NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Final Gas Control Inquiry Report

February 2005

1. Introduction

1.1 This submission on the Commerce Commission's (29 November 2004) Final Gas Control Inquiry Report (Report) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily 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 minister of energy has invited interested parties to comment on new matters raised in the Report, and other relevant matters that have not been the subject of earlier submissions or are not reflected in the Report. In particular, the minister has sought comments on the Report's recommendation that a targeted control regime comparable to that applied to electricity lines businesses under Part 4A of the Commerce Act 1986 should be applied to gas pipeline businesses.

1.3 The NZBR has been monitoring the Inquiry but has not previously made submissions on it. We are doing so now because the Report deals with a major industry in the economy and because we do not believe the Commission has heeded sound submissions made to it. In particular, it has not properly evaluated the net benefits to the public of imposing a control regime. In our view this is the key consideration in addressing the recommendations that are now before the minister and the government.

1.4 In this submission we use standard regulatory analysis to evaluate the Commission's recommendation. Section 2 looks at the definition of the problem; section 3 discusses the public policy objective; section 4 canvasses alternative courses of action and comments on the electricity lines option; and section 5 makes some concluding remarks.

2 Problem definition

2.1 As we see it, the key public interest concern in the energy sector is to secure future supplies of energy in an efficient manner so as to avoid shortages and advance the government's economic growth

objective. In respect of gas, the central issue is future supplies and pricing as the Maui field runs down.[1]

2.2 On our reading, there is no disagreement between the government's advisers and industry experts that the key requirement is for adequate incentives to invest efficiently throughout the energy sector. Economists refer to this as the need to achieve dynamic efficiency.

2.3 The executive summary of the Report makes it clear that, in respect of gas pipelines, current arrangements satisfy that test:

> The Commission's view is that there are no significant dynamic inefficiencies in the gas pipeline businesses.[2]

In the body of the Report, the Commission states more explicitly (at paragraph 6.42) that it was presented with no evidence of any problem of over- or under-investment that could be corrected through regulation.

2.4 Conversely, the Commission found that regulation of pipelines would be likely to reduce investment in them, harming future service quality and delaying supplies to new customers. In technical language, it found that control would impair dynamic efficiency.

2.5 While the Report (contentiously) assumed that regulation might produce some short-term gains for the community at large by, for example, limiting 'cost-padding', these benefits would be smaller than the costs to dynamic efficiency over time. Overall, the Commission found that regulation would harm the public, as assessed by the standard measure of economic efficiency.

2.6 Such findings illustrate the point that the existence of a natural monopoly[3] does not in itself establish that there is a problem of

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1 For a recent review of the issues, see Solid Energy's report *Energy Options: Securing Supply in New Zealand*, September 2004.

2 Report, paragraph 41.

3 Both the Productivity Commission and the Commerce Commission consider gas pipelines to have natural monopoly characteristics. See the Productivity Commission report, *Review of Gas Access Regime*, No 13, 11 June 2004.

monopoly pricing,[4] or that government regulation will do more good than harm.

2.7 Naturally, government regulation is likely to benefit one group (say group A) at the expense of another group (group B). If group A's gain is simply B's loss the regulation will impose costs on the community for no overall benefit. Section 52 of the Commerce Act provides *inter alia* that goods or services may be controlled in the interests of the persons acquiring them.[5] In terms of this Section, the Commission chose to consider forced transfers of "excess" profits to users as providing a public policy benefit that was additional to any efficiency benefits. This put the Commission in the invidious position of having to make arbitrary judgments about: (1) the proportion of the benefits of lowered prices that will be retained by users; and (2) how much national income should be sacrificed for each dollar transferred for the benefit of group A. In the event the Commission apparently decided that 100 percent of any forced price reductions would benefit users and that a cost to the national interest of 9 or 17 cents per dollar of "excess profits" transferred would suffice for a control recommendation in the cases of Vector and Powerco respectively.[6] The Report estimates that this recommendation, if adopted, would cost the nation around $1.4 million (annuity basis) in order to transfer around $11.9 million (annuity basis) from shareholders in these two companies.

2.8 Although we have not inquired specifically into the identity of the major customers of Vector and Powerco, we note that gas use is dominated by large companies: electricity generators and cogenerators, petrochemical users, and the steel, forestry and dairy sectors.[7] There is no obvious reason in equity why public policy should regard a dollar transferred to major users of gas as being worth more to the community than a dollar taken from the owners of Vector and Powerco. There is also a conflict of interest concern

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4 A gas pipeline can be a major expense that a company will not incur unless major users are committed (in advance) to funding. Given the countervailing power of major users, the issue of monopoly pricing may not arise.

5 Report, paragraph 2.20.

6 Report, paragraphs 6.15,134 and 119 respectively.

7 Solid Energy, *op cit*, p 21.

here arising from the government's ownership of gas-using electricity firms.

2.9 Implicitly acknowledging the undesirability of such a policy, the Report commended the idea of a threshold 'electricity lines' scheme on the grounds that it might serve the 'user-protection' objectives at a lower cost to overall national income.

2.10 However, it seems clear that any system for truncating returns above cost could deter investment in pipelines. Nor would pipelines alone be affected. Firms only invest in gas pipelines in order to transport gas. A regulatory regime that raises the costs and regulatory risks of investing in pipelines can also be expected to adversely affect other investments, such as the search for new fields.[8]

2.11 In short, the problem here appears to be not with markets but with legislation that encourages regulators to sacrifice the national interest for the (alleged) benefit of (mainly) large users. From the government's perspective, the reduced incentive to invest in gas could exacerbate supply and competition problems in electricity.[9]

3 Policy objective

3.1 Effective decision-making in the national interest is nearly impossible if arbitrary trade-offs have to be made between conflicting considerations. Hence the Productivity Commission's strong recommendation that the Australian federal government should use a single over-riding objective for evaluating gas access regime proposals, namely:

> To promote the economically efficient operation and use of, and economically efficient investment in, the services of transmission pipelines and distribution networks, thereby promoting effective competition in upstream and downstream markets.

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8 The Productivity Commission observes in its Overview, p XXXI, that the impact on investment in new fields "cannot be easily separated" from the impact on investment in pipelines.

9 The Productivity Commission observes at p XXVIII that, in Australia, "… the regulation of prices is leading to a distortion of investment (towards lower risk projects) and delaying the development of new pipelines, which then slows down the emergence of competition in related energy markets and between pipelines".

3.2 We concur with this view. The government's over-riding objective in responding to the Report should be to find the arrangements that best meet such an efficiency objective. To adopt these arrangements in a manner that is consistent with the legislation might require putting a high weight on the public interest test.

3.3 We note that in this context the Report does not appear to give adequate consideration to the importance of section 1A of the Commerce Act. This purpose statement applies to the entire Act, including section 52. Purpose statements are important interpretative tools in antitrust laws and we are not aware of any reason why they are not equally relevant to regulatory decisions. Section 1A would appear to direct the Commerce Commission towards economic efficiency as the overriding objective.

4 Options available to the government

4.1 The government's options appear to include the following:

- accept the control recommendations in respect of Vector and Powerco;
- defer/reject the control recommendations in respect of Vector and Powerco until the electricity threshold regime option has been evaluated;
- defer/reject the control recommendations until the merits of the Productivity Commission's recommended monitoring scheme and coverage tests are assessed; or
- reject all the recommendations in favour of the status quo.

4.2 Since the control recommendations fail to satisfy the efficiency test, according to the Report, we suggest that they should be rejected.

4.3 Some of the thresholds proposed for electricity lines businesses require benchmarking. Benchmarking is likely to be very problematic for gas pipelines, given the differences between them and the limited number of pipelines that could serve as benchmarks.

The Commission itself was able to draw "no definitive quantitative conclusions" from the benchmarking evidence put before it. Overall, it considered that the problems revealed by these studies "reinforces its prior reservations … about the ability in (*sic*) such studies to make like for like comparisons given the data currently available".[10]

4.4 There is also a fundamental inconsistency between the idea that a private pipeline operator is a profit-maximising monopolist and the proposition that it is simultaneously failing to minimise costs. (The Commerce Commission's insistence on making this assumption is one reason why we regard as controversial its view that intrusive regulation will raise productive efficiency by forcing cost savings. The Commission has not identified any reason why the takeover market would fail to discipline managers who were not cost-minimising, were it permitted to operate freely.) In our view, cost-padding is only likely to be a material and prolonged problem in cases of government ownership or other forms of regulation that induce cost-plus behaviour – such as rate of return regulation and the resetting of 'X' in CPI-X price-path regulation.

4.5 Similarly, the discussion on benchmarking for service quality seems to be inconsistent with the assumption of a profit-maximising monopolist. The accepted notion that a monopolist might raise price by holding back on quantity does not appear to apply in respect of quality since no rational customer could be expected to pay more for a lower quality product. Again, we would only expect this benchmarking to be relevant to a regulator when product prices are controlled in some way.

4.6 As the Commission itself notes in its discussion document on thresholds for electricity lines businesses, other threshold notions based on restricting profits or forcing the sharing of efficiency gains with customers have adverse implications for future investment (dynamic efficiency). It is widely acknowledged that dynamic

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[10] Report, paragraph 79.

efficiency is the most important efficiency consideration when major new investments are in prospect.

4.7 The above remarks serve to emphasise the last point that we wish to make in this context – the high risk of regulatory error from basing decisions on benchmarking data when there is no theoretical basis for determining whether anomalies reflect differences in costs, products and preferences or simply monopoly behaviour. The Productivity Commission's paper treated the likelihood of regulatory error as a serious concern. The scope for such a procedure to reduce investor certainty arises not just from the risk that the regulator will wrongly interpret data that fail to conform with the benchmark as evidence of monopoly behaviour. There is also the likelihood that the regulator, knowing that the benchmarks cannot be established with any precision, will reserve the discretion to expropriate some of the profits arising from the investment even if the business conforms with the benchmark. Consider the difficulties the following statements create for businesses trying to figure out what they have to do in order to comply with the law:

> If a business behaves in a manner contrary to the intention of a threshold, yet is not caught by existing criteria, the Commission will retain its discretion to determine that the business breached the threshold.
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> A business that did not set its prices in accordance with the price path would breach the efficiency threshold, unless benchmarking demonstrated it to be efficient.
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> A business would breach the profit threshold … unless the profit in excess of WACC (weighted average cost of capital) plus the margin resulted in efficiency gains or reflected the risky nature of investment.
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> Businesses that do not pass on to consumers a sufficient percentage of the benefits of efficiency gains … would breach the threshold.[11]

4.8 It should be obvious that all thresholds and subsidiary tests referred to in the above extracts are fundamentally arbitrary. In our view no government should contemplate exposing investors in any industry to such uncertainties unless the case for doing so can overcome an onerous burden of proof. The Report's testimony that there is no

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[11] These extracts are all from Commerce Commission, *Regulation of Electricity Lines Businesses, Discussion Paper*, 21 March 2002, pp 4-5.

material evidence of investment inefficiency at present surely establishes that such a case does not currently exist.

5 Concluding comments

5.1 The Report represents a considerable regulatory challenge for the government given the current need for greater private sector investment in energy in New Zealand. The Productivity Commission's report summed it up in an Australian context as follows:

> The challenge is to design a gas access regime that encourages the development of competition and innovation, and also imposes forms of regulatory intervention only where they are likely to generate net economic benefits.

5.2 We concur with this statement of the desirable objective of policy. We suggest that it is abundantly clear that no case has yet been made that either a control or a threshold approach would be likely to generate net economic benefits. At the same time it is easy to make a case that they could impair investment incentives.

5.3 We acknowledge the problem of compliance with Section 52 of the Commerce Act, which might be interpreted as aiming to favour one group over another even if the overall net economic benefits were negative. Here the Report appears to be deficient in overlooking the need to interpret this section in the light of the overall purpose of the Act, as set out in Section 1A. In the event that a fuller examination of the statutory requirement leaves it open for the government to determine what the trade-off between these two objectives should be, the minister would have the responsibility for advising his colleagues on the weight that should be put on the test of overall net economic benefits. We submit that he should recommend that Cabinet put the national interest first in respect of all the control recommendations.

5.4 On our assessment of national interest criteria, we do not favour the Commission's proposal for imposing a control regime on Vector and Powerco. We are also opposed to the Commission's request for enabling legislation to impose a price path threshold regime on any

individual business, let alone the industry generally, on the basis of the inadequate analysis in the Report.