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Submission on Franks and Ogilvie advice

In December 2013 Consumer NZ and the Employers and Manufacturers Association Northern Inc (EMA), in conjunction with MEUG, wrote to the Commerce Commission requesting that the Commission review the cost of capital input methodology providing for use of the 75th percentile for DPP and CPP regulation. This request was prompted by comments made by the High Court in its merit review decision questioning the justification for the uplift.

We are pleased that the Commission has been undertaking this work and have been following the various reports by or on behalf of the Commission.

We wish to make a brief submission in response to the Commission's invitation for interested parties to submit on the advice provided to the Commission by Franks and Ogilvie on behalf of MEUG.

In essence, Franks and Ogilvie advise:

- The purpose statement in s52A of the Commerce Act requires the Commission to use a consumer welfare standard (and not a total welfare standard) when making determinations under Part 4;
- The Commission cannot rely on the promotion of incentives to invest to justify adopting a WACC percentile estimate above the best estimate of a normal return, as that would not be consistent with outcomes produced in competitive markets and therefore contrary to the Part 4 purpose statement; and
- If the above is wrong and it is permissible for excess profits to be extracted with a view to incentivising investment, then evidence is required in order to be assured that investment will actually be incentivised (and that it is the best way to incentivise investment) before the uplift to returns is permitted.

Consumer NZ and EMA agree with all of the above propositions by Franks and Ogilvie.

Consumers, including commercial and industrial consumers, are front and centre under Part 4

Section 52A sets out a specific purpose consumer focused statement for Part 4, which provides:

52A Purpose of Part

(1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 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; and

(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and

(d) are limited in their ability to extract excessive profits.

This new purpose statement means that for decisions made under Part 4, the promotion of the long-term benefit of consumers is the key purpose. The High Court in its merits review decision in December last year described the long-term benefit of consumers as being 'the over-riding purpose of Part 4'. It said that consumers' interests were 'front and centre'.

Consumer NZ and EMA agree. It is only permissible for the Commerce Commission to set an input methodology allowing regulated suppliers to earn or target earning returns above a normal return if that would be in the long-term benefit of consumers.

We agree with Franks and Ogilvie that clear unambiguous evidence is needed to show that it would be in the long-term benefit of consumers to allow such an uplift before the Commission can grant the uplift. Such evidence does not, to us, seem to have been presented by the regulated suppliers.

Moreover – the focus in the purpose statement is on the long-term benefit of consumers in markets referred to in s52 (namely markets where there is little or no competition). We agree with Franks and Ogilvie that a total welfare approach focused on the overall efficiency of the economy as a whole (which is what the quite different main purpose statement in s1A of the Commerce Act provides for) is not consistent with the s52A purpose statement, which is consumer focused, and thus mandates a consumer welfare approach, which includes consideration of transfers of wealth from consumers to suppliers. The Powerco case quoted by Franks and Ogilvie is very clear that wealth transfers must be taken into account when decisions are made under Part 4.

Decisions under Part 4 must be consistent with competitive market outcomes

The second aspect of the purpose statement is that outcomes consistent with outcomes produced in competitive markets must be promoted.

Our organisations are both very familiar with the characteristics of competitive markets. Ongoing, sustained returns above a normal level are not characteristically present in competitive markets. In competitive markets if a supplier is earning above normal returns then this attracts entry by other suppliers and the excess or above normal profits are competed away.

We agree with Franks and Ogilvie that a long-term expectation of above-normal returns is not an outcome found in competitive markets, therefore it is not an outcome the Commission is permitted to permit under the cost of capital input methodology the Commission is setting under Part 4.

Incentives to innovate and invest must be for the benefit of consumers and consistent with those existing in competitive markets

Finally, s52A sets out the outcomes which Part 4 is striving to achieve with respect to suppliers of regulated goods and services. Paragraph (a), ensuring incentives to innovate and invest, is being strongly relied upon by regulated suppliers, which are arguing that an uplift to the WACC above the best estimate of a normal return is required in order to incentivise investment.

Franks and Ogilvie note that paragraph (a) is itself qualified by the preamble or opening statement of s52A(1), which means that the input methodologies are limited to incentivising only investment and innovation that is in the long term interests of consumers and consistent with outcomes produced in competitive markets.

We agree. Section 52A(1)(a) does not create an unfettered directive for the decision-makers under Part 4 to incentivise investment and innovation. Investment and innovation is only to be incentivised to the extent that:

- It is in the long-term benefits of consumers in markets with little or no competition (as per the over-riding purpose of s52A);
- It is consistent with outcomes produced in competitive markets (as per the second portion of the opening purpose statement)
- The resulting services are provided at a quality that reflects consumer demands (as per paragraph (b)); and
- The ability of regulated suppliers to extract excessive profits is limited (paragraph (d)).

We agree with Franks and Ogilvie that before setting an input methodology allowing a return above the best estimate of a normal return, the Commission needs to be sure that the proposed uplift:

- Is in the long-term benefits of consumers in markets with little or no competition, with real evidence establishing a consumer loss in the absence of the uplift;
- Is consistent with outcomes produced in competitive markets;
- Is necessary to produce the desired incentives to innovate and invest, with other regulatory tools such as the certainty created by the specification of input methodologies not being able to achieve the same outcome at less cost to consumers; and
- Will actually incentivise investment and innovation, as opposed to just providing a higher return to regulated suppliers on their current asset base without any real increased incentive to innovate or invest.

Franks and Ogilvie's advice states that the core issue is whether the real risk of excessive returns over the long-term is outweighed by the interest of consumers in investment and innovation. This was the key issue highlighted by the High Court in its merit review decision last December which led our two organisations, together with MEUG, to write to the Commission. The relevant excerpts from the High Court's decision were set out in the Appendix to our December 2013 letter. The key points to be drawn from those excerpts are the High Court's view that:

- The expectation of earning (only) a normal return on new investment ought to be an attractive proposition for a regulated supplier.
- 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, …
- 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.

In essence, the decision by the Commerce Commission as to the percentile level of the WACC estimate which will be specified in the input methodologies for regulated suppliers is one, as was so well articulated by Franks and Ogilvie in their advice to MEUG, that is constrained by the parameters of s52A. The decision must be one that is in the long-term benefit of consumers and is consistent with outcomes produced by competitive markets.

As Franks and Ogilvie note, allowing excess returns into an indefinite future is not consistent with competitive market outcomes, and therefore any decision to allow an uplift above the best estimate of a normal return would be inconsistent with the purpose of Part 4.

Yours sincerely

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