

**NEW ZEALAND BUSINESS ROUNDTABLE**

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**SUBMISSION ON THE DISCUSSION PAPER  
ON THE OPERATION OF THE SPECIFIC  
THRESHOLDS FOR PRICE CONTROL FOR  
ELECTRICITY LINE BUSINESSES**

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**FEBRUARY 1999**

## 1 Introduction

- 1.1 This submission on the Ministry of Commerce's December 1998 paper entitled *Electricity Industry Reform: Discussion Paper on the Operation of the Specific Thresholds for Price Control for Electricity Line Businesses* (the Paper) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.
- 1.2 The NZBR has taken a close interest in electricity sector reform issues over the past 15 years. We have strongly supported moves to put the industry on a more conventional commercial footing, subject to only light-handed regulation. We see full private sector ownership of all electricity businesses as being the natural ultimate consequence of this process.
- 1.3 In our submission in June 1998 on the Electricity Industry Reform Bill we expressed concern about the apparent lack of adequate analysis underlying the measures; the taking of private property rights without compensation or proof of violation of existing laws or regulations; the inadequate consideration given to options such as privatisation and the removal of any outstanding barriers to competition; and the failure to submit the proposed measures to the disciplines of a Regulatory Impact Statement. On the last point and in relation to the measures proposed in the current Paper, we understand from the Ministry of Commerce that a Regulatory Impact Statement will be provided on the latest proposals if and when the minister for enterprise and commerce takes them to Cabinet. We welcome the imposition of this discipline.
- 1.4 The latest proposals are two-pronged. They involve:
- permitting the Commerce Commission to undertake price control enquiries and impose price control where it concludes that competition is limited and price control would be in the interests of consumers; and
  - government-imposed performance thresholds for lines businesses.

## 2 Discussion

- 2.1 We concur with the government's underlying view that any problems of natural monopoly lie with lines and transmission businesses rather than with the generation or retailing of energy.<sup>1</sup> However, problems of natural monopoly are not necessarily so large as to warrant industry-specific measures and they are certainly not uniform across all aspects of these businesses. In our view, many of the problems New Zealand faces have been exacerbated by the government's failure to move more quickly to the privatisation of generation and distribution companies. We are also concerned that the drift in New Zealand into rate-of-return regulation of line businesses based on optimised deprival values is a threat to incentives to control costs and provide the appropriate quality of supply.

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<sup>1</sup> See, for example Paul Joskow, "Restructuring, Competition and Regulatory Reform in the US Electricity Sector", *Journal of Economic Perspectives*, Volume 11, Number 3, Summer 1997, pp 119-138 for an assessment of professional opinion on this point.

- 2.2 The Paper and the accompanying Information Brief are alert to the dangers of excessive costs and inadequate quality under current arrangements, but they incorrectly attribute them to natural monopoly in paragraph 11 of the Paper and in point 2 of Part B in the accompanying Information Brief. This leads them to ignore the possibility that these problems are due to the regulatory environment rather than to natural monopoly. In general, an unfettered, profit-maximising monopolist would be expected to minimise costs at the chosen level of output (in order to maximise profits). For the same reason it would also be expected to match the quality of products supplied to the range of customer preferences.<sup>2</sup>
- 2.3 Problems of excessive costs are more likely in the absence of profit-maximising incentives (as under government or trust ownership) or when heavy-handed regulation has created a cost-plus environment. At a later point the Paper acknowledges that the existing form of regulation of distribution companies arguably amounts to *de facto* rate-of-return regulation and so could be leading to excessive costs.<sup>3</sup> However, the Paper does not make the point that ownership matters for incentives, and its confidence that a regime with greater CPI-X characteristics will reduce cost-plus biases on a sustained basis must be questioned.<sup>4</sup>
- 2.4 The proposed regime would make the Commerce Commission an industry-specific regulator (in addition to its existing responsibilities) and impose regulatory burdens on firms that violate thresholds that do not depend on any analysis of market power or any calculation of an imbalance between marginal revenue and marginal cost. In our view both these developments are of concern.
- 2.5 We are sympathetic to the principles that the Paper suggests in paragraph 14 for the design and operation of specific thresholds. However, in our view the proposed regulation, based as it is on yardstick competition, does not satisfy the first of these principles – credibility. The difficulties are illustrated by the arbitrariness of the proposed weighting systems and the absence of any burden of proof of wrong-doing in terms of Commerce Act principles. The proposed measures will not address the problem that *de facto* rate-of-return regulation of the industry will put up costs on average by creating a cost-plus environment for all firms above the threshold. A recent paper by Professor Lew Evans of Victoria University of Wellington has canvassed the difficulties associated with regulation using yardstick competition.<sup>5</sup> The problems lead him to conclude that yardstick regulation is likely to be heavy-handed regulation. The incentive problems associated with heavy-handed regulation are exactly what New Zealand's 'light-handed approach' sought to avoid.

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<sup>2</sup> For a discussion of the provision of quality by an unregulated monopolist, see, for example, section 6.2.1 on pages 91-92 of *Reform of the Water Industry*, New Zealand Business Roundtable, August 1995.

<sup>3</sup> Refer to paragraph 32 (i) of the Paper.

<sup>4</sup> CS First Boston investigated this question for the New Zealand Business Roundtable in the context of the regulation of roads and concluded that: "Over extended periods of time, price-cap regulation does not generate significant advantages over traditional rate-of-return regulation", although it may have transitional benefits. (See page 69 in *Options for the Reform of Roading in New Zealand*, New Zealand Business Roundtable, June 1993.)

<sup>5</sup> *Convergence of Light and Heavy Handed Regulation*, paper prepared for the Transpower Electricity Conference, November 1998 by Professor Lewis Evans, executive director, New Zealand Institute for the Study of Competition and Regulation.

- 2.6 More generally, the basic presumption, referred to in paragraph 2.2 above and reaffirmed in the two sets of proposed weightings for determining thresholds, that high prices or high rates of return or poor quality reflect monopoly is inherently suspect and will cause endless dispute. High prices could reflect higher costs, perhaps because of geographic or competitive considerations, or perhaps because of a demand for greater quality. Professor David Giles and Nicholas Wyatt have found that average cost is markedly sensitive to the volume of output.<sup>6</sup> Variations in average quality across regions may reflect variations in demand for quality. High (accounting) rates of return may reflect timing issues, valuation issues or inframarginal economic rents. Policies that simply ride roughshod over objections raised on such grounds will be seen to be inequitable and inefficient.
- 2.7 Add to these irreducible difficulties the incentive problems associated with widespread government or trust ownership and the lack of well-defined objectives for Transpower and it is difficult to avoid the conclusion that the proposed policy mix is unstable. An unstable policy is unlikely to be time consistent. This means that it will create incentives that differ from those that policy makers desire, because decisions are based on how policy might evolve rather than on what it is stated to be. Disappointment with the outcomes that result from poorly analysed problems and heavy-handed regulation will generate pressures for further measures – a process of endless and ultimately unsatisfactory regulatory tinkering with which New Zealand is already too familiar.<sup>7</sup>
- 2.8 An alternative approach to the fundamental problem of limited competition for local lines would be to put greater reliance on private ownership and light-handed regulation. Compared to the status quo and the proposed measures, this approach should increase incentives to minimise costs, provide the level of quality that customers are willing to pay for, and improve dynamic efficiency. While there is a good case that prices would tend to be lower than under a cost-plus approach (because costs can be expected to be much lower)<sup>8</sup> the offsetting consideration is that prices *could be* higher in relation to costs (ie profits could be higher). The credibility of this option also depends on its political sustainability in the face of pressures from customers and competitors.
- 2.9 New Zealand's limited experience to date with the private ownership of local distribution companies does not suggest that there should be major concerns about private ownership of local lines, subject to light-handed regulation. Local distribution companies need customer goodwill, in part to help protect them against Commerce Act investigations. On the other hand, New Zealand has had decades of experience with government ownership of distribution companies and the case for change is rightly built on dissatisfaction with outcomes under those structures.
- 2.10 The choice between such options should only be made after a careful analysis and investigation of their relative strengths and weaknesses. The Paper and its accompanying documents do not perform such an investigation. Paragraphs 7(c) and 7(d) of Cabinet Office Circular CO (98) 5 require all Regulatory Impact Statements to set out feasible options for achieving desired objectives and a statement of the benefits

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<sup>6</sup> Giles, David and Nicholas Wyatt, "Economies of Scale in the Electricity Distribution System," Ch 23 of *Models, Methods, and Applications of Econometrics*, Peter C B Phillips (ed), Cambridge, Mass, Blackwell, 1992. Professor Evans discusses qualifications to this interpretation (see footnote 5).

<sup>7</sup> Two decades of tinkering with New Zealand's accident compensation arrangements illustrate the pattern.

<sup>8</sup> See page 17 of Capital Economics Limited's July 1998 report for the New Zealand Business Roundtable, *Regulation of Network Industries: The Case of Telecommunications*, for a brief summary of this trade-off by officials at the Commerce Commission.

and costs of the proposal and of other feasible options. In our view, this requirement must be met and the assessment should be made available for public scrutiny and comment prior to any Cabinet decisions.

- 2.11 Paragraph 7(b) of CO(98) 5 also requires a statement of the public policy objective that is "not specified so as to align it with (and thus pre-justify) the particular effects of the proposed regulation". Objectives based specifically on reducing prices to end-users, or forcing down costs, do not pass these tests since they do not meet the economic efficiency criterion which is relevant here. Public policy should be based on maximising the sum of producer and consumer surpluses. Dynamic efficiency is particularly important in capital intensive industries and must be explicitly considered. Measures that might primarily transfer wealth from producers or taxpayers to consumers in the short term, at the risk of adverse long-term effects, should be avoided. In our view, the Paper, at paragraph 13, fails to specify the objective in a manner that complies with CO(98) 5.

### **3 Conclusions**

- 3.1 The NZBR submits that major public policies should only be promoted on the basis of specific high quality research and analysis that is open to public scrutiny. To this point, the analysis has excluded consideration of a major alternative – greater reliance on private ownership and light-handed regulation.
- 3.2 Pending such analysis we conclude that the proposed measures should not be adopted. One of our major concerns about recent policy in this area is that increasingly intrusive regulations are being imposed on private sector suppliers without proof of any wrongdoing in specific cases or any compensation for infringement of existing property rights. The Commerce Act exists to deal in a principled manner with problems of the abuse of a dominant position. Bald assertions about the existence of monopoly power in all line businesses are being used to increase the regulatory costs on all, while by-passing the disciplines of due process that would otherwise be required under the Commerce Act. It is particularly instructive that what is arguably the most obvious source of concern about high costs and cost-based prices – widespread government and trust ownership – is being ignored.
- 3.3 The arbitrariness of the proposed thresholds, the uncertainty as to how the measures will work in practice, and the evident disregard for existing property rights are all unfavourable developments in terms of dynamic efficiency and average costs. In the absence of a more convincing case for these measures, we believe public policy in this area is too focused on achieving immediate price reductions and too dismissive of the longer-term costs of government ownership and regulation, and that it should be reconsidered.