19th December 2013

Dr Mark Berry
Chair
Commerce Commission

By email: mark.berry@comcom.govt.nz

Dear Dr Berry

Energy Prices and Urgent Review of Cost of Capital Input Methodology

We represent the interests of energy consumers. We write to request an urgent review of the cost of capital input methodology (IM) before the upcoming 2015 price-quality path resets for electricity transmission and distribution services. The High Court's merit review decision indicates the Court's view that a mistaken approach by the Commission may be costing consumers over $150m per year as monopolist suppliers extract what the Act refers to as excessive profit.

We ask that the Commission now use its powers in accordance with the Court's expectations, to investigate thoroughly the implications of the error identified, and to ensure that it does not continue until 2020. The total wealth transfer from consumers to monopoly suppliers over the relevant term would be well over $1bn on any approach to the Court's indications.

The High Court's Criticisms of the "Supplier Bias"

In *Wellington International Airport Limited* v *Commerce Commission* [2013] NZHC 3289 the High Court criticised the Commission's deliberate decision to err in favour of a weighted average cost of capital (WACC) estimate that was higher than the likely true WACC. The Court considered the Commission's rationale – that a higher WACC was necessary to incentivise investment and innovation – to be based on dubious assumptions and to lack a proper evidential foundation (contrary to Australian precedent). Appended are relevant excerpts from the decision.

Court's Expectations of Commission

Applying a narrow interpretation of the referral power under s 52Z(3)(b)(iii) of the Commerce Act, the Court held that it was not able to refer the IM back to the Commission. However, its expectation that the Commission would review the IMs of its own volition was strongly expressed:

> [1486] In reaching this decision not to amend the IM in respect of the use of the 75th percentile for DPP/CPP regulation, we are mindful that the IMs will be reviewed. At that time, we would expect that our scepticism about using a WACC substantially higher than the mid-point, as expressed above, will be considered by the Commission. We would expect that consideration to include analysis – if practicable – of the type proposed by MEUG. We would also expect the Commission to consider MEUG's two-tier proposal in light of our observations.

The High Court decision puts the Commission on notice of a significant risk that the current cost of capital IM allows monopolist suppliers to extract excessive profits with no obvious countervailing benefit to the long term interests of consumers.

Preventing a Decade of Excessive Returns

Because of the way price-quality paths interact with IMs, if the Commission does not complete a review of the current IM before the end of September next year, the monopoly suppliers will retain that ability to extract excessive profits until 2019 or 2020. The scheduled reset of their price-quality paths will apply the current, uncorrected IM for the full length of the paths, even if the IM is reviewed in the meantime.

As you know, IMs must be reviewed at intervals no greater than 7 years, but otherwise no specific review period is set. The Commission can amend IMs at any time, so long as it complies with s 52V of the Act.

We ask the Commission to issue the necessary notice to start this review process immediately, so that any resulting amendments to the IM can be applied to the electricity transmission and lines services price-quality paths due to be reset on 1 April 2015 and all other applicable determinations. We understand that for this to happen, any amended IM would need to be published by 30 September 2014.

Review Can Be Carried Out Irrespective of Appeal Process

There may be appeals against the High Court decision (including by MEUG). The period for filing appeals does not expire until 14 February 2014. However, on the reasoning of the Court it is not a solution for the Commission to wait and see whether appeals are lodged or for the outcome of any such appeal. Even if the Court of Appeal is satisfied as a matter of law that the High Court had good grounds for urging that the mistake be corrected, it may share the High Court's view that the discretions for remedy are limited. The Court of Appeal may conclude that the Commission is better-equipped to do the balancing necessary to establish that the corrected IM would be materially better. It may find itself unable to give effect to a compelling conclusion that it is highly likely that excess profits are being extracted. Publicity for such a conclusion would not engender public confidence in the efficacy of the price control regime.

In other words we think that the perceived integrity of the regime, and the reputation of the Commission, could depend on consumers knowing that the issue has been fully explored and decided at the first available opportunity. That would be hard to achieve if delay allows the current uncertainty and likelihood of extraction of excess profit to persist until 2020.

Though they will want to preserve an overly generous WACC for as long as possible, the regulated suppliers too have a strong interest in the robustness and longevity of the regime. If the current generosity is preserved by omission to review the IM now, the uncertainty as to what will emerge when the price-quality paths are reset will be mentioned repeatedly in investment analysis. Six years of uncertainty for investors in regulated suppliers, about such a material aspect of their permitted WACC, is not conducive to confidence in the regime.

We ask that the Commission take the initiative, and ensure that a condition which the Court considers to be a mistake is not allowed to remain effective past the end of next year. Time is of the essence. If the Commission misses the opportunity to review the IM in time for the next round of price-quality path determinations, the effect will be part of the debate over electricity prices through-out that period.

We also note that the Commission's ability to amend the IM is not dependent on the outcome of any appeal. Any amendment of the IM would be future-focused. It would also give rise to a new right of appeal. Were the Commission to amend the IM of its own accord, any price-quality paths to which the existing IM applies would not be affected. Were an appeal decision to be available before the review was finalised, the Commission c could take relevant findings into account. The parties too could take a review decision, and the prospect of it, into account in deciding the level of resource to apply in appealing.

A Notice of Intention Will Start the Process Running

It is in the long term interests of consumers that a review of the cost of capital IMs be undertaken immediately, at least on the matter drawn to the Commission's attention by the Court. We request the Commission to start this process by issuing a notice of intention under s 52V(1) without delay.

Yours sincerely

SE Chetwin

Suzanne Chetwin
Chief Executive
Consumer NZ

Kim Campbell
Chief Executive
Employers and Manufacturers Association Northern Inc

Ralph Matthes
Chief Executive
Major Electricity Users Group Inc

Copied to:
Hon John Key, Prime Minister
Hon Bill English, Minister of Finance
Hon Steven Joyce, Minister of Economic Development and Associate Minister of Finance
Hon Tony Ryall, Minister for State Owned Enterprises
Hon Craig Foss, Minister of Commerce and Minister of Consumer Affairs
Hon Simon Bridges, Minister of Energy and Resources

Appendix: Relevant Excerpts from Decision

The Court said:

> [1472] In the first place, the expectation of earning (only) a normal return on new investment ought to be an attractive proposition for a regulated supplier. In the price control regulatory framework, the return is almost guaranteed. Each supplier is a monopoly. The normal regulatory imperative in such circumstances is to prevent suppliers from over-investing. Why then, should higher likely returns be provided?
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> [1473] Secondly, it is far from obvious that higher than normal expected returns would stimulate greater efficiency of any kind. On the contrary, they would render excess profits likely, even if less effort were made by suppliers to generate efficiencies than in a workably competitive market. In monopoly enterprises, the concern is always to prevent inefficiency creeping in. Providing a revenue cushion is not the way to create the right incentives.
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> [1474] If dynamic efficiencies are, as the Commission believes, most important, how exactly are higher expected returns supposed to stimulate them? Dynamic efficiency implies finding better ways to meet customer needs and adapting to changes in market circumstances. But necessity, not plenty, is the mother of invention. Utility industries – and certainly electricity transmission and distribution companies - are unlikely to be leaders in dynamic efficiency, precisely because they do not need to be.
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> [1475] Thirdly, the outputs of regulated suppliers are inputs to numerous – probably all – other sectors of the economy, as well as being used by final consumers. If the prices paid by user industries are higher than the resource cost of producing the outputs (viz, electricity and gas transmission and distribution), then inefficiency is promulgated throughout the economy. That is what is implied by higher than normal expected returns.
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> [1476] At the least, the inter-sectoral effects ought to be considered, and if possible estimated. This has not been done in the present regulatory processes. If evidence from studies in other times and places exists, it was not placed before us, and seems to have played no part in the Commission's thinking. That could be understandable if the inter-sectoral economic mechanisms and effects were notorious: so well-known and accepted as not to require citing. To our knowledge, such is not the case.
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> [1477] Nor is overseas practice suggestive that such an approach has found more than narrow favour, since the only examples from the numerous regulatory decisions made every year were two relating to United Kingdom airports.
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> [1478] Other arguments for the 75th percentile approach might be put. For example, choice of the 75th percentile could conceivably have been expected – or hoped – to reduce disputation over the cost of capital IMs. In that case, use of a single "uplift" factor in the cause of making less than normal returns unlikely might be justified. But the present circumstances are very far from that happy state, with every WACC parameter that could be contested subject to appeal.
>
> [1479] In our view, applying the 75th percentile estimate to the initial RAB is unlikely to be necessary to promote incentives to invest and innovate. Future investment choices by suppliers must rationally be influenced by expected earnings on those future investments, not by earnings on past investments. (The experience with past investments may of course be relevant to future investments, but that is another story.)

[1480] The idea that greater revenues produced by higher allowed earnings on past investments (ie on the initial RAB) provide the wherewithal for more future investment is contrary to rational investment choice. Those existing higher earnings, once earned, are a given. The source of funds for future investments does not influence the riskiness of future investments; nor, therefore, does it influence their attractiveness. If anything, an abundance of capital is likely to lead to wasteful investment.

[1481] Any concern about effects on investment by yet-to-be-regulated industries would seem to be misplaced. No evidence of such an effect was presented, nor evidence that regulators anywhere in the world have held such concerns.