the initial regulatory tax asset value.

112 If this is correct, then this is an incorrect assumption to make. Deloitte has advised Powerco that it has access to sufficient information to calculate the tax written down value of Powerco's network assets had they not included amalgamation or acquisition premiums as at 1 April 2010 with a "high degree of accuracy".[22] They have also advised Powerco that this work is able to be completed within a reasonable timeframe.

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[21] PwC Report 1, page 1.

[22] Deloitte New Zealand *"Letter to Paul Goodeve, Powerco", (5* August 2010).

113 It is also noted that Powerco's proposal for the Commission to ignore the effects of past transactions is consistent with the most recent practice in Australia on this matter. As set out in PwC Report 1 by Mr Balchin, the Australian Energy Regulator is in the process of determining initial taxation asset values for firms that previously were regulated on a pre tax basis. In its decisions on the initial taxation asset values for the privately owned firms – Jemena Gas Networks and ESTA Utilities – it has adopted an initial taxation asset value that reflected the original cost of the assets less an assumed tax depreciation on those assets. This approach implies that any transaction premium on the assets has been ignored.[23]

114 Further, as a matter of law, Powerco submits that inconsistent decision making of this nature is irrational. The unlawfulness of inconsistent decision making has been considered by a number of English courts, all of which provide support for the proposition that fairness and good administration require that the reasoning advanced by a regulator should not be contradictory, and thus internal inconsistency in regulatory decision making is likely to be held to be irrational.

115 In *R v Chief Constable of West Yorkshire, ex p. Wilkinson* [2002] EWHC 2353 (Admin) Davis J held at [74]:

> Inconsistency is not necessarily to be equated with irrationality, but if a decision is reached in a particular case which cannot stand as a matter of consistency with another decision reached in the same case, then that should, in my view, be taken into consideration in deciding whether the decisions under attack are decisions properly open to be made and not irrational.

Good regulatory practice also requires consistency

116 In **Appendix 2** to our submission we have reproduced material on the approach taken in a number of jurisdictions to "good regulatory practice" or "best practice regulation".[24] As is clear from this review, many jurisdictions emphasise the need for consistency in regulatory decision making. As a matter of good regulatory practice regulatory decisions should be internally consistent, and consistent across participants and sectors over time.

117 In Powerco's view, contrary to good regulatory practice the Commission has recommended an approach to the tax treatment of past acquisitions that lacks internal consistency, and has done so without sufficient justification. At the very least, the Commission must provide its reasons for this inconsistency so Powerco and others can address the issues on their merits.

118 And as a matter of best practice and economics, as elaborated by Mr Balchin in PwC Report 1, Powerco submits that the Commission should revise its approach to past acquisitions for tax purposes in line with its approach going forward.

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[23] PwC Report 1, page 8.

[24] See the submission of New Zealand Airports on the Commission's "Draft Input Methodologies Determination and Draft Reasons Paper" for specified airport services (12 July 2010), Appendix A.

F: PRICING METHODOLOGIES

Electricity pricing methodologies

119 Powerco refers to and endorses the points made in ENA Submission 4 in relation to the Commission's draft pricing methodologies input methodology. In particular, Powerco agrees:

119.1 with the draft determination to define this input methodology in terms of pricing principles. We agree with the ENA recommendation for an additional principle (in terms of incentivising investment in energy efficiency and demand side management) to ensure this input methodology is consistent with and supportive of the requirements of the Commission under section 54Q; and

119.2 that this input methodology be given effect by way of information disclosure regulation.

120 However, like the ENA, Powerco has concerns as to how this input methodology is intended to be used as part of a CPP application process. We support the ENA recommendation that any CPP application be required to demonstrate the extent to which the proposed CPP pricing methodology is consistent with this input methodology (in the same manner as would be required under information disclosure requirement), but that the Commission not put itself in the place of adjudicating whether one CPP pricing methodology better meets the purpose statement relative to another. We note that the ENA recommended approach is consistent with that adopted by the Electricity Commission to give effect to its pricing principles through information disclosure mechanisms.

121 As discussed in ENA Submission 4, the legislative context for this input methodology in terms of electricity is such that the Commission may not ultimately be responsible for the development of pricing methodologies for EGBs at all. However, as the issues will remain live in the GPB context. Powerco's submissions in this regard are relevant to both EDBs and GPBs.

Gas pricing methodologies

122 In the gas context, Powerco also supports the proposed Gas Distribution Pricing Principles and the Commission's decision not to apply the pricing methodology input methodology to the DPP.

123 However, as with electricity, paragraph 5.4.2 in the draft GPB Determination relating to CPPS allows the Commission to amend a pricing methodology or substitute a new pricing methodology if it considers that a different pricing methodology would better meet the purpose of Part 4 of the Act. The Commission may make these amendments or substitutions each year of the CPP regulatory period.

124 The Commission has provided no rationale for this in its Draft Decisions. In Powerco's submission it is inappropriate (as it is uncertain and therefore cuts across the purpose of input methodologies) for the Commission to give itself such a large degree of discretion to substitute a new pricing methodology if it deems the supplier's methodology does not meet the principles. The Commission's current proposal provides little limitation on the Commission's powers.

125 Reticulated gas is a challenging consumer market and although overall energy use has increased in recent years, consumption of natural gas has declined. Overall, consumption has declined at an annual rate of 4.9%.[25] Reversing the trend of falling connection numbers and declining consumption is fundamental to any gas distribution business and pricing is a careful balance of a number of different factors. Falling connection numbers and declining consumption can cause an accelerated downward spiral due to the fixed cost nature of the business.

126 The Commission's current proposal to allow it the discretion to amend or substitute a pricing methodology in a CPP gives rise to unacceptable risk and uncertainty as to the extent of the Commission intervention in pricing in an area of Powerco's business that requires particularly careful balancing. This is inconsistent with the requirement for the input methodology to provide businesses with certainty of the material effects of the Commission's approach.

127 Powerco will provide further comment on this issue in its submission on the CPP processes and procedures.

[25] Ministry of Economic Development *"Energy Data File"* (June 2008), Table A.4a.

G: REGULATORY RULES AND PROCESSES

128 Powerco refers to and endorses the submissions made in ENA Submission 5 in relation to the Commission's draft rules and processes input methodology. In particular (and as elaborated in ENA Submission 5) we draw the Commission's attention to the following points.

Specification of price

129 Powerco supports the Commission's proposed weighted average price cap, net of Pass-through costs and Recoverable costs. This specification of price would be a continuation of that used in the DPP. We agree with the ENA that the specification of price will need to be reconsidered as part of the upcoming work stream on Energy Efficiency and Quality Incentives, and that as a result the Commission may need to amend or re-open this input methodology.

Pass through costs

- ***Criteria for Pass-through costs***

130 Powerco agrees with the ENA suggestion that the criteria for Pass-through costs should be amended to be those costs:

130.1 outside the control of the supplier, or subject to regulation under Part 4;

130.2 that have not otherwise been recovered under a DPP, or were not otherwise included in the derivation of a CPP; and

130.3 that have been approved as a Pass-through cost by the Commission, with such approval not to be unreasonably withheld in relation to costs that comply with criteria (1) and (2).

- ***Incentives to manage Pass-though costs***

131 Powerco supports the Commission's intention to develop a mechanism that has the potential to provide incentives for EDBs to manage some Pass-through costs. However, as discussed by the ENA, the Commission's proposed approach in the draft determination provides it with a high degree of discretion, with no guidance or constraints on the exercise of that discretion (contrary to subsection 52T (2)). We agree with the ENA that the appropriate approach to developing incentive mechanisms in this context is to develop a procedure by which the Commission and an EDB agree on incentive arrangements, including under a DPP, with the default being a 100% pass-through.

- ***Costs of complying with the new legislation***

132 Powerco disagrees with the Commission's position that the costs of complying with new legislation should not be treated as a Pass-through cost and that if the impact is material then suppliers can apply for a CPP. Such requirements would be industry-wide and it would be totally inappropriate to rely on a CPP to address an industry-wide issue. A CPP application is also far too costly and the outcome too uncertain to be used in such a situation.

Recoverable costs

133 The Commission's core focus in creating the new "Recoverable costs" category appears to be incentivising EGBs to efficiently manage some of the costs that may otherwise be considered pass through costs. While Powerco agrees with the

overall objective, it only makes sense where the costs in question are within Powerco's control. We also agree with the ENA that there are better ways – as elaborated on in ENA Submission 5 - for the Commission to achieve this objective than its current proposed Recoverable Cost framework.

134 Our focus in this submission is on avoided transmission costs as one form of Recoverable Cost of particular concern to Powerco.

Avoided Transmission Costs

135 Powerco disagrees with the Commission's proposed approach to avoided transmission charges under which EDBs will have to seek the Commission's approval to include avoided transmission charges as a Recoverable Cost. The Commission does not specify the approval process, nor what happens if the Commission does not approve the avoided transmission charge as a Recoverable Cost. We agree with the ENA that this approach is inconsistent with the requirement that the input methodologies provide businesses with certainty of the material effects of the Commission's approach. To this end, Powerco submits that the rules on inclusion of avoided transmission charges must be included in the rules and processes input methodology determination.

136 Powerco has three types of avoided transmission costs (as defined under the current Electricity Default Price Path):

136.1 new investment contract (*NIC*) charges from Independent Transmission Services (a transmission supplier);[26]

136.2 asset transfers from Transpower to Powerco, and further capital investment in these assets by Powerco;[27] and

136.3 payments from Powerco to embedded generators on Powerco's network, whose production of electricity at certain peak times reduces Powerco's Transpower transmission charges.

137 Four primary issues arise from the Commission's EDB Draft Decisions in relation to avoided transmission charges:

(1) the need to supply evidence to demonstrate that the overall cost of supplying electricity has fallen due to an asset transfer from Transpower to Powerco;

(2) the need to seek approval for the amount of costs from NICs and avoided transmission costs;

(3) inconsistency in wording of the Draft Determination and Draft Reasons Paper on NIC charges; and

[26] This is a type of cost under 8.4.15(d): A New Investment Contract charge, which are charges payable by an EDB under a New Investment Contract with Transpower, or an equivalent contract with another transmission provider.

[27] This is a type of cost under 8.4.15(e): Avoided transmission charges, which occur when an EDB undertakes a capital investment that both lowers transmission charges to the EDB, and lowers the total cost of supplying electricity lines services.

(4) the treatment of avoided transmission charges due to embedded generation electricity production and uncertainty of the treatment of transferred assets after five years.

138 Powerco's submissions in relation to each issue are set out below, and should be read in conjunction with the ENA submissions in this regard.

(1) Evidence required for avoided transmission costs

139 To recover an avoided transmission charge, Powerco would need to clearly demonstrate that the proposed action reduces the overall cost of supplying electricity. Powerco is concerned that this requirement will generate uncertainty to such an extent that it will deter investments that are beneficial to consumers. This is partly because not enough detail is specified in the input methodology, and partly due to the difficulty of providing information. As the Commission itself notes,[28] demonstrating the reduced cost will be difficult as EDBs have limited information on the costs to Transpower of operating assets and the costs and charges will change over time.

140 Powerco shares the ENA's concerns about the "efficiency test" that would be applied by the Commission in seeking to approve the Recoverable Cost or not. We support the ENA submission that a better approach is for the Commission to adopt its recoverable cost framework, but omit the efficiency test. This would ensure that transaction costs and risks for EDBs are lowered, in pursuit of these desirable efficiencies. At the very least the Commission should have a threshold at which approval is sought to avoid creating a barrier to low value transactions.

141 Further, if all NICs and avoided transmission costs have to be approved as Recoverable Costs, the Commission must carefully consider the timing of transitioning Recoverable costs into the electricity DPP regime. For example, Powerco will finalise its electricity prices from 1 April 2011 in December 2010. If the amended DPP Determination is published in November 2010 (which seems optimistic), there will be little, if any time for the Commission to agree on Recoverable Costs that can be included in the price path from 1 April 2011 to 31 March 2012. At the very least, the Commission should specify a time period in the Determination by which it will consider applications and publish a decision.

142 Powerco also submits that the requirement should not be retrospective. All investments that have taken place before the publication of the input methodologies should be allowed as transmission Pass-through costs as is currently provided.

(2) Approval of NICs and avoided transmission costs

143 The Commission proposes to require charges from NIC and asset transfers to be approved as Recoverable Costs before they may be passed through. The same issues discussed above apply here:

143.1 the lack of detail in the input methodology creates uncertainty and may deter beneficial investments;

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[28] Commerce Commission *"Input Methodologies (Electricity Distribution Services) Draft Reasons Paper"* (June 2010), paragraph 8.4.29 (Example: Avoided Transmission Charges).

143.2 the requirement should not be retrospective and all current NICs should be automatically included as Recoverable costs; and

143.3 a maximum time period to consider decisions should be provided for in the input methodology.

(3) Inconsistency of wording on New Investment Contracts

144 Powerco is concerned that the wording of clause 3.2.4(1)(c) of the EDB Draft Determination is unclear. In paragraph 8.4.15(d) of the EDB Draft Reasons Paper the Commission states that New Investment Contract Charges under an "equivalent contract with another transmission provider" will be considered a recoverable cost category. However, clause 3.2.4(1)(c) in the EDB Draft Determination only states that "an equivalent type of contract" will be included. Powerco recommends that clause 3.2.4(1)(c) in the EDB Draft Determination should be clarified to ensure that it includes transmission providers other than Transpower.

(4) Treatment of Embedded Generation as an avoided transmission cost

145 In Powerco's submission, any charges that arise from embedded generation substituting for use of the transmission system should be included as avoided transmission charges and should continue beyond the five year period.

146 This is because part of Powerco's total transmission charge is determined by the size of certain peaks on Transpower's transmission system in the Lower North Island. Therefore, when embedded generators produce electricity on Powerco's network at the same time as these transmission peaks occur, the total transmission charge to Powerco falls.

147 To recognise this and incentivise embedded generation, Powerco has contracts with many embedded generators to pay "network support service" payments. This is in line with the Electricity Governance (Connection of Distributed Generation) Regulations 2007, which includes a pricing principle that "where incremental costs are negative, the generator is deemed to be providing network support services to the distributor, and may invoice the distributor for this service."[29] The terms and conditions for these payments are detailed in Appendix A of Powerco's Distributed Generation Policy.

148 We note that section 54V(2)(b) of the Commerce Act requires the Commission to take into account, before exercising any of its powers, duties or functions, any electricity governance regulation or rule that relates to or affects the pricing methodologies applicable to any other line owner. This includes the Electricity Governance (Connection of Distributed Generation) Regulations 2007.

149 To this end, there are two issues with the Commission's current proposal for avoided transmission charges. Firstly, the definition of "avoided transmission charge" in 3.2.4(5) of the EDB Draft Determination seems to indicate that an EDB

[29] Clause 20 of the Electricity Governance (Connection of Distributed Generation) Regulations 2007 states that "Connection charges that are payable by the generator must be determined in accordance with the pricing principles set out in Schedule 4". Schedule 4 lists a number of pricing principles, including 2(e) quoted above.

must undertake an action to reduce transmission charges. This is reinforced by the description of an avoided transmission charge in the EDB Draft Reasons Paper which occurs "when an EDB undertakes a capital investment". There is no investment undertaken by an EDB in making payments to embedded generators. This creates doubt as to whether payments to embedded generators can be included as avoided transmission charges.

150 The justification for passing through avoided transmission charges was accepted by the Commission in implementing the thresholds regime from 2003 and, more recently, in the Commission's Threshold Reset Discussion Paper in 2009[30]. In this paper the Commission continued to support the inclusion of distributed generation as avoided transmission charges:

> In addition to boundary changes, transmission charges can be avoided through the development of distributed generation. Any avoided transmission charges as a result of the transfer of assets from Transpower to an EDB or development of distributed generation should be reflected in charges to customers and thus should also be reflected in setting the thresholds.

151 Secondly, under clause 3.2.4(3) of the EDB Draft Determination the avoided transmission charge is only recoverable for five disclosure years. In practice this means that Powerco will need to stop payments to embedded generators after five years, providing a large disincentive to the generators and having detrimental consequences to the transmission network. The process has worked well under the Threshold Regime, and Powerco submits that it should continue here.

152 The EDB Draft Reasons Paper does not discuss the treatment of embedded generation as an avoided transmission cost or provide any explanation for why the Commission's position may have changed. This makes it difficult to respond to any concerns the Commission may have.

153 Alternatively, if the Commission does not adopt our proposals for recovering the costs of embedded generation (which are in line with proposals from the ENA and which we strongly encourage the Commission to accept), at the very least Powerco submits that the Commission should not override existing contractual arrangements. EDBs should be allowed to continue passing through payments to embedded generators until current contractual agreements can be changed.

Reopeners

154 In Powerco's view, the Commission's draft decisions on reopeners for CPPs are a positive step in the right direction. However, one central issue remains: all of the circumstances that could give rise to reconsideration (reopeners) of a CPP should apply equally to a DPP (other than a transaction event). The CPP process is not designed as a mechanism by which an EDB could instead obtain an expeditious response to such events arising where a DPP applies. It is much too slow and

[30] Commerce Commission *"Regulation of Electricity Lines Businesses, Targeted Control Regime, Threshold Reset 2009 Discussion Paper"* (19 December 2007), page 75.

cumbersome to be used as such, and particularly as a response to a catastrophic event.

155 The Commission considers a DPP provides an inadequate baseline against which to make the incremental adjustments required under a reopener. As elaborated by the ENA, this is not so. A DPP is designed to approximate the recovery of an EDB's annual costs and it follows that if an event gives rise to a change in those annual costs, then the DPP could be adjusted to reflect those changes in costs. These changes in costs need to be identified whether under a DPP or CPP.

Commission reliance on misleading information

156 We agree with the ENA that the issue of a supplier providing false or misleading information should be framed in less pejorative terms, along the lines of the Commission having relied on incorrect or misleading information that has had a material effect.

Aggregation of regulatory mechanisms

157 Powerco considers that the Commission's approach to aggregation of regulatory mechanisms after a transaction event is overly prescriptive and involves (in the case of the CPP) the uncertainty of the Commission considering and then issuing a joint CPP, thus introducing unnecessary uncertainty into such events. We support the ENA recommendation for the following approach:

157.1 if two or more suppliers of electricity lines services become related entities, they may merge their price-quality paths (but are not required to do so), but if they do so, they must merge their information disclosures in the same reporting period;

157.2 if the merging entities in (1) include an (exempt) consumer-owned supplier and a supplier that is not exempt, the consumer-owned entity needs to adopt a DPP (and there need to be rules as to how that happens);

157.3 if two or more consumer-owned suppliers of electricity lines services become related entities, they may merge their information disclosures (but are not required to do so);

157.4 when merging price-quality paths, the merged entity must demonstrate that the merged price and quality paths are equivalent to the sum of the pre-existing price and quality paths, and provide transparency as to how the merged price and quality paths have been calculated; and

157.5 when merging information disclosures the merged entity must provide transparency as to how the disclosures have been merged.

Efficiency sharing mechanism (the Incremental Rolling Incentive Scheme)

158 Overall, Powerco supports the Commission's proposed Incremental Rolling Incentive Scheme (*IRIS*) as a mechanism for carrying forward efficiency gains and thereby improving the incentives for regulated suppliers to achieve those efficiency gains.

159 However, a key issue for Powerco is extending the IRIS to DPPs as well as CPPs, and specifying how this will occur as part of an input methodology rather than as

part of the DPP process. We support ENA's view that an efficiency carryover mechanism under the DPP is a regulatory process or rule which, pursuant to section 52T of the Act, must be included as an input methodology, subject to the same input methodology procedural disciplines that increase certainty and provide for appeal rights.

160 We also agree with the ENA that implementing such a mechanism under the DPP is materially better at meeting the Part 4 Purpose than the alternative of no efficiency carryover mechanism.

161 As raised in Part D of our Submission, we are of the view that the IRIS structure could be used to provide appropriate incentives for EDBs to undertake mergers or acquisitions within the EDB sector. Such incentives are critical to maximise incentives and not deter investment in unregulated businesses, and to ensure the sector evolves in an efficient manner. The two main modifications to the IRIS to achieve this are a method to establish a baseline post-merger, and an extension of the 5 year period to 10 years to ensure rewards from merger activity are commensurate to the risks involved and reflect the period over which benefits can in practice be achieved.

162 As all parties appeared to agree at the Conference last year, the efficiency benefits flow only after the businesses have been effectively integrated and businesses processes and structures have been changed. Thus, compared to other sources of efficiency gains, mergers and acquisitions require both a larger effort and financial investment as well as being realised after a much longer delay.

163 ENA Submission 5 illustrates that if the carry forward period is extended from 5 to 10 years (two regulatory periods) then regulated suppliers will receive 38-49% of the efficiency gains arising from a merger rather than just the 23-31% that could be expected over 5 years (which is insufficient to provide the necessary merger and efficiency incentives). We refer the Commission to ENA Submission 5 for further elaboration of these points.

P_0 starting price adjustment

164 Finally, as elaborated in Part C (Regulatory Framework) of Powerco's Submission, in our view the P_0 starting price adjustment fits naturally in the 'specification and definition of prices' limb of the rules and processes input methodology. The Commission itself has noted that the term 'price' is defined very widely to include individual prices, average prices or revenues.[31]

[31] Commerce Commission *"Input Methodologies (Electricity Distribution Services) Draft Reasons Paper"* (June 2010), paragraph 8.3.3.

APPENDIX 1: THE RECORD

List of documents from other regulatory consultation processes that Powerco relies on in this context (and that form part of the record)

- Mr Balchin, *Control of Natural Gas Distribution Services: Draft Decision Paper, Statement for Powerco* (30 November 2007)
- Mr Balchin, *Control of Natural Gas Distribution Services: Cross-Submission on Draft Decisions Conference* (18 March 2008)
- Mr Balchin, *Memorandum – Treatment of Taxation in the Commerce Commission's Draft Decisions Document* [Gas Authorisation] (2007)
- Powerco Submission on Draft Decisions Paper (30 November 2007)
- Powerco Cross-submission on Draft Decisions Paper (18 March 2008)
- Powerco Further Submission on Asset Valuation (24 July 2008)

APPENDIX 2: GOOD REGULATORY PRACTICE

What is good regulatory practice?

A1. This Appendix sets out the approach taken in a number of jurisdictions to "good regulatory practice" or "best practice regulation". Drawing on each of those jurisdictions, the concepts that might be considered fundamental to good regulatory practice are as follows:

A1.1 ***Independence***: Any decision made by a regulator should be free from undue external influence. A regulator should have the expertise necessary to fulfil its role without undue external influence.

A1.2 ***Transparency***: A regulator should be open with stakeholders and should establish visible decision-making processes.

A1.3 ***Consistency***: Regulatory decisions should be consistent across participants and sectors, and over time.

A1.4 ***Predictability***: A regulator should carry out its decision-making in a manner that allows for future planning by the regulated.

A1.5 ***Flexibility***: The Regulatory approach should be capable of evolution and refinement over time and in response to changing external conditions. The regulator should not shut its mind to alternative regulatory tools.

Oxera Paper

A2. In his paper in Oxera's Agenda publication, "Best-practice principles in regulation: part 2 – the regulators" (May 2010), Mike Toms outlines what, to him, regulatory best practice should look like.

A3. Factors considered important by Toms include:

(a) understanding the industry;

(b) approaching regulation with an open mind;

(c) admitting to any prejudices;

(d) asking the right questions when seeking comment on specific questions in consultation papers;

(e) treating responses to consultation seriously;

(f) consistency in regulatory decision-making;

(g) specific and timely information requests;

(h) understanding the consequences of regulation for consumers; and

(i) considering the long-term.

A4. In terms of consistency of regulatory approach, Toms observes:

> One of the most difficult issues for investors in regulated companies is inconsistency. In making investment decisions they cannot foretell the future regulatory environment...They face particular difficulties if they observe regulators apparently disregarding their own policies. Similarly, confusion follows when different regulators in the same jurisdiction deal with similar issues in materially different ways. There is a legitimate question about the extent to which regulators should sacrifice some independence for greater consistency. This does not mean that regulators should be totally constrained by precedent, but it does mean that due weight should be given to what has gone before, and that big changes to policy or practice should be well flagged so that markets do not suffer from shock.

A5. The approach taken by Toms is similar to that suggested in each of Australia, the United States and the United Kingdom, as outlined below.

AUSTRALIA: Utility Regulators Forum - Best practice utility regulation

A6. Similar factors have been identified in Australia as fundamental to good regulation.

A7. The Utility Regulators Forum produced in 1999 a set of "best practice principles" to guide the behaviour of regulators and to improve regulation or identify less burdensome ways of achieving regulatory goals.

A8. The Forum intended that the principles would serve as a checklist for utilities and regulators for examining current and proposed regulatory tools. The nine best practice principles set out in the discussion paper are as follows:

(a) communication (information to stakeholders on a timely and accessible basis);

(b) consultation (participation of stakeholders in meetings);

(c) consistency (across market participants and over time);

(d) predictability (a reputation that facilitates planning by suppliers and customers);

(e) flexibility (by using appropriate instruments in response to changing conditions);

(f) independence (autonomy – free from undue political influence);

(g) effectiveness and efficiency (cost-effectiveness emphasised in data collection and policies);

(h) accountability (clearly defined processes and rationales for decisions, with appeals); and

(i) transparency (openness of the process).

A9. It was noted that "[t]he principles need to be considered as a 'package', as there must be a degree of balancing of some of the principles against others. For example, the principle of flexibility (adapting regulatory approaches and tools over time and to suit circumstances) could be seen as contrary to the principles of consistency and predictability. The objective of maximising public benefit should be kept in mind when competing priorities are considered" (page 4).

A10. Of these principles, the elaboration provided in the paper as to the requirements of consistency, predictability and flexibility are set out below:

> **Consistency:** consistency of treatment of participants across service sectors, over time and across jurisdictions, was highlighted as a key principle for providing confidence in the regulatory regime. This principle is linked to the provision of consistent and fair rules that do not adversely affect the business performance of a specific participant.
>
> **Predictability:** The principle of predictability of regulation is an essential requirement for utilities to be able to confidently plan for the future and be assured that their investments will not be generally threatened by unexpected changes in the regulatory environment. The principle is particularly important in the utility sector, which is characterised by major infrastructure works with long investment time horizons.
>
> Regulators need to appreciate the long-term nature of assets and related investment decisions in the utility sector. The implementation schedule of regulations that will affect the cost or price structure of market participants must therefore be taken into account. Similarly there should be predictability in respect to government policies on externalities that are likely to have an impact on utility pricing and investment, such as environment, technical, safety and social welfare policies.
>
> In some circumstances predictability is not possible, that is where there is economic instability or rapid technological or political change, but these circumstances should, as far as possible, be made exceptions. The rule to which regulators should strive is a consistent and predictable regulatory environment.
>
> Key mechanisms for providing predictability in regulation include the establishment of decision-making criteria that are well defined and the provision of clear timetables for the review of standards and regulations.
>
> **Flexibility:** Flexibility involves the use of a mix of regulatory tools and the ability to evolve and amend the regulatory approach over time as the external environment changes. This assumes that the organisation has knowledge of, keeps up to date with, and is open to alternative regulatory approaches. At times courage may be required to implement new initiatives rather than to recycle approaches which can become a part of the culture within the public sector.
>
> Flexibility includes taking into account the condition of the local market when considering the design of regulation. These local conditions include the extent of infrastructure, the number of existing participants in the market and the existence of long-term contractual obligations.

Key mechanisms for providing flexibility in regulation include being open to alternative regulatory tools and recognising conditions change over time.

UNITED STATES: *Improving regulatory efficiency and effectiveness*

A11. In a paper entitled "Improving Regulatory Agency Efficiency and Effectiveness – best practices, process and organisational structures" a group form the Centre for Energy Economics and the University of Texas listed as important to effective regulation the following factors:

(a) communication;

(b) consultation;

(c) consistency;

(d) predictability;

(e) flexibility;

(f) independence;

(g) accountability;

(h) transparency;

(i) timeliness;

(j) resources;

(k) structure; and

(l) expertise.

A12. Of those, the four seen as the most important, and mostly inclusive of other aspects, were independence, enforcement powers, transparency and accountability (page 6).

A13. Included in that paper was a table providing a list of characteristics that different researchers or forums found as necessary or desirable to effective regulation:

WFER 2003[32]	World Bank[33]	USAID Nexus study	CEER	PURC[34]	Utility Regulators Forum[35]	Stern (1997)
Independence	Independence	Independence	Independence	Legal mandate, values	Independence	Informal Independence
A minimum set of functions and public service obligations		Legal mandate & financial resources	Enforcement powers	Values		
Impartiality, transparency & simplicity	Legitimate/ accountability	Transparency	Transparency & accountability	Resources	Accountability & transparency	Accountability & Transparency
Diligence and ethics	Competency/ expertise	Expertise	Competency		Effectiveness & efficiency	Expertise
Appeals		Public involvement[36]	International activities		Communication	
Dispute resolution in individual cases					Consultation	
Benchmarking					Consistency	
Predictability					Predictability	
Flexibility					Flexibility	

UNITED KINGDOM: *Better regulation taskforce*

A14. In 2001, the Better Regulation Taskforce in the United Kingdom examined the work of economic regulators. The key regulatory principles identified by the taskforce were:

(a) *transparency*: the case for regulation should be clearly made and the purpose clearly communicated; proper consultation should take place before creating and implementing regulation; and regulations should be simple and clear, and come with guidance in plain English.

(b) *accountability*: Regulators should be clearly accountable to government and citizens and to parliament and assemblies; there

[32] World Forum on Energy Regulation held in Rome in 2003.

[33] Primarily from Bertolini (2004) and Estache (1997) but these factors are also discussed by Smith (1997a-c) as well as other World Bank publications.

[34] PURC list is mostly based on Designing an Independent Regulatory Commission by Berg et al.

[35] Office of Water Regulation (1999), Perth, WA, Australia.

[36] Public involvement is the central theme of the Nexus study (AEAI and PA Government Services, 2005). It can be seen as the necessary condition for transparency and accountability, but it is a necessary condition for success according to the study.

should be a well publicised, accessible, fair and efficient appeals procedure.

(c) *proportionality*: Compliance should be affordable to those regulated – regulators should 'think small first'; as far as possible, a light regulatory touch is used, with strict penalties when failures occur.

(d) *consistency*: Alternatives to state regulation should be fully considered, as they might be more effective and cheaper to apply; New regulations should be consistent with existing regulations; departmental regulators should be consistent with each other.

(e) *targeting*: Where possible, a goals-based approach should be used, with enforcers and those being regulated given flexibility in deciding how best to achieve clear, unambiguous targets; regulations should be reviewed from time to time to test whether they are still necessary and effective. If not, they should be modified or eliminated.

A15. In addition, and as an example of the regulatory approach taken by major regulators in the United Kingdom, the Office of Communications (OFCOM) has given the following voluntary commitments to regulation:

How we regulate*:*

(a) OFCOM will always seek the least intrusive regulatory methods of achieving our policy objectives;

(b) OFCOM will strive to ensure that our interventions are evidence-based, proportionate, consistent, accountable and transparent in both deliberation and outcome;

(c) OFCOM will regulate with a clearly articulated and publicly reviewed annual plan, with stated policy objectives.

APPENDIX 3: PRICEWATERHOUSECOOPERS – ESTABLISHING THE INITIAL TAXATION ASSET BASE

[Attached as separate document]