

27 February 2015

Open letter on our proposed scope, timing and focus for the review of input methodologies

1. This letter provides an opportunity for interested parties to comment on:
 - 1.1 our proposal to review all input methodologies under section 52Y of the Commerce Act 1986 (the Act) by December 2016;
 - 1.2 our preliminary thoughts on how we might focus our review; and
 - 1.3 key topic areas which we have identified could be possible areas of focus.
2. Before we commence work on the review, we are interested in your comments on this letter to help inform our views on the appropriate scope, timing and focus of this review process, in particular:
 - 2.1 which input methodologies would be included in the review at this stage;
 - 2.2 the process that would be followed; and
 - 2.3 the proposed time frames for the review, including when the review would start and finish.
3. The deadline for providing your comments is **5pm, Friday 20 March 2015**.

Each input methodology must be reviewed within seven years of its publication

4. Input methodologies are the upfront rules, processes and requirements of regulation. Input methodologies currently apply to:
 - 4.1 all suppliers of electricity lines services, gas pipeline services and specified airport services subject to information disclosure regulation; and
 - 4.2 all suppliers of gas pipeline services, 17 suppliers of electricity distribution services and Transpower New Zealand (Transpower) subject to price-quality regulation.
5. The purpose of input methodologies, in section 52R of the Act, is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to regulation.

6. We must review each input methodology no later than seven years after its publication.¹ However, there are different ways that we could go about this, and the review could be done in several tranches. For example, while all input methodologies need to be reviewed within seven years of their publication, input methodologies published on the same date do not need to be reviewed at the same time.
7. The original input methodologies were determined on 22 December 2010 under section 52T of the Act and published on 20 January 2011. A number of these were re-determined in 2012, and other amendments have been made from time to time. The input methodologies for Transpower's capital expenditure proposals were determined on 31 January 2012 under section 54S of the Act and published on 9 February 2012.

We propose to review all input methodologies by December 2016

8. We propose completing the review of input methodologies by December 2016, as this would allow any resultant changes to the input methodologies to be applied before the 2017 reset of the default price-quality paths for gas pipeline services.
9. Given the general desirability of taking a cross-sector approach to reviewing input methodologies, our preliminary view is that it would be appropriate if we reviewed all the input methodologies at the same time, ie, aiming to complete the review of all input methodologies by December 2016.
10. This would mean completing the review of all input methodologies set (and amended) by the Commission to date, including Transpower and default price-quality path input methodologies which were re-determined in 2012. In addition, we would also propose to include within the review any input methodologies amended under section 52X prior to the completion of the review.
11. Including all input methodologies within the scope of this review process would align the potential timing of subsequent reviews of the input methodologies under section 52Y.

Considerations relating to the review's timing

12. Considerations relating to the review's timing include the phasing of the review with:
 - 12.1 the reset of the default price-quality paths for gas pipeline businesses, which must be determined by May 2017;
 - 12.2 resets of the price-quality paths for electricity distributors and Transpower, which must be determined by November 2019; and
 - 12.3 expected price setting events by Auckland and Christchurch airports by July 2017, and Wellington airport by April 2019.

¹ Commerce Act 1986, s 52Y(1).

Reset of the default price-quality paths for gas pipeline businesses

13. A final decision for the reset of the default price-quality paths for gas pipeline businesses is due by 31 May 2017. It is open to us to commence the review this year and we see benefit in aiming to complete the review of the input methodologies for gas pipeline services by December 2016 so that any input methodologies that change as a result of the review would be applied as part of this reset.
14. On the other hand, not completing the review until after this reset would mean that any updated input methodologies would not be given effect to in the default price-quality paths for gas pipeline businesses until the following reset. Consumers of gas pipeline services would therefore have to wait until 2022 to realise the benefits of any changes.

Resets of the price-quality paths for electricity distributors and Transpower

15. Resets of the price-quality paths applying to 17 electricity distributors and Transpower must be determined by 30 November 2019. Completing the review by December 2016 would provide increased certainty for electricity distributors and Transpower on the input methodologies which would apply to the resets.
16. Another issue to consider for Transpower is the timing of the review of the input methodologies for Transpower's capital expenditure proposals, which must be reviewed by 2019. We could review these at the same time as all the other input methodologies (eg, by December 2016). Doing so may better allow for common issues relating to Transpower's capital expenditure proposals and other similar input methodologies to be considered at the same time.

Expected price setting events by Auckland, Wellington and Christchurch airports

17. Price setting events by Auckland and Christchurch airports are expected to occur in July 2017. The next Wellington Airport price setting event is due in April 2019.
18. Completing the review by December 2016 would enable us to address issues with the current input methodologies identified in the section 56G reports, and to consider further the appropriate weighted average cost of capital (WACC) percentile estimates to publish for airports, prior to the next price setting events.

Input methodology amendment processes before this review process is completed

19. We have already issued notices of intention to work on amendments to the input methodologies to cover the following matters:

- 19.1 the operation of the Incremental Rolling Incentive Scheme (IRIS); and
- 19.2 the appropriate WACC percentile estimates to publish for airports information disclosure.

Proposed amendments regarding the operation of the IRIS

- 20. We expect to publish proposed amendments to input methodologies for IRIS for electricity distribution services shortly, which are intended to complement the amendments we published on 27 November 2014. These amendments address situations in which electricity distributors move from one default price-quality path to another, and situations in which electricity distributors transition between a default price-quality path and a customised price-quality path.
- 21. We have also previously notified interested parties that we intend to consult separately on proposed amendments to IRIS for gas pipeline services, and will notify interested parties of our process at a later date.

Potential amendments to the WACC percentile regarding regulated airport services

- 22. We announced in December 2014 that we would issue a process paper on the intended timeframes for amendments to the WACC percentile regarding regulated airport services in the first quarter of 2015.
- 23. We have also published that process paper today. It explains our proposal to further consider the appropriate WACC percentiles for airports as part of the proposed review of all input methodologies by December 2016.² Given that target date, we anticipate that any amendments made as a result of the review would be completed well in advance of Auckland and Christchurch airports resetting their prices.

Possible amendments applying to requirements for customised price-quality path proposals

- 24. In 2014, we asked for feedback on the approach and process we followed for setting the customised price-quality path for Orion New Zealand. Having received feedback, we said we would examine matters that impact specifically on future customised price-quality path proposals in 2015, after we had finished resetting prices for electricity distributors.
- 25. We anticipate releasing further details of any process to amend input methodologies for requirements relating to customised price-quality path proposals shortly.

Preliminary thoughts on the possible focus of our review

How we might focus our review

- 26. Once the review has begun, we have an obligation to review each of the input methodologies that are included within this review process (and which would be

² Commerce Commission “Further work on the cost of capital input methodologies for airports. Proposal to consider the WACC percentile for airports as part of the input methodologies review” (27 February 2015).

outlined in the notice of intention). However, given that there are constraints for all parties in terms of time and resources, we think it is appropriate to focus the review on those areas which are likely to have the most significant long-term benefit to consumers.

27. We set the original input methodologies after extensive engagement with interested parties, and there was a subsequent merits appeal process that reviewed the majority of those input methodologies.
28. We therefore suggest that substantial changes of the current input methodologies are unlikely to be desirable, particularly in light of the purpose of input methodologies in section 52R.
29. We have applied the input methodologies over the past four years, and although we have more experience with some areas of the wider regime than others, our initial view is that the current scope of the input methodologies (ie, the matters covered) is sufficient.
30. Our preliminary view is that the review would focus on changing those aspects of the current input methodologies that would:
 - 30.1 promote the section 52A purpose more effectively;
 - 30.2 promote the purpose of input methodologies in section 52R more effectively, without detrimentally affecting the promotion of the section 52A purpose; or
 - 30.3 significantly reduce compliance costs, other regulatory costs or complexity, again without detrimentally affecting the promotion of the section 52A purpose.

Possible key topic areas

31. Based on our conversations with interested parties, and our experience with the input methodologies to date, we understand potential topic areas for the review include:
 - 31.1 matters raised by the High Court relating to the cost of capital, such as whether to adopt a 'split' cost of capital, the rationale for the term credit spread differential, and whether to retain the simplified Brennan-Lally Capital Asset Pricing Model (CAPM), given the 'leverage anomaly';
 - 31.2 key parameters of the cost of capital model, including asset betas and the tax-adjusted market risk premium;
 - 31.3 indexation of the cost of debt;
 - 31.4 the appropriate WACC percentile estimates to publish for airports information disclosure;

- 31.5 the form of control for default/customised price-quality regulation (ie, revenue cap versus price cap);
- 31.6 the potential impact of disruptive technologies, such as implications for the depreciation and indexation of asset values;
- 31.7 lessons learned from the airports' section 56G reports, including the treatment of depreciation, indexation and revaluations;
- 31.8 airport land held for future use; and
- 31.9 opportunities to reduce complexity and compliance costs.

We seek your views on the appropriate scope, timing and focus of this review process

- 32. We see a benefit in engaging with interested parties now to make sure we have your views on the appropriate scope and timing before we commence work on the review.
- 33. In particular, we are interested in your views on:
 - 33.1 which input methodologies should be included in the review at this stage;
 - 33.2 the process that should be followed; and
 - 33.3 the proposed time frames for the review, including when we should start the review and when we should aim to finish it.
- 34. We are seeking constructive dialogue and an efficient review process. Therefore we would appreciate hearing your views on the possible focus areas for our review, including key topic areas, recognising that we must review each of the input methodologies that are included within this review process.

How you can provide your comments

- 35. Please provide your comments on this letter by 5pm, Friday 20 March 2015.

Address for comments

- 36. Comments should be addressed to:

Keston Ruxton (Manager, Market Assessment and Dairy, Regulation Branch)
c/o regulation.branch@comcom.govt.nz

Format for comments

- 37. We prefer to receive your comments in both MS Word and PDF file formats. Please include "Comments on proposed review of input methodologies" in the subject line of your email.

Next steps

38. After we have considered comments on this letter, we will decide on the scope and timing for the review. If we aim to complete the review by December 2016, we would inform interested parties of our decision by publishing a notice of intention shortly. This notice would set out which input methodologies we intend to review at this stage, and outline the process we intend to follow, and the proposed time frames.
39. If we decide not to aim to complete the review by December 2016, we would inform interested parties of that decision as soon as practicable.

Yours sincerely

A handwritten signature in blue ink that reads "Mark Berry". The signature is written in a cursive style with a small horizontal line underneath the name.

Dr Mark Berry
Chairman
Commerce Commission