



**NEW ZEALAND INSTITUTE FOR THE STUDY
OF COMPETITION AND REGULATION INC.**

Price Regulation of Electricity Networks: implications of law change

30 October 2008

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CORPORATE MEMBERS

Contact Energy Ltd

Fonterra Co-operative
Dairy Group Limited

Meridian Energy

Powerco

Telecom Corporation
of New Zealand Ltd

Transpower New Zealand Ltd

Vector Ltd

Victoria University of Wellington

Westpac Institutional Bank

Commerce Amendment Bill passed on 5 September 2008
New Part 4 (replacing Part 4A) comes into force on 1 April
2009

Outline

- Five topics
 - Purpose statement
 - Default price-quality paths (design/transition)
 - Exemptions
 - Customised proposals
 - Appeals
- Particular Issues



Purpose Statement

Context of the Part 4 review

- No purpose statement for Part 4
- But Part 4A purpose statement since 2001
- Section 57E



Efficiency/Wealth Transfer Issue

- The search for a workable solution to accommodate both goals is problematic
- Ultimately a judgment call is required as to which goal or what balance in goals prevails
- Short to medium term allocative impacts of wealth transfer will overwhelm medium to long term dynamic efficiency (investment) considerations



Efficiency/Wealth Transfer Issue

International practice is heading away from “shopping lists”
(eg s 7 Australian National Electricity Law)

“The purpose of this law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply”



Section 52A

...to promote the long-term benefit of consumers ... by promoting outcomes that are consistent with the outcomes produced in competitive markets such that suppliers of regulated ... services:

- (a) Have incentives to innovate and invest
- (b) Have incentives to improve efficiency
- (c) Share benefits of efficiency gains with consumers (including through lower prices)
- (d) Are limited in their ability to extract excessive profits



How Will Section 52A Apply?

- Just a repeat of s 57E?
- Commission may assert it has already taken (a) and (b) into account in the application of s 57E
- Prediction -- s 52A will be applied essentially in the same manner as s 57E
- Surprising that most submitters supported s 52A



Default Price-Quality Paths

- No 2009 reset
- First default price-quality path (1 April 2009 to 31 March 2010) (ss 54J(2) and (3))
- Information disclosure s 52O determination as soon as practicable after 1 April 2009 (ss 54I(1) and 53C)
- Second default price-quality path to be published by 1 December for the period 1 April 2010 to 31 March 2015 (or 2014) (ss 54JK(1), 53M(7) and (5))



Content of Default Price-Quality Paths

- Three matters (ss 53P and 52P)
 - Starting prices
 - Rates of change
 - Quality standards
- Components
 - Likely to be based on input methodologies, but this is not a requirement (ss 52T and 52P(3)(c))
- Timing problem
 - Input methodologies not set until June 2010 (or possibly later) (s 52U(1))
 - Potential for default price-quality path adjustment if post- 1 April 2010 input methodologies would result in a materially different path (s 54JK(3) and (4))



What Will Input Methodologies Look Like?

- Must be in sufficient detail to enable ELBs to reasonably assess their regulatory position (s 52T(2)) (eg WACC number rather than a range)
- But what will input methodologies actually look like?
 - Factual basis
 - Level of prescription
- How likely is it that there will be a dispute between the regulator and those regulated as to the sufficiency of the detail?



Individual Assessments of Rate Changes

- Start point for the default price-quality path is that one common rate change applies to each type of service (s 53P(5))
- Section 53P(8) -- alternate rate changes for individual suppliers can be imposed:
 - if this is necessary or desirable to minimise undue financial hardship to the supplier or to minimise price shocks to consumers
 - As an incentive for suppliers to improve quality
- Therefore, focus on individual price-quality paths for each ELB?



Customised Proposals

- Notwithstanding the set of default price-quality paths on 1 April 2009 and 2010, ELBs won't be able to apply for customised proposals until after June 2010 (s 54P(1))
- No ability to withdraw application (s 53R)
- Limited to 4 a year (s 53Z(2))
- Time for consideration -- 10-15 months (ss 53S-U)
- Increase/decrease via claw-back (ss 53V, and 52D)



Appeals

Standard appeal rights proposed for both input methodologies and final customised proposal decisions

But

Section 91(1A) -- appeals of final customised proposal decisions may not include an appeal against all or any part of an input methodology



The Dual Appeal Problem

Input methodologies are likely to be central to final decisions

Input methodologies may only be decided once every 7 years (s 52Y(1))

Appeal rights for input methodologies are limited to a 20 day window once every 7 years (s 52Z(1))



Two Sets of Problems with Appeals

- The input methodology appeal phase
- Factual matrix potentially unsound in the case of final appeals (in addition to constraints on appealing input methodologies in this setting)



Input Methodology Appeal Problem

- What level of detail will input methodologies contain?
- ELBs have only 20 days to assess whether they fully understand the potential application of input methodologies and whether their understanding is the same as the regulators
- Uncertainty will potentially result in the appeal of each and every input methodology in 2010

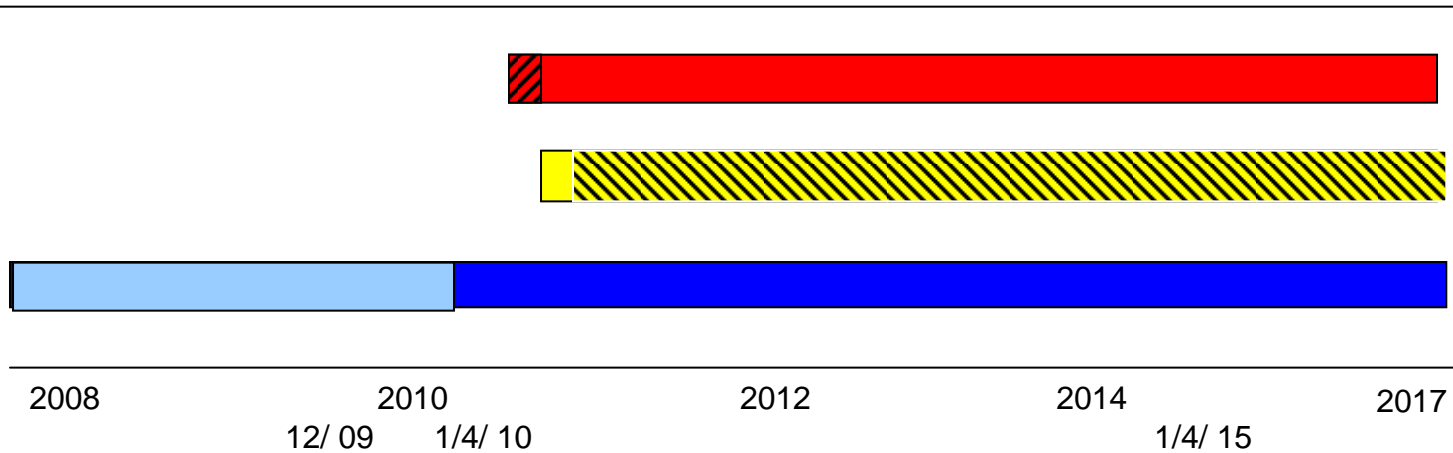
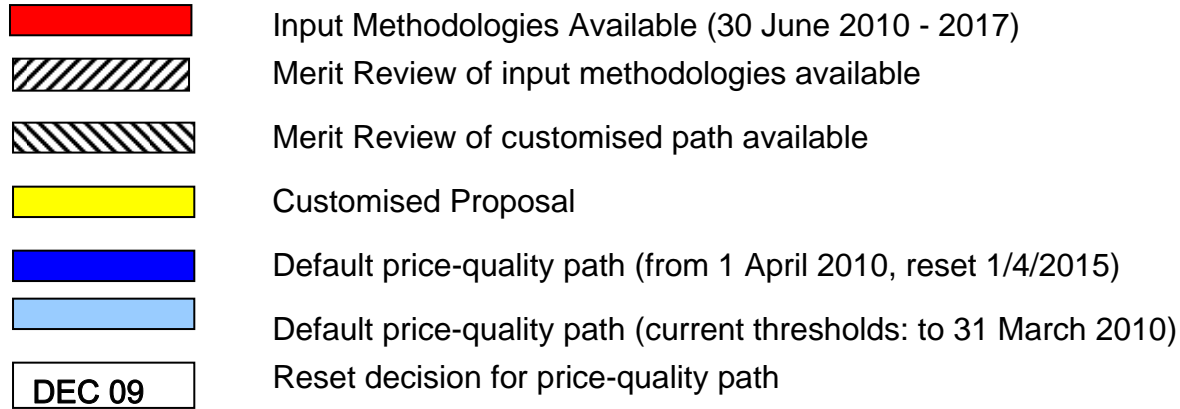


Potential Problems with the Factual Matrix for Final Appeals

1. Input methodologies to be set June 2010 (and there may be an appeal of these, based on the facts applying at 2010)
2. Next reset of default price-quality path in 2015
3. Assume an application for a customised proposal in 2015 and a decision on this in 2016, with an appeal in 2016
4. The appeal in 2016 cannot reopen the 2010 input methodology decision
5. Therefore all relevant facts applying to input methodologies from 2010 to 2016 cannot be taken into account



Summary of Time Lines



Particular Issue 1: Certainty

- The purpose is to (52R) promote *certainty* regarding rules, rule requirements etc and (52T(2)) *in sufficient detail such that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier.*
- Certainty would have been enhanced by providing, as Australia does (Ch 6, National Electricity Rules), that among input methodologies is that the supplier not be regulated in such a way that its credit rating slip below some level “BBB+” due to this regulation.
- Certainty will be affected by the definition of methodologies and their balance with implementation: regulation is not mechanical



Particular Issue 2: how do input methodologies differ from implementation?

(WACC 1)

1. The regulatory rate of return is determined by a) the WACC and b) adjustments for business and regulatory risk (affected by the form of regulation)
2. The WACC is determined by theory and unobserved components
 1. That have intrinsic volatility; and
 2. That are guessed with estimates that have much variation



Particular Issue 2: how do input methodologies differ from implementation? (WACC 2)

3. For the WACC and the regulatory return the same theory and data yield a wide distribution
4. A choice of number within some range,
a ————— b
5. To impart any certainty the location has to be known and so location in the distribution is part of the methodology .
6. Data to populate the model need not be known but its construction and estimation techniques must be so specified.



Particular Issue 2: how do input methodologies differ from implementation?

(WACC 3)

7. Thus, implementation and methodology in essence the same, in which case appeals should apply to methodologies in appeals of final determinations
8. A gap between implementation and methodologies opens up scope for the Commission in regulation and expands areas of appeal in final determinations



Particular Issue 2: how do input methodologies differ from implementation?

(WACC 4)

9. The WACC may seem the simplest methodology to settle because it (seemingly) has a settled formula but it is taking some some 4 years to implement the development of a WACC methodology
10. The best way to test a methodology is to implement it and explore its implications: but this won't generally be possible for lines companies as there is 20 days to appeal methodology developed by the end of 2009 that may not be applied for a long period



Particular Issue 3: transfers or efficiency?

1. As mentioned, the proposals do not more strongly suggest that efficiency be the criterion
2. Investigations (52T(2)b) provides that distributional considerations are seemingly given equal weight with efficiency, and (52I(3)) that every effort be made to quantify both.
3. The Revised Act does call (52T(3)) for the methodologies to not unduly inhibit investment (which seemingly envisages some inhibition of investment)
4. lists “quality” factors that regulation should not inhibit: including energy efficiency (54Q).



Particular Issue 4: exemptions

1. The exemption for small cooperatively owned lines companies is reasonable since there is no market power issue here: but information disclosure applies
2. Amalgamations will be limited to an extent by the threshold of 150,000 ICPs
3. Essentially the same arguments as for cooperative companies applies to municipally-owned lines companies: the only difference is that profit may be returned via reduced local taxes and dollars for projects: such profit may well be a relatively efficient tax
4. Provides that 15%-20% of consumers (of some sort (54H)) may instigate a Commission regulation enquiry
 1. What form of regulation would it be with no market power problem?
 2. The threshold may be low enough for interest group pressures to effect regulation



In Broad Terms

1. The revision arose largely because of implementation problems
2. The proposal is, socially desirably, more selective regulation, and appeal rights
3. The revision is detailed and
 1. There are timing issues
 2. The objective is no clearer
 3. Certainty of the regulatory rules will depend upon the specification of workable methodologies and their relationship to implementation
4. Implementation remains the key to a lively productive lines sector

