

THE NEW REGULATORY REGIME FOR ELECTRICITY LINES BUSINESSES: GREAT EXPECTATIONS UNFULFILLED

Mark Berry and Lewis Evans

Background

Electricity lines businesses (“ELBs”) have been subject to regulatory control since 2001, following the enactment that year of Part 4A of the Commerce Act (“Act”). “Thresholds”, which have served as screening devices, have been the centre point of this regulatory regime. Breach of these thresholds has simply resulted in “please explain” consequences. For the period 2003-07, there were 127 breaches of the thresholds by 27 of the 28 ELBs. In all but a few cases, no further action was taken in respect of any of these breaches. In the few instances where further action has been proposed, administrative settlements were eventually reached.

Such an environment, which has often been described simplistically and erroneously as one of “light-handed regulation”, might be expected to have been embraced by the ELBs. But instead, application of this regime has produced the following concerns:

- Preponderant weight being attached by the Commerce Commission (“Commission”) to short-term wealth transfers as a benefit of regulation.
- An initial capital measurement (ODV) Handbook assessment of asset values which do not reflect appropriate values in the case of many ELBs.
- Forward-looking uncertainty in the application of ODV-based regulatory methodology, and about whether the Commission may switch to other asset valuation methodologies.
- No ruling on a WACC methodology, notwithstanding that there has been a panel employed by the Commission to study this matter for some three years.
- Administrative settlements which provide no meaningful precedent against which ELBs may assess likely outcomes of breaches of the thresholds.
- Threshold and price path assessments which do not appraise whether, ELBs will be regulated in such a way that their credit ratings fall below a given rating (such as the BBB+ rating constraint under Ch 6 of the Australian National Electricity Rules).

- A lack of accountability for Commission threshold and administrative decisions, because such decisions are not subject to merits review or appeals.

Great Expectations

Against this background, and other obvious inadequacies under the generic price control provisions of Part 4 of the Act, the case for reform of these regulatory regimes was made. A new regulatory regime applying to ELBs will come into force on 1 April 2009. These reforms are set out in the Commerce Amendment Bill 2008 ("Bill"), which passed its Third Reading on 5 September 2008.

Many regulated entities have welcomed the Bill, including most of the ELBs. These include some ELBs that will continue to be regulated. Small consumer cooperative ELBs will not be regulated under the proposed Bill, although they will remain subject to information disclosure requirements.

Primary perceived virtues of the new regulatory regime are that certainty and accountability will be enhanced. We submit that on closer scrutiny, and in time, it will become apparent that this confidence is misplaced and that expectations that these goals are about to be met will not be realised. Our three primary reasons for this position are as follows.

Reason #1: Dynamic efficiency considerations may continue to be compromised; the purpose statement remains problematic

Purpose statements in Acts of Parliament are important. They are not merely high level statements of principle. Rather, in many cases they provide the substantive basis upon which regulatory decisions are made. In the case of ELBs, the purpose statement will strongly influence the form of regulation, including its implementation.

Currently, section 57E provides that the purpose of Part 4A is to promote the efficient operation of markets through targeted control for the long-term benefit of consumers, so as to ensure that ELBs (a) are limited in their ability to extract excessive profits, (b) face strong incentives to improve efficiency and (c) share the benefits of efficiency gains with consumers, including through lower prices.

The new section 52A of the Bill substantively follows current section 57E. The promotion of the long-term benefit of consumers is again a centre point of this new purpose statement. This goal is, apparently, to be achieved by promoting outcomes consistent with those which may be expected in competitive markets such that ELBs will have incentives to innovate, invest and improve efficiency, will be limited in their ability to extract excessive prices and will share the benefits of efficiency gains with consumers (again including through lower prices).

In one sense, section 52A differs from section 57E in that there is now more direct reference to dynamic efficiency. But the Commission's deliberations to date under Part 4A already reflect that the Commission considers it has taken these factors into account. Accordingly, we predict that section 52A has the potential to be applied in much the same manner as section 57E. The multiplicity of goals poses potential conflict, and competing interpretations that include conjecture as to whether some aspect not on the list has been excluded deliberately.

There is an inevitable tension between goals of dynamic efficiency (the long-term benefit of consumers) and wealth transfer. Where regulators are required to choose which goal is to be granted primacy, other goals may be compromised.

Based upon decision-making trends to date under Part 4A, and other regulatory regimes administered by the Commission, we predict that the following outcomes and problems will continue to attach to the new section 52A, as they have done under the current section 57E:

- Wealth transfer assessments will continue to be an important element affecting how regulation will be implemented.
- Wealth assessments will continue to be treated as though they are a benefit component of a regulatory quantitative cost-benefit analysis. It will mean that the unsound Commission preoccupation with comparing short- to medium-term wealth transfers with medium- to long-term dynamic efficiency will continue.
- The Commission's analysis will almost certainly continue to not identify the social benefit of regulatory decisions; in large part because it is not able to identify the quantified assessed transfers with welfare improvement in society in the short term, let alone in the long term. By way of examples, no allowance is likely to be made for the fact that in many cases consumers may be producers or shareholders of regulated entities (including through participation in superannuation schemes), or the fact that the tax system relatively transparently transfers (30%) of corporate profits.

Reason #2: The set and implementation of the "input methodologies" will be problematic and uncertain; such methodologies are unlikely to deliver the expected outcomes

There will now be no 2009 reset of the current thresholds for ELBs under current Part 4A. Rather, the current thresholds, expiring on 31 March 2009, will be the default price-quality path applying up to 31 March 2010. The critical transition in relation to this path will unfold in the course of 2009. By 1 December 2009, the Commission will be required to reset the price-quality path for regulated ELBs to apply from 1 April 2010.

What will this reset process be based upon? The centre point of the new regulatory regime is "input methodologies". It is assumed that these regulatory input methodologies can be specified in advance of implementation, and that they will provide the basis for regulatory certainty on a forward-looking basis.

Input methodologies are set out in check list form in the new section 52S. They include asset valuation, WACC, pricing methodologies and so on. It is unclear what level of prescription is required for the input methodologies and concomitantly how input methodologies differ from implementation. There is a requirement that they be in sufficient detail to enable the assessment of regulatory positions, which would require that formulation should be close to implementation or prescription of the final decision.

Those ELBs that object to the rolled over price thresholds as their price path from 1 April 2010, or any other subsequent default price-quality path, have the option of seeking a "customised" alternative price path. While it is mandatory that input methodologies be set and applied to core adjudicative tasks (such as the assessment of customised proposals), surprisingly there is no requirement that specified input methodologies be taken into account in the reset process for the default price-quality path. Rather, in this context, the Commission has, it seems, a discretion as to which input methodologies it may use. The combined application of sections 54K and 52P(3)(c) means that in theory the Commission may be able to selectively determine which input methodologies may apply to the default price-quality path reset for 1 April 2010.

If the past is anything to go by, the approach the Commission uses for the set of default price-quality paths may not be clear and may differ somewhat across ELBs. Notwithstanding that the general rule relating to price path resets is that there should be only one rate of change - i.e. x - factor for each type of regulated service, new section 53P(6) enables the Commission to set alternative rates of change for any particular supplier. Accordingly, individual rate change assessments may be likely for each ELB.

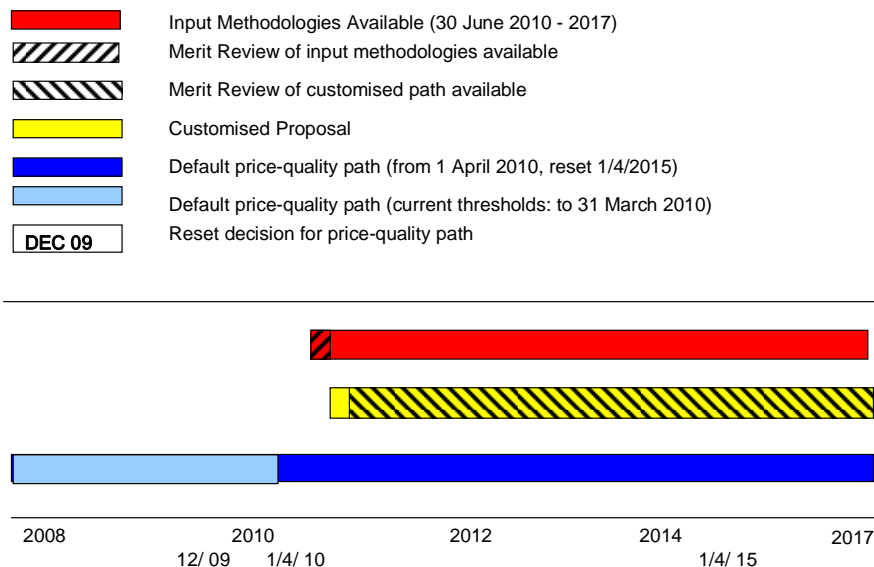
Initially, there is a time-line disjunction in the price reset process, because input methodologies need not be set until 30 June 2010 (or 30 December 2010). This means that the input methodologies will not be available until 7-13 months after the date that the first default price-quality path is reset for ELBs. The Commission may presumably endeavour to manage this disjunction. For example, consultation may be expected to be well advanced on the input methodologies by the time that the 1 April 2010 price-quality path is set, and it may be predicted that the Commission will strive to keep these work streams in harmony. If, however, there is a disjunction between these two work streams, it is to some extent rectifiable where the subsequent set of input methodologies would result in a substantially different path to that which has been reset. For this reason, we do not dwell further on this point.

A matter of more considerable moment is that input methodologies are generally to be established in advance of their application, perhaps well in

advance. The Commission is required to reset input methodologies only once every 7 years. Accordingly, any given set or reset of input methodologies has the potential to apply to two resets of the default price-quality paths for ELBs over a 7 year period.

These various time line problems (including time lines attaching to appeal rights, which we discuss below) can be highlighted in diagrammatic form, as follows:

Schematic Depiction of Time Lines



Against this backdrop, we predict that the input methodologies will be problematic, and will not deliver the anticipated certainty, because:

- At no point is there articulation of the expected level of prescription in the input methodologies. Taken literally, the requirement that input methodologies be in sufficient detail to enable ELBs to assess their regulatory position means that there cannot be a dividing line between the input methodology and implementation.
- The level of prescription remains a matter for the sole discretion of the Commission. It poses agency concerns because the Commission will both set and enforce the input methodologies. The Commission may take differing approaches to the level of prescription for input

methodologies depending on their incentives in relation to appeal rights. In the case of input methodology decisions, such incentives may lead the Commission to limit the level of prescription and increase the span of implementation. This could well result in debate as to the adequacy of these input methodologies for regulatory guidance purposes. This concern could also of itself trigger appeals, as we discuss later.

- Further, it is simplistic to anticipate that input methodologies can be set in stone in advance, divorced from their implementation potentially over a 7 year period in the manner that is proposed. Input methodologies may need to be fact intensive, and may need to account for intrinsic market volatility over time, in order to deliver proper outcomes and the desired regulatory certainty. In short, the formulation of input methodologies and their subsequent implementation are not distinct severable tasks, as is clearly intended under the general scheme of the Bill.

Reason #3: Appeal rights have been fashioned in a restrictive manner and they will be unlikely to provide appropriate accountability

Under current Part 4A, ELBs have had no ability to seek merits review or appeals of Commission decisions. Against this background, the introduction of appeal rights has been welcomed by the industry. But upon closer scrutiny, we submit that the appeal rights that are proposed are unduly restrictive and are unlikely to provide the accountability mechanism that may be anticipated.

The appeal rights conferred under the Bill do not attach to decisions pertaining to the set of default price-quality paths. Rather, they apply only in respect of input methodology decisions and final decisions pertaining to customised proposals.

We deal with each of these categories of appeal in turn.

Procedural and substantive concerns applying to the appeal of the input methodologies are present; consultation on the development of these methodologies notwithstanding. They are as follows:

- The procedural concern attaches to the limited window of opportunity for these appeals. The Commission may elect only to reset input methodologies once every 7 years. The period for the appeal of such decisions is limited to 20 working days; hardly time to test the methodologies by application of them. Thereafter, these appeal rights will attach only for 20 days each 7 years.
- A further problem, evident from the discussion above, will be the subject matter of such appeals. What level of detail, and what factual basis, will be exposed for appeal in this setting? In all likelihood there will be inadequate information before the court to properly determine any such appeal. This issue will apply at the time when appeals are

first available in 2010. The problem will be all the more acute at the time of the next reset of the default price-quality path in 2015, because there will be no basis to take into account market volatilities and evolution occurring between 2010-2015 (unless the Commission unilaterally elects to reopen any given input methodology).

- An allied problem is that ELBs may consider it prudent to appeal all input methodologies in the course of the 20 day window in July 2010, following the first set of such methodologies. As customised proposal appeals may not relate to all or any part of input methodologies (as discussed below), ELBs may predictably elect to litigate at this preliminary point all input methodology matters that could conceivably be excluded from customised proposal appeals. If a matter at issue is not addressed at all in an input methodology, then presumably it will remain open to appeal at the customised proposal stage. But in all other cases where input methodologies touch upon matters which may potentially be in dispute at some future time, ELBs will have an incentive to litigate them early on at the input methodology appeal stage, so as to achieve the maximum certainty possible. Without knowing how the Commission proposes to formulate input methodologies, it is difficult to advance this point further. But it may be that input methodologies that lack a high degree of specificity will give cause for concern, because ELBs may not know if their understanding of these methodologies is in harmony with the views held by the Commission. Accordingly, in this setting grounds for appeal may include that the input methodologies are in insufficient detail. Just how the courts will handle such a flood gate of litigation will be another matter.

Turning to appeals of final decisions for customised proposals, we predict that they will be unlikely to provide much in the way of a check and balance because:

- There will be few applications for customised proposals. The risks in submitting such proposals will be high, because once the election is made to go down this path, there is no ability to withdraw the application. Applicants can end up worse off under the customised proposal path if there is a finding that the default price-quality is too high, for whatever reason, as the Commission can order claw back in relation to some or all of the over-recovery. The time within which these applications will be processed (10-15 months) may act as a further deterrent.
- Any such appeals as may be made will be seriously constrained, because proposed section 91(1AA) provides that such appeals may not include an appeal against all or any part of the input methodologies. It is difficult to imagine that any appeal of a final customised proposal decision will not involve some aspect of an input methodology, and its application. Accordingly, section 91(1AA) has the potential to render this appeal right redundant. From the Commission's

perspective, the more detailed (the closer to implementation) it makes its input methodologies the less scope there will be for its decisions on customised proposals to be subject to merit appeal. In this context, there will be ample scope for argument as to the level of detail required to entitle the application of section 91(1AA), as we have already foreshadowed.

In conclusion

We make three concluding points.

First, some of the central concerns under the current regime are unlikely to be answered under the new regime. For example, the prospect that dynamic efficiency concerns may be compromised remains, and constraints such as limits on potential credit rating outcomes of regulation are not present.

Second, the centre point of the new regime, input methodologies, involves issues of concern in formulation and application. These concerns do much to undermine the assumed regulatory certainty that the new regime is intended to deliver. Deliberations on input methodologies, throughout the reform process, have been at a high level of abstraction. There will be considerable devil in the detail of input methodologies and, in time, this will be likely to expose the error in the assumption that these methodologies will deliver certainty.

Third, appeal rights as are proposed are seriously constrained, and are unlikely to deliver an appropriate level of accountability of decision-making. The premature and limited nature of appeal rights relating to input methodologies means that such appeals must be determined with reference to a time frame which is inadequate to assess the application of these methodologies. Further, there will be a considerable tension in the level of detail required for input methodologies, and this tension will spill over into grounds for appeals of input methodologies, and incentives on the part of the Commission to limit its exposure to appeals in the customised proposal appeal setting.

26 September 2008