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Dear Paul,

Submission on Cost Benefit Analysis for Switching Arrangements

Introduction

1. Thank you for the opportunity to make a submission on the Gas Industry Company's (GIC's) consultation paper "*Cost Benefit Analysis of Options for Switching Arrangements in the New Zealand Gas Industry*", 16 March 2006.
2. No part of our submission is confidential and we are happy for it to be publicly released.

Mighty River Power's views

3. Mighty River Power supports the GIC's use of a quantified Cost Benefit Analysis (CBA) as a tool for evaluating the options for customer switching arrangements.¹ In endorsing the use of CBA we stress that a CBA is just one piece of information that is helpful in making policy decisions. As the GIC has noted "*...monetary costs/benefits are only one aspect of the overall evaluation of the options*".² We also stress that inevitably any CBA will have its limitations, and it is important to be aware of these when relying on CBA.
4. Charles River Associates (CRA) has not been as explicit as they could have been in respect of identifying the limitations of the CBA they conducted. In respect of the limitations of the CBA that CRA conducted, we note the following:
 - a. CRA have not provided details of the basis on which the software providers were asked to provide quotes.

¹ Mighty River Power has discussed the importance of quantified CBA as a tool for policy decision making in some detail in Section 8 of our submission to the Electricity Commission "*Submission to the Electricity Commission in response to the Consultation Paper "Options for Enabling Transmission Alternatives"*", 22 July 2005. This is attached as an Appendix.

² GIC's consultation paper "*Concept Design for Wholesale Gas Market*", March 2006 at page 5.

- b. The CBA is a productive efficiency analysis. It does not consider allocative or dynamic efficiency. In particular, it does not quantify the dynamic efficiency benefits from lower barriers to switching – which would take the form of greater competition. The dynamic efficiency benefits from greater competition may well exceed the static (productive) efficiency benefits.
 - c. The CBA does not take into account that lower switching costs can be expected to result in greater competition and a greater level of switching. The CBA instead assumes a constant level of switching over-time. This suggests that the CBA has understated the net benefits of the switching registry.
 - d. Evaluating the net benefits over a five-year period will result in an understatement of the net benefits. This is proven by CRA's sensitivity analysis.³ The reason for this is that much of the costs of the switching registry are one-off and upfront while the benefits are on-going and likely to increase over-time (with greater competition and a greater level of switching).
 - e. While the above suggests that aspects of CRA's methodology results in an understatement of the net benefits we were surprised that the CBA suggested productive efficiency benefits of \$27-\$28 per switch from a switching register. This would be a very substantial cost saving.
5. Having said all that, we draw the following conclusions from the CBA:
- a. We consider that CRA's CBA is useful for evaluating the switching options.
 - b. The CBA reinforces our view that Option 3 is superior to Option 4.
 - c. In this respect it is also notable that the data gathering (from potential suppliers) for the CBA identified that Option 3 could be implemented but that this would not rule out Option 4 being implemented later on. Option 4 could be implemented as an increment to Option 3. This suggests that Option 3 has value which the CBA has not quantified.

³ Refer to Figure 2 of CRA's report "*Cost Benefit Analysis of Options for Switching Arrangements in the New Zealand Gas Industry*", 28 February 2006.

Concluding remarks

6. Mighty River Power continues to support the GIC's intention to standardise and upgrade the protocols for customer switching. Mighty River Power considers that it is to the long-term benefit of end-users for barriers to switching/competition to be removed or minimised. It should also be noted that we continue to support the Central Registry option (Option 3).
7. If you would like to discuss this matter directly with Mighty River Power, please do not hesitate to contact either me (on 09 308 8213 or neil.williams@mightyriver.co.nz) or our Gas Retail Manager, Jan van Staden (on 09 580 3792 or jan.vanstaden@mightyriver.co.nz).

Yours sincerely



Neil Williams
General Manager - External Affairs

Appendix: Excerpt from Mighty River Power's submission on Transmission Alternatives

8 Absence of a quantitative Cost Benefit Analysis

50. Mighty River Power was surprised and is concerned that the Transmission Alternatives Consultation Paper does not include a quantitative CBA. Mighty River Power is of the view that the EC will not be in a position to determine that procurement of transmission alternatives should be regulated in the absence of a CBA. This does not mean that the matter hinges entirely on the CBA. Rather the CBA is one, albeit important, piece of information on the desirability of regulatory intervention.

51. In this respect, Richardson J observed, in the case of *Telecom v Commerce Commission*:³⁵

"...the desirability of quantifying benefits and detriments where and to the extent that it is feasible to do so...there is in my view a responsibility on the regulatory body to attempt so far as possible to quantify detriments and benefits rather than rely on a purely intuitive judgment to justify a conclusion that detriments in fact exceed quantified benefits".

52. The Commerce Commission has recognised this judgment in its regulatory proceedings, and has noted:³⁶

"The Commission considers that it is required to attempt so far as possible to quantify detriments and benefits rather than rely on a purely intuitive judgment to justify a conclusion as to the balance between detriments and benefits. This is not to say that only those detriments and benefits that can be measured in monetary terms are to be included in the Commission's analysis[.] Those of an intangible nature, which are not readily measured in monetary terms, must also be assessed."

53. The Commerce Commission's ex-Chief Economist, Dr Michael Pickford, noting the Courts' express view on the requirements for quantification of costs and benefits, has stated:³⁷

"The Commission believes that it is under an obligation to use quantification to the extent that it is feasible, albeit making allowance for the uncertainties in any such exercise."

³⁵ *Telecom Corporation of New Zealand Limited v Commerce Commission* [1992] 3 NZLR 429 at 447.

³⁶ Paragraph 75 of the Commerce Commission's "Section 64 Review and Schedule 3 Investigation into Unbundling the Local Loop Network and the Fixed Public Data Network - FINAL REPORT", December 2003.

³⁷ In a paper entitled "The evaluation of public benefit and detriment under the Commerce Act 1986" (Commerce Commission Occasional Paper No 7, February 1998).

54. The passage from the *Telecom v Commerce Commission* case has been cited with approval in a number of subsequent cases including, for example, *Ravensdown Corporation Ltd v Commerce Commission* (High Court, Wellington, AP 168/96, 9 December 1996, Panckhurst J and Professor Lattimore) and *Rugby Union Players' Association Inc v Commerce Commission* (No 2) [1997] 3 NZLR 301.

55. The comments made by Richardson J were not specific to the particular legislation that the Commerce Commission administers. The EC accordingly faces the same requirements.

56. Regardless of any legal requirements, a quantitative CBA is a desirable and beneficial part of regulatory decision making. In support of this view, we note that the Commerce Commission has also stated:

"The Commission considers that quantitative modeling is useful to the degree that it focuses on key assumptions regarding characteristics of the market and the way in which participants are likely to act, with and without regulation. The Commission's view is that the value of a model is in its ability not to produce 'proof' of the net benefits of regulation, nor to supplant the Commission's exercise of judgment, but rather in providing support to the Commission's deliberations by:

- *focusing interested parties on verifiable economic arguments;*
- *making transparent the values of key parameters and assumptions in the analysis; and*
- *producing quantitative estimates of the results of proposed regulation.*"³⁸

"In undertaking its role under the Act, the Commission will need to manage the risks associated with regulatory intervention.

*"These risks can arise from...the Commission making decisions on the basis of imperfect information..."*³⁹

57. Mighty River Power agrees with the Commerce Commission's views on CBA.

³⁸ Paragraph 315 of the Commerce Commission's "Schedule 3 investigation into regulation of mobile termination: Final Report", 9 June 2005.

³⁹ Paragraph 71 of the Commerce Commission's "A guide to the role of the Commerce Commission in making access determinations under the Telecommunications Act", 28 May 2002.