



October 2007

Electricity Update

Commerce Commission Activities

Since the implementation of Part 4A of the Commerce Act in 2001, the Commerce Commission (**Commission**) has shown an intention to be particularly active in the area of regulation of electricity transmission and distribution businesses. The Commission is concerned with striking a balance between allowing adequate investment in networks and a desire to prevent lines businesses from extracting excessive profits from the natural monopolies that arise from their supply network.

As mentioned in past newsletters, over the last two years the Commission has declared an intention to control Unison, Transpower and Vector. The last month has seen a flurry of movement in this area, notably in the form of the Supreme Court's September decision in *Unison Networks Limited v Commerce Commission* (SC 12/2007 [10 September 2007]), and the 5 October provisional acceptance of Transpower's offer of an administrative settlement.

Supreme Court rules that Commerce Commission's threshold setting regime for large lines businesses is legitimate

Last month's Supreme Court decision affirmed that the Commission's threshold regime regulating large electricity lines businesses is in line with the purpose of Part 4A of the Commerce Act (**Act**).

Unison, one of the four largest lines businesses in New Zealand, commenced judicial review proceedings against the Commission in 2004, arguing that both the thresholds set by

the Commission and the approach the Commission took in investigating the Unison's Part 4A threshold breaches were unlawful.

The action stemmed from the Commission's 2003 decision to set an initial price path threshold backdated to 8 August 2001, and a revised threshold that would take effect from 1 April 2004. Unison claimed that the thresholds were inconsistent with the purpose and requirements of the legislation. Unison increased its prices, thereby breaching both thresholds.

Unison claimed the Commission's actions in setting the thresholds were outside the statutory purpose of the regime (outlined in section 57E of Part 4A of the Act). It argued that the scope of the powers enabling the Commission to implement thresholds was much narrower than the interpretation the Commission had followed. It claimed that the thresholds as set directed the Commission's attention to irrelevant criteria, which meant that important issues that might be indicative of a need to declare an intention to control could be missed.

The Supreme Court dismissed Unison's challenge. In its judgment, the Supreme Court noted that the Commission's power to set thresholds is broadly worded, and reaffirmed that the "power is designed to achieve broad economic objectives and is given to a body with expertise in the field." The Court could find "no necessary implication that narrows the scope of the power to set the thresholds." The thresholds must simply be relevant to the purpose of the Act in the sense that they will contribute to the administration of the targeted control regime. They can so contribute simply by identifying potential candidates for control on a general basis, and do not necessarily need to identify businesses operating inefficiently as Unison submitted.

The Court found that the Act was “clear that thresholds must be set on the basis that their breach will provide a platform for obtaining information relevant to the possible imposition of targeted control as explained in s 57E”. A threshold breach will not give rise to an automatic declaration of intention to control. Instead, it will give the Commission grounds to consider whether there is a valid explanation for the breach and whether or not it should declare an intention to control. “The post breach inquiry into whether control should be imposed is designed to address whether the price increases of particular companies during the period of the initial threshold were justified in terms of the purposes of s 57E.”

The current thresholds have been in place since 1 April 2004 and are due to expire at the end of the current regulatory period on 31 March 2009. The Ministry of Economic Development is currently undertaking a review of the Part 4A regime. While no decision has been made on the form of the new thresholds, the Commission has expressed a view that the current broad structure should form the initial basis for the new regime. It believes that the Government’s aim for “regulatory stability, transparency and certainty” will be served by a certain degree of continuity, but has said that it is open to considering alternative options.

Commission provisionally accepts Transpower’s offer of Administrative Settlement

In the first week of October, the Commission provisionally accepted Transpower’s administrative settlement offer as an alternative to placing the company’s transmission services under regulatory control.

The Commission announced its intention to make a declaration of control of Transpower under Part 4A of the Act on 22 December 2005, following Transpower’s 2003 and 2004 breaches of its price path thresholds and the November 2005 announcement of a 19.1% price increase for 2006. Transpower also predicted price increases of 13% on average for the next five years.

The Commission delayed making the declaration of control following the decision by Transpower’s Board to work towards an administrative settlement. Since that time, Transpower has submitted several proposals of administrative settlement, culminating in the offer made on 31 August 2007. The Commission considers that this latest offer is a satisfactory basis from which to proceed to negotiation.

The pricing effect of Transpower’s offer is:

- (a) The forecast price increases of 19.1% for 2006/7 will be reduced to 10.2%, subject to final approval by the Commission. The entire 19.1% had been rebated to customers, so this will represent an increase in revenue which will be applied against the Economic

Value Accounts (as an economic loss or gain) to form part of the balance as at 30 June 2007.

- (b) The initial forecast of 13% price increases in 2007/2008 will be revised. This initial forecast was reduced to a 2.7% increase pending the Commission’s preliminary approval of the offer. It will be increased to 8.1% under the proposal, but the figure will be subject to final approval by the Commission. The gains arising from this price increase will be applied against the Economic Value Accounts to form part of the balance as at 30 June 2008.
- (c) Between 2009 and 2011, Transpower will determine its annual revenue requirement according to a number of indicators outlined in the settlement offer. These include:
 - (i) a base operating expenditure of \$199.61 million for 2006/07 indexed at CPI-0 each year
 - (ii) WACC at 7.8%
 - (iii) an adjustment for under or over-recovery using the Economic Value Account mechanism
 - (iv) an adjustment to the Economic Value Account resulting from the current review of asset replacement cost value (to be applied to the Economic Value Account in 2009/10)
 - (v) a requirement that only assets approved by the Electricity Commission, once commissioned, can be entered into the asset base using depreciated historic cost (DHC), and
 - (vi) tax calculated using the tax payable approach (with the addition of an interest tax shield).

The Commission has publicly stated that it believes that the latest offer balances out the need for Transpower to invest efficiently in the transmission grid and limits its ability to extract excessive profits.

If accepted, the offer will mean a significant change to Transpower’s regulatory oversight. Transpower will agree to abide by four thresholds, three replacing the existing price path threshold and a fourth which will maintain the current quality threshold set out in the Act. The new thresholds are:

- (a) *A new transmission (revenue) threshold*

This requires Transpower to demonstrate that it has applied a set of principles (outlined in Schedule 1 of the formal settlement proposal) in deriving its annual revenue requirement when setting prices for those services that fall within the definition of specified services. It is proposed that this will apply from 1 July 2007 to 1 July 2011. This threshold will only be subject to change in accordance with the Commission’s final decision on the price increase for the particular year, or once the Economic Value statements that report on Transpower’s financial performance (based on its audited financial results) are finalised.

(b) A new transmission (non Part F) capital expenditure threshold

If the proposal is accepted, this will apply from 1 July 2007 until 30 June 2008. After this time, if any non capital expenditure is proposed outside the Electricity Commission's oversight in Part F of the Electricity Governance Rules of 2003, the Commission will reset the threshold for expenditure for each financial year according to a detailed list of "reset principles" outlined in Schedule 2 of the formal settlement proposal.

(c) A new system operator threshold which will apply until 30 June 2011

This threshold will require Transpower to demonstrate that it charged for System Operator Services in accordance with the System operator Provider Agreement. This will effectively enforce the terms of the existing contract between Transpower and the Electricity Commission unless the system operator role is materially changed prior to 30 June 2011.

The Commission has invited consultation on the proposed settlement and anticipates reaching a final decision before Christmas. Submissions from interested parties are due by 9 November 2007.

Further information

For further information on any of the issues raised in this newsletter including assistance with drafting submissions, please contact Carolyn van Leuven or Andrew Matthews.



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