MAJOR ELECTRICITY USERS' GROUP

17 June 2013

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

Dear Ministers

Improving productivity in the electricity sector

The members of the Major Electricity Users' Group (MEUG) are significant exporters or import substitution industries and large power users. Members use a quarter of New Zealand's electricity to produce goods and services adding in excess of $13 billion per annum to GDP.

Total electricity charges to all consumers are approximately $6 billion per annum. The electricity sector is characterised by oligopolistic competition and monopoly network services. The Electricity Authority primarily through the Electricity Industry Participation Code (the "Code") governs and facilitates competition in spot, ancillary services, wholesale contract and retail markets that comprise ⅔ of sector costs. The remaining ⅓ of supply costs are monopoly services regulated by the Commerce Commission under Part 4 of the Commerce Act. Every 1% improvement in the efficiency of the supply chain is worth $60 million per annum.

In April we briefed the Minister of Energy and Resources, Hon Simon Bridges, on policy issues and areas that we consider have significant potential for improvements. A copy of that briefing note is attached. We also undertook to write to Ministers on matters outside Mr Bridges portfolio. Hence this letter with a focus on broader policy issues currently not within the detailed work of the regulators.

The greatest opportunity for consumers in the near term is to improve competition at all levels. This work is within the scope of the Electricity Authority and the emphasis should be not to ease up on pro-competitive changes. The greatest risk to near term power prices are increasing monopoly charges. This risk is almost a forgotten policy issue.

To mitigate the harm to consumers from increasing monopoly charges we suggest:

- Making it clear that Part 4 of the Commerce Act regulating line monopolies will be improved promptly if experience now shows that it has been exploited or has otherwise been gamed or rendered ineffective;

- Urgently developing a policy that would allow MEUG to participate in any appeal process for the merit review of Input Methodologies by removing the risk of court awarded costs;

- Reviewing how to improve consumer participation in the electricity sector regulatory decision making by the Commerce Commission and Electricity Authority; and

- Making it plain that Ministers are considering the circumstances under which the government would write-down uneconomic investments of Transpower.

You will notice that all these recommendations would send messages to the regulated industry participants, to affect behaviour now. It appears to MEUG that the monopolies rationally game the regulatory processes, calculating their risks and potential returns from delay, from tactical use of litigation, relying on the inertia in existing settings including the political costs to the Government and to regulatory bodies of responding to contentious experience. In short we urge that the Government introduce a balancing factor into their calculations, to discourage 'ruthless' gaming of design deficiencies and safeguard provisions.

The threat of tougher regulation has always been a factor of effective light-handed regulation. We think that it may have been overlooked that elements of light-handed regulation remain, after merit review provisions were introduced as a safeguard in the price control regime. MEUG hopes that a reminder to monopolies that their conduct will determine the future of that regime will be salutary.

Greatest opportunity is improved competition

The Electricity Authority has a widespread and detailed work programme to make pro-competitive changes to the Code and facilitate non-Code activities that improve choice for consumers and opportunities for innovation by suppliers. We support that work.

The ASX New Zealand electricity futures curve has been stable for several months with most recent trades reflecting a flat nominal price of approximately $72/MWh at Otahuhu on an annualised basis to end of 2016[1]. This is approximately the same as the Electricity Authority estimate of the wholesale price component of an average household power bill for year ending March 2010[2]. If retail competition continues to improve and all else equal (including future wholesale prices reflecting current expectations) then retail margins should decrease.

If despite a flat or falling futures curve retail margins remain unchanged or even increase over the next two to three years, then other policy options should be considered. In increasing order of severity of intervention, options would include:

- Making it clear that the recent government investment in raising consumer consciousness of price competition will be maintained and even increased, so retailers cannot assume that there will be a return to any steady state from which to recoup high costs;

- Requiring publication of separate energy and line components on all power bills. The Electricity Authority is currently considering this option[3];

- Disclosure of separate generation and retailing accounts by vertically integrated businesses; and

[1] As at 7 June 2013

[2] EA, Breakdown of a typical bill, March 2013, using data to March 2010, refer http://www.ea.govt.nz/dmsdocument/13295 The EA is currently updating this analysis.

[3] It may be optimal to adopt this option now rather than consider if retail competition improves. We are waiting for the Electricity Authority's consultation paper before taking a view on this.

- Legislated separation of generation and retailing businesses.

It may also be prudent to have a planned review of the effectiveness of the competitive part of the sector from the 2009/10 reforms. In submissions to the 2009 Ministerial review MEUG suggested a review five years after the package of reforms was introduced[4]. This was not taken up in the final report of the Ministerial Review.

It appears to MEUG that such a review could show success in much of that package, particularly considering the lack of 'rationing' and the performance of generation and the wholesale market over the dry period just ended.

Greatest risk is increasing line charges

Distribution charges are likely to increase by at least CPI over the next few years. However, Transpower's charges (which flow into every consumer's bill) will rise at a significantly higher rate. The Commerce Commission and Electricity Authority have many work streams to facilitate productivity improvements by the monopolies and for those improvements to flow through to lower than otherwise line charges for consumers. This is all useful work.

However efficient outcomes and balance between the interests of consumers and monopoly suppliers are, in our view, being undermined by key aspects of Part 4 of the Commerce Act and its implementation.

Without change there is a risk that delivered power prices will continue to rise because savings in the increasingly competitive parts of the sector are more than offset by higher monopoly charges. Changes to key policy levers as suggested below are likely to moderate the effect of increasing monopoly charges.

Compounding this risk is flat and in some cases decreasing demand for electricity both in energy volumes over a year and at peak demand times. In some cases fewer end customers have to meet increasing real line charges thus compounding the effect on final prices. Because the price control regime effectively allows the recovery of deemed cost, as some customers find ways to minimise their usage and charges, the others must pick up a disproportionately increasing share. That will multiply the effect of increases in charges. We think this trend will continue as customers with shrinking disposable household income or thinning profit margins look to squeeze out avoidable costs. The change in focus for most businesses on "squeezing existing assets" since the 2008/09 GFC has not abated.

Customer minimisation of line charges and the consequent reduction in transmission and distribution line usage is becoming increasingly possible with new technology meters, better pricing signals, and opportunities for demand side response and or household or business onsite generation. Onsite generation is often termed distributed generation (DG) as it is not directly grid connected and includes micro DG such as household solar photovoltaic's (PV) through to large industrial DG integrated into manufacturing processes (co-generation). These developments are on the cusp of changing electricity markets worldwide.

[4] MEUG to Electricity Technical Advisory Group and Ministry of Economic Development, 16 September 2009 (http://www.meug.co.nz/includes/download.aspx?ID=105548), paragraph 6. F) MEUG "Proposes that a sunset review policy be enacted requiring MED and EMA to review within 5 years the effectiveness on improving competition and management of dry-year risk of the policies introduced as a result of this Ministerial review. This Ministerial Review should have taken place after the second dry-year scare in 2003. We cannot afford to have a repeat of the situation where policy makers are reluctant to acknowledge or allow a review of policies that prove to have been poor decisions. A more realistic approach is needed. Electricity markets are complex and unintended consequences can happen. A legislated requirement for a review in 5 years will provide an opportunity to decide if more radical structural options are needed such as separation of vertically integrated suppliers or mandatory hedging requirements."

For example South Australia had a reported "127 MW of installed grid-connected solar systems" as at the end of August 2011[5]. This is a significant source of electricity. For comparison this installed grid-connected PV supply in South Australia is larger than the recently opened McKee 100 MW gas fired power station in Taranaki[6]. We do not support the policies the South Australian Government is using to push PV into the market because it requires subsidies, adds costs to electricity users' and destabilises the market for PV equipment suppliers as interventions change. Nevertheless; the economies of scale and cost of the technology are bringing closer the point when that trend could accelerate without interventions.

Overview of Part 4 of the Commerce Act enacted in 2008

All electricity and gas monopolies are subject to information disclosure regulation. Non-customer owned and larger distributors are also subject to Default Price-Quality Path (DPP) regulation. Should that generic low cost regulation not suit their circumstances they can apply for Customised Price-Quality Path (CPP) regulation. Transpower is subject to the most tailored regulation called Individual Price-Quality Path (IPP) regulation. Information disclosure, DPP, CPP and IPP are based on Input Methodologies specifying common parameters such as regulated asset base, cost of capital etc. The Input Methodologies were expected to be long lived and revised no later than every seven years. DPP, CPP and IPP are re-determined no later than every five years.

This hierarchy of increasing regulatory prescription depending on size and ownership of each monopoly was a key feature of the Part 4 changes enacted in 2008. The changes had bi-partisan support in the House. MEUG supported this shift from the prior very light-handed regulatory regime rather than having standard OCED heavy handed regulation for all. We still believe being at the lighter end of the OECD regulatory spectrum is best for New Zealand given the relatively small size of most of the 29 electricity distributors relative to other OECD country line monopolies and that most of the small distributors are community owned[7].

Need for clear indications of intention to review Part 4 of the Commerce Act

Other aspects of Part 4 were also novel and in our view have proven deficient. The new merit review provisions, whereby parties can appeal to the High Court for a merit review of Commerce Commission decisions on Input Methodologies, were enacted in response to widespread urging from regulated businesses, their lawyers and other advisors. Part 4 was supposed to increase regulatory certainty, with prescribed iterative consultative processes to improve the quality of the prescriptions that are unavoidable under price regulation. The resulting rules were supposed to create incentives and freedoms for monopolies that were more similar to those under competition, than before. Merit review was the capstone of the quality control incentives for the Commission.

The processes included some safeguards against gaming by monopolies[8], but they have proven to be ineffective[9]. The consequence is prolonged uncertainty, and enormous process costs for the Commission as well as the parties.

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[5] Government of South Australia, Renewable Energy Plan for South Australia, 19 October 2011, p10, http://www.renewablessa.sa.gov.au/files/111019-renewable-energy-plan-for-south-australia.pdf found at http://www.renewablessa.sa.gov.au/about-us/publications-and-reports

[6] Todd Corporation media release, Prime Minister opens Nova Energy McKee Power Plant, 21 March 2013, (http://www.toddcorporation.com/content/prime-minister-opens-nova-energy-mckee-power-plant)

[7] There is a wider policy issue of whether 29 distributors for a country the size of New Zealand is efficient when for example the UK has 14 distribution network operators (http://www.ofgem.gov.uk/Networks/ElecDist/Pages/ElecDist.aspx). MEUG notes the question of the productivity and efficiency of having 29 distributors is a longer term policy issue to be considered once more data from the Information Disclosure regime is available in future years.

[8] Input Methodologies determined by the Commission apply while appeal processes run and claw-back provisions reduce any benefits to monopolies of protracting the process of finalising the methodologies.

The Commission announced its decisions on the Input Methodologies in December 2010, after a two year process of consultation and exposure drafts. Various parties including MEUG lodged merit review claims in February 2011. Procedural jostling and demands on court time meant that 2011 saw no substantive consideration of the appeals. Eventually the High Court heard claims last quarter 2012 and concluded hearings this year. The High Court decision is still awaited. The Act allows appeals on questions of law to the Court of Appeal and, with leave, to the Supreme Court. It is widely anticipated that the High Court decision will be appealed regardless of the outcome.

We think merit review in principle is needed as a check on Input Methodology decisions by the Commerce Commission but how it is implemented needs re-assessing. That view has been formed from the following observations:

- Appeals are likely to mean that the actual cost of the monopolies' services since 2010 will not be known to users until well past the half-way point of the 7 years for which they are supposed to be fixed. Indeed, if our lawyers' more pessimistic predictions are correct, the consultation for the review and update for the second 7 year period could be underway before all first period appeals are concluded.

- The Rules Committee of the judiciary declined the invitation of Ministers to design rules of procedure suitable for the novel role given to the Court for merit review. In effect the Court steps into the shoes of the Commerce Commission with power to rewrite the methodologies under appeal. That is the role of a subordinate legislator. In the absence of rules suitable for a legislative process, the appeals were conducted largely as for a 'normal' hearing of a dispute of rights under our adversarial system, where the Court is merely the umpire. The Court only slowly and partially dispensed with unsuitable disputes of rights procedures, where evidence is tested for its probative value under rules designed to discard unreliable 'facts' about past events. Theoretically a correct version can be ascertained and all others are then "not true".

  Legislative processes generally seek as much information as possible within time and resource constraints that might assist in predicting the future (the effect of the rules). They are focussed on the future, not 'facts' from the past. The primary goal is to minimise unintended consequences. All information is 'admissible' and taken into account, but the legislators' discretion weighs it for predictive and explanatory value, knowing explicitly that there is no possibility of an absolute true or false answer. And legislative processes are iterative. Rule-makers know they will have to revisit their work and refine and amend it over time. Accordingly perfection is neither sought nor expected.

  That contrasts with the deep culture of the courts, where resources and time consumed in reaching decisions come second or are deemed irrelevant, where they conflict with reaching the 'right' answer.

  At length some hybrid features have emerged in the current Court merit review. However, all departures from the inappropriate norms familiar to the Court raise the appeal risk. The Court has recognised uncertainly that it is exercising a legislative or rule-writing function and that some of the rules (including the natural justice requirements which lawyers use to trump cost and time constraints) should accordingly have less force[10].

[9] Both mechanisms have been less complete than MEUG thinks was expected by the designers of the scheme. And the safeguards have not neutralised the incentives for monopolies to try to exhaust the regulators and consumer interests with tactical appeals and objections.

[10] *Wellington International Airport Ltd & others* v *Commerce Commission,* Wellington HC CIV 2011 485 1031, Clifford J, 22 December 2011 at paragraphs [90] to [99]

The process should have been explicitly interrogative or inquisitorial. The Court should have heard from the parties' lawyers only briefly in support of succinct written explanations of the grounds of appeal, and statements from the parties showing what they think would have been the best framing of the Input Methodologies. The Court should have been able to set strict timetables for representatives to appear before the Court to answer the Court's questions on the propositions before them on the papers. The parties should have also made available their experts who should have been 'hot-tubbed' for the benefit of the Court. The relevant provisions of the Commerce Act did not permit that.

The question whether the Court has power to alter parts of a determination may not be determinative in the current review. The Court may decide that the risks of recommending a material change to any methodology are just too great without a chance to test it with the parties and their experts for unintended implications. A methodology is like a complex crossword, the application of multiple algebraic formulae, and assumptions both explicit and implicit. Some factor changes could be made safely, such as varying a reference range, or a rate in a formula, but adopting some of the more structural changes urged on the Court could be at risk of making nonsense of parts it does not intend to change.

Our courts do not traditionally test decisions in draft with the parties, though there are some procedures for getting provisional indications of likely decisions (sentencing indications for example). The merit review tribunal should have been able to test its provisional findings with a draft version of the methodologies as altered together with any explanations that should guide future exercises. An exposure draft could invite written comment, followed by a further interrogative session when the Court could test with counsel their criticisms of and recommendations on the draft decision.

- The Court functions with a "closed record". That is, only evidence that was before the Commission could be considered by the Court. This rule was designed to stop the gaming of the Commission's preceding consultative process, with the keeping of evidence and the major argument for the Court appeal. But the result has been close to farce, as arcane propositions from cutting edge finance and economic theory were explored in excruciating slow motion by lawyers, without the benefit of expert submissions.

- MEUG was the only customer representative that lodged a merit review appeal on the electricity and gas Input Methodologies. Our claim was on a very narrow aspect of the cost of capital Input Methodology. Several monopolies and primarily Vector, Powerco and Transpower lodged multiple claims across several Input Methodologies. The monies at stake are material. For the merit review of cost of capital alone: based on Powerco's scenarios, if all the monopolists' original claims were successful, then line charges in aggregate will increase by $648 million per annum and if MEUG's best position is successful, they would decrease by $132 million per annum[11]; the estimated impact on an average household power bills is an increase of $385 per year if all of the monopolies' cost of capital claims are successful and a decrease of $78 per year if MEUG's best argument is

[11] MEUG memo "What's at stake" memo tabled with the High Court on 3 September 2012 as part of the merit review hearings using 75th percentile WACC estimates, refer http://www.meug.co.nz/includes/download.aspx?ID=123900. A copy of this memo is attached. Transpower started the court hearing claiming 90th percentile WACC but subsequently retracted that position. Before that retraction MEUG wrote to Transpower on 11th September 2012 copy to shareholding Ministers on the excessive nature of that claim, refer http://www.meug.co.nz/includes/download.aspx?ID=123971 . At 90th percentile MEUG estimate charges would have increased by approximately another $200m pa on the 75th percentile cases. Note one of MEUG's claims is that the 75th percentile assumption is incorrect and WACC should be calculated at the midpoint.

successful[12]. Even more substantial sums are at risk if distributors are successful in appeals against asset valuation Input Methodologies[13].

These are material exposures to customers that should lead to policy makers asking if the merit review process is working as expected. Note the Labour-Greens NZ Power proposal announced 18th April 2013 claimed savings of $300 per household per year. This has received much public attention whereas the risk, relative to the status quo, to household power bills increasing by $385 per household per year has not. Relative to MEUG's view of the cost of capital, the maximum risk to households of excessive line charges should monopolies win all their appeals, is $463 per household per year.

- MEUG urges that the regime recognise the importance of the well recognised 'framing effect' on decision-makers, including adjudicating tribunals. In brief, they tend to reach decisions within the range created by the opening parameters of claim by the contending parties. If MEUG had not participated, those parameters would have been the Commission's Input Methodologies at the bottom end, and the most extreme of the monopolies' claims at the other. The framing effect is addressed by the traditional role of the courts in an adversarial system. They are not expected to search themselves for superior solutions not advanced by the parties. Accordingly, without MEUG the merit review would be highly unlikely to have considered the merits of solutions less favourable to the monopolies than the position the Commission took. But that opening position of the Commission itself attempted to balance the Commission's own opening positions at the commencement of consultation, and that of the monopolies. It was significant that the Commission repeatedly acknowledged in the Input Methodology determinations that they were "generous' to the monopolies[14]

- Even without the asymmetry in the framing of the issues to the Court, the process favours the monopolies because they have deeper pockets than consumers.

  MEUG's participation in development of Input Methodologies and the High Court merit review has been costly. There have been three phases and three types of cost in each. The initial two year phase to December 2010 ended in Input Methodologies being determined. The second phase from February 2011 and ended first quarter this year was the High Court merit review process. The third phase conducted in parallel to the second comprised tactical judicial review proceedings initiated by Vector and Transpower, and a High Court decreed re-consideration of one aspect of Transpower's cost of capital in early 2012. In each phase MEUG incurred direct external advisory costs for legal and finance expertise, MEUG staff time and MEUG member management time. The external legal and consulting expertise for the two years ended 31st March 2013 alone cost in excess of

[12] MEUG memo "Impact on households" tabled with the High Court as part of the merit review on 3 September 2012, refer http://www.meug.co.nz/includes/download.aspx?ID=123899. A copy of this memo is attached.

[13] MEUG supported the Commerce Commission Input Methodology on asset valuations and hence we did not participate to any great extent in those High Court hearings. Had we wanted to take a contrary view it is unlikely we would have had the resources to participate in both the limited scope of appeal on cost of capital we undertook and asset valuation Input Methodology.

[14] Reinforced by the just released expert commentary of Prof. Yarrow for the Commission on Orion's application for a customised price-quality path (refer http://www.comcom.govt.nz/assets/Electricity/Customised-Price-Quality-Paths/Orion-CPP/Yarrow-review-of-claw-back-issues-Orion-CPP-30-May-2013.pdf). In discussing the WACC set out in Input Methodologies (IM) he says(p16) "... it might be argued that, whilst the practice is common, the degree of 'aiming off' in NZ lies at the generous end of the spectrum of international practice ...". This reinforces the position in MEUG's merit review claim that the IM WACC is too high.

$600,000[15]. If MEUG's in-house opportunity cost of staff time and MEUG members' management costs were included at least another $100,000 of costs would have been incurred. This does not include external expertise and indirect costs over 2009 and 2010 when Input Methodologies were being populated. And we have yet to see the High Court decision and in all likelihood the prospect of an appeal round on those judgements.

It is not clear that faced with a similar situation in the future that MEUG members would be willing to commit such resources. Member representatives individually have to justify expenditure in their budgets to managers who correctly note that all consumers are free-riding on that effort. They cannot show conclusively that benefits from maintaining or improving the integrity of Commerce Commission positions will proportionately flow through to members.

Monopolies are different as their interests in the outcome are more concentrated. We believe the monopolies have spent tens of millions of dollars advocating their position[16] and pursuing their litigation strategy. That is rational for them, because there is no doubt that they will benefit if they win.

- Another process impediment to effective customer participation is the risk of court awarded costs. This risk becomes acute if, as is expected, the monopolies appeal the High Court merit review decision no matter what the outcome. Because the incentives are highly asymmetric, it is unlikely that the directors of a monopoly could be criticised in duty terms for appealing. The incentives are asymmetric because the traditional approach of the New Zealand Courts in effect allows the appellants to "bank" their gains in a determination, and put at risk only the gains they hope to make from the process. New Zealand Court practice (with the general passivity of the judges in an adversarial system) makes it highly unlikely that the final outcome will contain an element of deterrent (or compensation) for cherry picking or tactical behaviour. By way of contrast, the UK Competition Appeal Tribunal unapologetically exposes appellants to the risk that any part of a determination might be adjusted. That prospect generally renders it unprofitable to use the process tactically. There is a view that the Tribunal actively uses its discretion to discourage flimsy or exaggerated claims.

- The monopolies' claims sought to cherry pick the Commission's Input Methodologies. If all aspects of a Determination are open, without limitation to the aspects put in issue by the parties, an appeal by a monopoly is a much less one-way gamble. The advice to MEUG is that all aspects are open for change in merit review, on the logic of the relevant Commerce Act provisions, but that position would likely be opposed by the monopolies, and perhaps by the Commission. If the High Court in the current process makes substantial changes in Determinations, the question of its power to deal with issues not argued by the parties will become a matter of further appeal. The Commission and the parties generally will probably want to study the first High Court merit review decision before deciding whether to support an open jurisdiction.

- MEUG will be reluctant to participate in further appeals without an assurance that we will not face court costs against us if we lose. We see our advocacy as having been strongly in the public interest. We would be prepared to take a costs award risk if we were

[15] The cost may have been up to another $300k higher if MEUG had not secured a fixed price arrangement for part of the external advice. The trade-off for that fixed price arrangement however was it limited the range of MEUG's challenge in the merit review proceedings.

[16] Vector reported "regulation costs Vector running at least $17 million a year", refer 2012 Annual Meeting, Presentation by Chairman Michael Stiassny and CEO Simon Mackenzie, 18-Oct-12, slide 25 found at http://www.vector.co.nz/corporate/investor-relations/presentation.

irresponsible or advanced positions that were plainly meritless, or for public/political consumption only. Similarly, if our advocacy prolonged proceedings unreasonably we could see some cost risk as being salutary. But we are confident that the Commission would confirm to you that our involvement has been constructive, and indeed perhaps vital to securing the balance and quality of challenge that the Court needed. We think there is a small risk of court costs being awarded against us in the current merit review by the High Court. We remain exposed to a decision that the Commerce Commission will seek costs as a matter of rigid policy, for fear of being seen to accede to a precedent that could later be used to its disadvantage by monopoly opponents. We are also exposed to the monopolies seeking cost awards.

- We ask Ministers, in particular the Minister of Commerce, to engage with us as a matter of urgency, to develop a policy that would enable us to be indemnified by the Ministry of Commerce in respect of an appeal in which we could represent the consumer interest. In 2010 during consultation we asked Ministers for expert economist or financial analyst support for the consumer side. We pointed to government practice in Australia in similar matters, and to the active role played in regulatory matters by Treasury, the Reserve Bank and others with economic expertise in the past. In the result there was no such input into the Determination process, so that we were left almost alone to secure some consumer balance and quality of the representations before the Commission.
- There is no pre-eminent merit review process worldwide of which we are aware. There is continual evolution of competition law processes and criteria. Merit review needs to be tailored to each country's specific regulatory environment. Improvements need to be made when regimes are found wanting.

Merit review is one aspect of Part 4

At a broader perspective Part 4 was enacted in 2008 just as the world and New Zealand was in an optimistic expectation of continuing GDP growth phase. Real and perceived barriers to building infrastructure were dismissed. In that environment the changes to Part 4 were drafted and have been implemented with a bias favouring development and certainty to monopoly suppliers. The world has changed as a result of the 2008-09 Global Financial Crisis (GFC) and with it views on GPD growth, need for large electricity and gas infrastructure developments and a focus on value for money now rather than nebulous future benefits.

How can consumer participation in Code and monopoly regulation be improved?

The merit review process highlights the resource asymmetry between customers and monopolies in participating in important regulatory setting processes. This is not a new problem though, with all classes of customer struggling to keep abreast of and contribute effectively to the minutiae of developing and revising determinations by the Commerce Commission and Code changes by the Electricity Authority.

A well resourced, independent and innovative regulator is necessary to balance the interests of customers with the interests advocated by the well resourced and highly motivated monopolies. For regulators to understand customer needs various techniques can be used including surveys, presentations with Q&A sessions and site visits. Most helpful are written and expert countervailing views to the monopoly positions. It is this expert countervailing view that is largely missing from consultation on Part 4 and Code changes apart from MEUG's participation. MEUG is focussed on the wholesale and transmission parts of the supply chain leaving a gap in expert customer countervailing views on retail and distribution issues. MEUG's coverage of wholesale and transmission and generic monopoly regulatory issues (eg cost of capital) is also paper thin and levels of commitment to the extent we have pursued the merit review are unlikely to be repeated as noted above.

Without more direct customer participation at all levels the risk is that uncertainty because of a lack of understanding will undermine confidence by some or all customers in the performance of the regulators. MEUG therefore recommends Ministers direct officials to consider options to improve more direct consumer participation in implementation and changes to Part 4 regulation and the Code. Options need to be carefully considered to avoid unintended consequences. For example in Australia a contestable fund was established for customer advocacy with funding by way of a levy on all consumers. This resulted in the capture of a large proportion of the funds by narrowly focussed lobby groups with objectives that did not necessarily support general electricity consumer interests or improve sector productivity.

We ask that you let us know promptly if there is a government view that it is constitutionally obliged to be neutral before the Commission or a court in a merit review process, and if so, any reasons. We would want to offer more submissions on that question because it is not supported by practice of many years standing, here, and in other similar jurisdictions. MEUG is advised that it is not supported by constitutional law or convention either. A Minister should not be prevented from assisting consumer parties in competition law processes where they consider there to be public policy merit in doing so. Redressing imbalance in the information and research resource employed to ensure high quality rule writing and review process should also qualify.

We suggest a simple and pragmatic balancing mechanism, as an interim solution that could become permanent. It would involve the Ministry of Business, Innovation and Employment ensuring that it had a fully informed view on the matters in contention, but itself undertaking research, or engaging experts for the purpose, and making their work available for consumer representatives like MEUG, to draw on, in productive consultation. It has the advantage of ensuring that other arrangements are not hijacked for purposes unrelated to improving the quality of the process.

A policy to decide when a write-down of uneconomic investments by Transpower is appropriate

There is another important policy question that Ministers should address; that is under what circumstances the Government should write-down clearly uneconomic investments made by prior or future Boards of Transpower? We note two relevant points for this question:

- In competitive markets it is economically welfare enhancing for assets to be written down at shareholders expense rather than to the account of customers. This happens automatically in markets and the regulatory regime for regulated monopolies should mimic that outcome.

- We disagree with any claims that uneconomic assets built by Transpower were approved by the regulator being the Electricity Commission prior to November 2010 and the Commerce Commission since. The role of the regulator is to advise which projects and at what maximum cost Transpower is allowed to charge customers and have the force of law to recover those charges. The ultimate decision to build or not, whether approved by the regulator for cost recovery through transmission charges or not, has always resided with the Transpower Board. Accountability for poor investment decisions should rest with the Transpower Board and predecessors Boards.

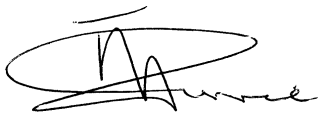
Analysis by the Electricity Authority has shown for example that the 400 kV capable North Island Grid Upgrade Plan (NIGUP) will cost consumers approximately $100 million per year but deliver benefits one tenth of that amount. The pros and cons of writing down the asset value of that line to reflect the benefit that accrues to consumers would send a strong message to Transpower to ensure they should be more concerned about future grid investments being over-built or built too early that will fall to the account of shareholders.

Concluding comments

MEUG is interested in good policy outcomes. That requires, amongst other things, an open and evidence based debate. Consistent with that approach MEUG would like to release this correspondence and the attachments soon after Ministers have received this letter.

We would welcome an opportunity to discuss these suggestions further. To arrange a meeting please contact Ralph Matthes, MEUG Executive Director.

Yours sincerely



Terrence Currie
Chair

Copy to:
Chair and Chief Executive of the Commerce Commission
Chair and Chief Executive of the Electricity Authority

Attachments:

- MEUG letter to Hon Simon Bridges, Minister of Energy and Resources, Congratulations and briefing on electricity policy, 5 April 2013
- MEUG memo to High Court, What's at stake?, 3 September 2012
- MEUG memo to High Court, Impact on households, 3 September 2012