

Regulatory Alert

3 July 2009

Promoting investment under Part 4 of the Commerce Act – Still just a pipe dream?

Part 4 of the Commerce Act 1986 (“Act”) was rewritten last year to promote investment. On 19 June 2009 the Commerce Commission (“Commission”) took the first major step towards implementing the new regime by releasing its Input Methodologies Discussion Paper (“Discussion Paper”) and a raft of supporting papers.¹ This Alert considers whether there are any signs that the new Part 4 will change the Commission’s approach to regulating natural monopolies, such that the underlying intent of the new Part 4 might be achieved.

The purpose of Part 4 and the role of input methodologies

When the Commerce Amendment Bill (“Bill”) implementing the new Part 4 to regulate natural monopolies was introduced in March 2008, Hon Lianne Dalziel and Hon David Parker (then Ministers of Commerce and Energy respectively) stated that:

The Bill introduces a purpose statement specifically for this section of the Act to give clearer guidance to the Courts and the regulator that the aim of regulation is to promote investment.²

When the Bill was passed in September 2008, Hon Lianne Dalziel said that:

Infrastructure businesses will have more incentives to innovate and invest in their future growth under [the Bill]...

The passing of this Bill is excellent news for the growth and improvement of New Zealand infrastructure businesses that are natural monopolies. It will provide greater certainty for regulated businesses and incentives for investing in infrastructure while giving consumers protection from excessive prices and poor quality...

This is another important step in the government’s ongoing efforts to foster investment in innovation and infrastructure that will help our businesses grow and improve productivity.³

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Providing certainty on regulatory rules is a key way of promoting investment. Input methodologies therefore became a prominent part of the reform process: these require the Commission to set upfront regulatory rules, requirements and processes applying to the regulation, or proposed regulation, of goods or services under Part 4.

Further requirements to promote certainty include that the Commission must give interested parties a reasonable opportunity to give their views on any proposed input methodology, including on any material changes to an existing input methodology, and that once set, these methodologies must be applied by the Commission. These requirements taken together should ensure that the Commission cannot easily change its position on matters that are essential to regulated suppliers’ returns.

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Can the Commission let go of the past?

The Discussion Paper outlines the Commission's preliminary views on input methodologies for regulated electricity lines, gas pipelines and specified airport services. From reading the Discussion Paper, regulated suppliers could be excused for thinking that the Commission has formed the view that the Part 4 reform objectives will be achieved by the mere fact of setting input methodologies, albeit as clearly and unambiguously as possible. The Commission's proposed approach to a number of the key 'inputs' for relevant regulatory instruments appears substantially the same as its approach prior to Part 4 being rewritten.

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The Commission's general approach to asset valuation is to take a valuation from some years prior to the starting date for regulation and then roll it forward to the start of the regulatory period. Subsequent revaluation gains closer to the starting date for regulation are not allowed to be included in the asset base unless they have been treated as income. The Commission's rationale is that including gains in the regulated asset base would create windfall profits.

The contrary argument is that this amounts to retrospective regulation, as the Commission is effectively penalising companies for their pricing practices prior to the commencement of regulation. The new Part 4 includes a new section 53P(4), which states that when resetting starting prices under a default price path the Commission must not seek to recover any excessive profits made during any earlier period.

The Commission has not been discouraged by the spirit of this provision and is continuing with this general approach to asset valuation for all entities regulated under the new Part 4. This will no doubt be a key focus of submissions.

At the risk of over-simplification in a complex area, it is difficult to see how the balance of regulation under Part

4 can be materially shifted towards the promotion of investment unless the Commission softens its resistance to regulated companies earning normal returns on the most recent valuations of their assets.

The cost of capital is the other critical input methodology for investment. The Commission has acknowledged that the global financial crisis is an important consideration for various cost of capital parameters (ie debt premium) and is open to receiving evidence on its impact. The real concern to investors is how the longer term impact of the crisis on the cost of capital is taken into account when making regulatory decisions now. However, it will be a difficult task for potential investors to establish the precise impact of the crisis on long term investor expectations. Further, the Commission appears to be treating this as a short term volatility issue, that can be accommodated by periodic adjustments to the cost of capital throughout the regulatory period (presumably based on available data). Such an incremental approach appears out of step with trying to accommodate the fundamental ongoing financial uncertainty facing investors, and therefore risks failing to provide real investment incentives in a difficult financial market.

Key strategic considerations for submissions

Implications of merits review

The inclusion of merits review was one of the most contentious issues during the reform process. Ministers and officials were finally persuaded that it provided an important accountability mechanism and could improve the quality of regulation.

To allay concerns about regulatory gaming, there is a prohibition in section 52ZA of the Act on producing any new evidence to the Court (usually, the High Court has the discretion to allow the introduction of new evidence). This means that parties can only rely on evidence submitted during the consultation on input methodologies. Therefore it is imperative that throughout the consultation process parties make their best arguments to the Commission on the proposed input methodologies, supported by evidence, bearing in mind that the Court can only amend or replace an input methodology if it is "materially better" at achieving the purpose of Part 4 and/or the purpose of input methodologies.

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Scope of input methodologies

The Discussion Paper raises questions as to the scope of input methodologies. Under section 52T, input methodologies are not defined exhaustively. The Commission rightly considers that input methodologies are not intended to cover every aspect of regulation, and that some requirements will be left to the determination imposing regulation. For example, although quality standards are not precluded from being an input methodology, they are not explicitly included. However they must be included as part of any section 52P determination relating to price-quality regulation.

The Commission has asked for parties' views on what matters should be covered as part of an input methodology determination, or whether they could be included in a section 52P determination for information disclosure or price-quality regulation. The key distinction appears to be that input methodologies can be appealed, and a section 52P determination by the Commission cannot. Also, the consultation process for input methodologies is expressly set out in the Act, which must be followed if a material change is made. The Commission is also expressly bound to apply an input methodology, whereas determinations apply to the regulated entity only.

Way forward

Submissions on the Discussion Paper are due on 31 July 2009 (submissions on the Reset Paper are due on 17 July). There is a great deal of complex material that must be digested and responded to in a very tight timeframe, at a critical junction of the regulatory process. This is concerning if it comes at the expense of quality regulation.

Nevertheless there is a long way to go. Submissions on the Discussion Paper will be followed by cross submissions and a conference (expected to be held in September). This will be followed by consultation papers on specific topics for some or all of the regulated sectors. The Commission will then release draft input methodology determinations early in 2010, followed by further submissions and cross-submissions, and workshops as required. Final Input Methodology Determinations are required by 30 June 2010 (unless the Minister extends the deadline up to six months).

It appears that regulated companies will need all of that time to convince the Commission that the reform of Part 4 was designed to achieve a change in substantive regulatory outcomes in favour of investment.

CONTRIBUTED BY CRAIG SHRIVE, CATHERINE MARKS AND TESS BRIDGMAN

1. *The Revised Draft Guidelines: The Commerce Commission's Approach to estimating the Cost of Capital*. This includes a consultant report entitled *Recommendations to the New Zealand Commerce Commission on an Appropriate Cost of Capital Methodology*.
The Transpower Process and Recommendation Discussion Paper. This paper outlines the Commission's preliminary views on its options for the price-quality regulation of Transpower. Before the expiry of the administrative settlement between Transpower and the Commission on 30 June 2011, the Commission is required to recommend to the Minister of Commerce the type of price-quality regulation that should apply.
The Reset of Default Price-Quality Path for Electricity Distribution Businesses Discussion Paper ("Reset Paper"). This paper sets out the Commission's preliminary views on how the default price-quality paths that apply to suppliers of electricity lines services (other than Transpower) should be reset. It builds on two papers previously released by the Commission and the submissions to those papers. It has two associated consultant reports prepared by Economic Insights Pty Ltd: *Asset valuation and productivity-based regulation taking account of sunk costs and financial capital maintenance* and *The theory of network regulation in the presence of sunk costs*.
2. "Bill give better incentives for infrastructure investment", Media Statement, 13 March 2008.
3. "Infrastructure investment gets boost from law changes", Media Statement, 5 September 2008.

REGULATORY CONTACTS:

Andrew Peterson

Partner, Auckland
andrew.peterson@russellmcveagh.com
DDI: + 64 9 367 8315
Mobile: +64 (0) 27 560 5021

Derek Johnston

Partner, Wellington
derek.johnston@russellmcveagh.com
DDI: + 64 4 819 7535
Mobile: +64 (0) 27 446 6848

David Clarke

Partner, Wellington
david.clarke@russellmcveagh.com
DDI: + 64 4 819 7516
Mobile: +64 (0) 27 244 5658

Sarah Keene

Partner, Auckland
sarah.keene@russellmcveagh.com
DDI: + 64 9 367 8133
Mobile: +64 (0) 27 535 5034

Pat Bowler

Partner, Wellington
pat.bowler@russellmcveagh.com
DDI: + 64 4 819 7500
Mobile: +64 (0) 27 442 8040

Tim Clarke

Partner, Wellington
tim.clarke@russellmcveagh.com
DDI: + 64 4 819 7532
Mobile: +64 (0) 27 224 5843

Craig Shrive

Associate, Auckland
craig.shrive@russellmcveagh.com
DDI: + 64 9 367 8855
Mobile: +64 (0) 27 599 6609

James Every-Palmer

Partner, Wellington
james.everypalmer@russellmcveagh.com
DDI: + 64 4 819 7370
Mobile: +64 (0) 27 580 1616

Nicola Purvis

Consultant, Wellington
nicola.purvis@russellmcveagh.com
DDI: + 64 4 819 7750
Mobile: +64 (0) 27 248 8012