

# Commerce Commission

## Energy Sector Regulation: Predictable improvements in a changing sector and why it matters

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- Commission overview
- Competition and the Commission
- WACC – why we are reviewing it
- Electricity and gas sector regulation
- Current work
- Emerging challenges



# Overview

## Commerce Commission

### Competition

#### Consumer

- Fair Trading
- Consumer Credit
- Product Safety

#### Competition

- Mergers and acquisitions
- Business competition



### Regulation

#### Electricity



#### Gas



#### Airports



#### Telco



#### Dairy



# What we seek to achieve

- We seek to achieve the following for New Zealanders:
  - Markets are more competitive and consumers' interests are protected
  - The performance of regulated suppliers and markets provides long-term benefits for consumers





# Competition

We enforce, and provide information and guidance on:

- the Fair Trading Act 1986
- the Credit Contracts and Consumer Finance Act 2003
- Part 2 of the Commerce Act 1986
  - **Cartels and unilateral conduct**
- Part 5 of the Commerce Act 1986
  - **Mergers and acquisitions**



# Regulation

We have responsibility under the:

- Commerce Act 1986 (Part 4)
  - Electricity lines, gas pipelines and airport services
- Telecommunications Act 2001
- Dairy Industry Restructuring Act 2001



# The benefits of competition

Competition is a key driver for delivering greater productivity and growth. Effective competition creates an incentive for firms to:

- Innovate
- Improve efficiency
- Produce products and services at a price and quality demanded by consumers

There are significant economic benefits from effective competition.



# Our impact

An effective competition agency and regulator helps to ensure:

- There is a level playing field for competitors. The rules are known and players are monitored
- Market power is not abused
- The level of competition in a market is not substantially lessened by amalgamation
- Prices are set by effective competition or regulation
- Consumers are protected
- Regulated businesses face incentives to perform, invest and provide long-term benefits for consumers





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# Regulating for competitive outcomes

- We know that competition drives desirable economic outcomes and behaviour when the rules are clear and fairly enforced
- Electricity lines and gas pipelines are natural monopolies
- By and large, natural monopolies don't compete
- But we still want the benefits that competition brings:
  - innovation
  - investment
  - price pressure
  - rewards for efficiency
  - improved quality



# Purpose of Part 4 of the Commerce Act

To promote the long-term benefit of consumers by promoting outcomes that are consistent with outcomes produced in workably competitive markets so that suppliers:

- have incentives to innovate and invest
- have incentives to improve efficiency and provide services at a quality that reflects consumer demands
- share efficiency gains, including through lower prices
- are limited in their ability to extract excessive profits



# Input methodologies

- To promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to regulation
  - Cost of capital (WACC)
  - Valuation of assets
  - Cost allocation
  - Treatment of tax
  - Pricing methodologies
  - Processes and rules

# WACC – why we are reviewing it

- Merits Reviews 2012 – 2013
  - all Input Methodologies
  - Appeals by regulated suppliers and consumer groups
  - High Court with lay members
- Court rejected all appeals in relation to WACC
- Commission had set the WACC Input Methodologies at the 75<sup>th</sup> percentile
- MEUG argued for 50<sup>th</sup> percentile



# WACC – why we are reviewing it

- Court made a number of comments
  - created uncertainty
- Consumer NZ, Employers and Manufacturers Association (Northern Inc) and MEUG

# WACC – why we are reviewing it



- Commission consulted on desirability of review
- Feedback polarised
- Regulated businesses strongly against the review

# WACC – why we are reviewing it

- Other parties submitted in favour of a review, eg, Fonterra, Carter Holt Harvey, Winstone Pulp International, Air New Zealand, Contact Energy.

# WACC – why we are reviewing it

*“Electricity and gas ... is our highest input cost after wood cost so the price paid for electricity and gas impacts on the company’s operating costs and hence ability to compete in the international market.*

*Since CHH Pulp & Paper is an export earning business for the New Zealand economy, it is essential to the viability of our operations that electricity is obtained at a fair and reasonable price.*

*... CHH Pulp & Paper supports an urgent amendment to the cost of capital input methodologies to change the specification from the 75<sup>th</sup> percentile to the mid-point.”*

- Carter Holt Harvey submission

# WACC – why we are reviewing it



- Still much debate in and around the process
- Final decision due at the end of this month



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# Regulated industries

- Electricity lines services
- Gas pipeline services
- Airport services
- Other – Part 4 inquiry
- Telecommunications
- Dairy

‘Part 4’ (Commerce Act 1986)



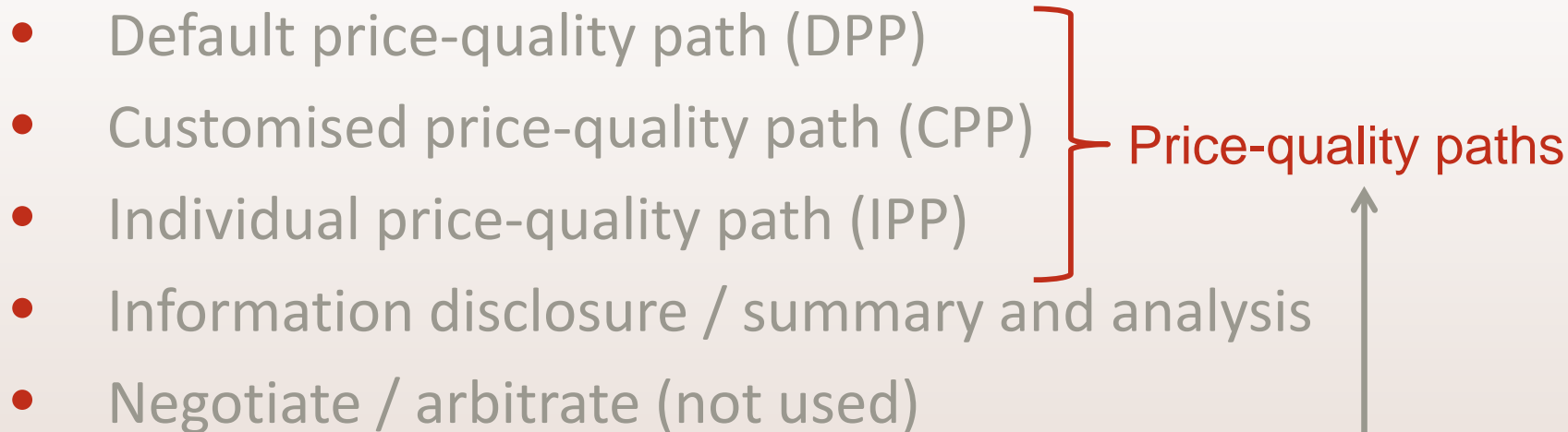
# Our 'Part 4' regulatory tools

## Methods of regulation

- Default price-quality path (DPP)
- Customised price-quality path (CPP)
- Individual price-quality path (IPP)
- Information disclosure / summary and analysis
- Negotiate / arbitrate (not currently used)

# Our regulatory tools

## Methods of regulation – electricity, gas, airports

- Default price-quality path (DPP)
  - Customised price-quality path (CPP)
  - Individual price-quality path (IPP)
  - Information disclosure / summary and analysis
  - Negotiate / arbitrate (not used)
- Price-quality paths
- 

### Key inputs

- Regulatory asset base (RAB)
- Weighted average cost of capital (WACC)
- Forecast expenditure (capital and operating)
- Quality standards

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# Current work

## Reset of price-quality paths

- Electricity distribution default price-quality path (2015-20)
- Transmission (Transpower) individual price-quality path (2015-20)
- Both will take account of the WACC to be determined before the end of October

## Resets are major projects for the Commission

- WACC percentile also a significant project
- Number of other areas have received less focus

Increased focus on compliance and understanding performance

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# Emerging challenges

## Some major issues for the 2020 reset of price-quality paths

- Future demand
- Disruptive technology
- Affordability and fuel poverty
- Death spiral
- Changing consumer expectations
- New business models
- Climate change (extreme weather)
- Others



Increased  
uncertainty?

# Key questions

## What will all this mean for consumers?

- What will be the role of the networks?
- More, less or different assets?
- What investment and when?
- What role will innovation play?
- Will there be competition?
- How will regulation need to evolve?
- Who takes the lead in answering these questions?

**Ultimately consumers are interested in the impact on price and quality**

# Our expectations



Transpower and the distribution businesses to take the lead in understanding the impacts on their networks

- Role of the network business to manage risk and uncertainty

## What does this mean

- Development of long term business plans (AMPs)
- Use of scenarios/option modelling (Transform model)
- Industry working groups and forums (Smart Grid Forum)
- Input to the Commission processes



# Themes from Industry

Not specific to any project or process – just from our general engagement

- Uncertainty is increasing
  - Suggestions for
    - Higher WACC
    - Greater opex allowances or new pass through costs
    - Bringing forward cash flows (ie accelerated depreciation)
- **This all leads to higher prices**

# Themes from consumers



Not specific to any project or process – just from our general engagement

- Have concerns about higher prices
- Have expectations that reliability will be maintained
- Need to think about what happens in competitive markets
- Examples of what happens in the markets they are operating in
- Not necessarily able to pass through prices to their consumers
- Expectation suppliers innovate and those that don't are exposed to the consequences

# The Commission's role

## Opportunity for improvement

- Input methodologies (rules and processes for regulating these businesses) must be reviewed every seven years, so the first review is due to be completed by the end of 2017
- Will apply to the 2020 reset for electricity
- This review will need to take into account the future challenges that we discussed today, as well as many others
- Input from stakeholders is key



# Connecting with the Commission



The Commission's approach is to always be clear and transparent

Website: <http://www.comcom.govt.nz/>

Regulation Branch email: [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

Regulatory calendar: <http://www.comcom.govt.nz/regulated-industries/regulatory-calendar/>

What we want to see from energy industry participants

- Giving consideration to emerging challenges
- Active engagement with the Commission





