



CASE ASSOCIATES

# **Effective Regulation**

## **Assessment and Reform of Economic Regulation of Electricity Distribution Services in New Zealand**

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## ABOUT CASE

Case Associates is an internationally renowned economic consulting firm working across a wide range of regulatory, competition and economic matters. Our particular expertise is in the economics of competition and regulation in energy, telecommunications, transport, and financial networks.

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The views and opinions expressed in this document are those of the authors and do not represent the views of Powerco NZ Ltd and/or its affiliates.

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## Executive Summary

The New Zealand Government is currently reviewing the regime for regulating electricity network service providers. The Ministry of Economic Development (“MED”) has issued a Discussion Document to consult on how the regime may be improved to better meet the Government’s objectives. Case Associates (“Case”) has been retained by Powerco to provide an independent assessment of the current regime as part of Powerco’s contribution to the current review.

The review of the current regime is overdue. The past six years have witnessed lengthy disputes, delays and ad-hoc decision-making as companies and the Commerce Commission have fought over the purpose and implementation of the current law. This has created considerable uncertainty, raised costs for investors and put long-term investment at risk. Unless the defects are remedied, regulation will fail to meet the Government’s aims of promoting investment and providing long-term benefits for consumers.

The Government has recognised the need for change and has stated that long-term investment is now a priority which the regulatory regime must address. But the recent Discussion Document issued by the MED falls short of putting forward clear proposals that will promote investment and consumer welfare.

### Proposals

Given the weaknesses of the current regime, we recommend substantive reforms designed to better meet the Government’s aims of promoting investment and providing long-term benefits for consumers. To achieve this we recommend the following:

1. There should be a statutory remit for the Commerce Commission to impose ex-ante regulation on electricity network businesses and where possible to foster competition. Electricity lines businesses (“ELBs”) are natural monopolies and are regulated as such in every other OECD jurisdiction.
2. Remove the cost benefit analysis (“CBA”) approach as the basis for intervention. In this context CBAs are redundant and moreover have no value where redistributive goals are being pursued.
3. Implement uniform regulation of all ELBs, including those owned by trusts, with incentives for long-term investment.
4. The legal framework should state that where there is no competition in the provision of a service, and no reasonable prospect of competition, the service

should be subject to ex-ante economic regulation which comprises two key elements:

- a. **Consumer protection:** service providers should: a) meet all reasonable demands for electricity connection and supply; and b) provide a secure, reliable and efficient service at cost-reflective prices.
- b. **Incentives for long-term investment:** enable service providers to finance their efficient activities and earn a reasonable return on their investments.

Furthermore, the regulator should be given a role to monitor competition in the relevant market with the view to determining that, if competition develops and becomes effective, the service may be deregulated and subject to competition law.

5. There should be a clear separation of roles between the Government and the Commerce Commission. Parliament would determine the statutory framework which would require the delegation to the regulatory authority to implement the economic regulation as an independent agency.
6. The Commerce Commission should set out technical criteria, principles and processes it will use to implement the regime:
  - a. Rules and process for setting and reviewing end-user prices.
  - b. Principles for encouraging investment in networks.
  - c. Regulatory review procedures and rules for consultation.
7. The Commerce Commission's decisions should be subject to merits review.
8. The Commerce Commission should be well resourced to have the capacity, and attract the skills and experienced staff required, to implement economic regulation. Funding could be through a levy on regulated companies.

## 1. Assessment of the Current Regime

The Government's current review is motivated by the recent experiences of the regulatory control inquiries into airports and gas pipelines services under Part 4 and the application of Part 4A of the Act. These experiences have highlighted a number of weaknesses in the regulatory control provisions of the Act. The MED has identified these as being amongst other things:

- uncertainty around the policy intent of regulatory control;
- inefficiency of regulatory processes;
- potentially insufficient accountability for regulatory decisions; and
- concerns as to whether the Part 4A thresholds regime is meeting its design objectives.

According to the MED, the objective of the review is:

*“to ensure that economic regulation in New Zealand is consistent with providing for the long term benefit of consumers within New Zealand ... Consistent with the broad objective, the review will consider whether any amendments to the Act are desirable to reinforce the Government's policy objectives on investment in infrastructure.”<sup>1</sup>*

The purpose of this report is to evaluate the current regime for regulating ELBs against the MED's stated objective and make recommendations for changes with the aim of better achieving that objective.

The thresholds regime for regulating ELBs is set out in Parts 4A and 5 of the Commerce Act. Part 4A gives the Commerce Commission the power to declare control of goods and services supplied by ELBs. Under this regime the Commerce Commission sets and publishes an ex-ante price threshold, which is an average price cap, for all ELBs. If a line company breaches the threshold, the Commerce Commission is required to determine whether or not to declare control of that lines business. Under the declaration to control, a business cannot supply goods or services unless it receives authorisation from the Commerce Commission and the business must supply its services in accordance with the authorisation. Finally, Part 5 of the Commerce Act sets out the Commission's powers to provide authorisations.

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<sup>1</sup> “Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document”, Ministry of Economic Development, Wellington, New Zealand, April 2007.

## 1.1. Regime Creates Uncertainty

Once a company is shown to have breached the threshold there is considerable uncertainty about the consequences of the breach. This stems in part from the wide discretion that the Commerce Commission has on the scope of the inquiry and the terms to be included in the authorisation. It also stems from the number of ad-hoc agreements that the Commission has struck with different ELBs which the Commission has itself said should not serve as precedent for future authorisations.

Apart from high level principles, the current legislation provides no guidance to the Commission on the criteria, principles and processes for imposing control. This creates significant uncertainty for investors who are more likely to under-invest or delay costly maintenance for fear of breaching the thresholds.

The thresholds regime is effectively an ex-ante price cap – it constrains companies' prices to below a certain threshold. This in turn affects firms' revenues and influences their operating and investment behaviour. In this respect, the thresholds regime works very much like conduct regulation but it differs from best practice (so-called 'incentive regulation') in a number of important ways, namely:

- The threshold regime is backward-looking. The average cap is based on past costs, not future costs and investment requirements.
- Because they are based on benchmark (and not actual) costs, thresholds move prices away from efficient (i.e. cost reflective) levels.
- The average cap provides no incentives for companies otherwise operating below the threshold to improve efficiency and companies that would usually operate above the threshold may be unable to finance their investment activities.

## 1.2. Regime Lacks Incentives for Investment

The threshold regime encourages under-investment in infrastructure. This goes against the Government's clearly stated objective to promote infrastructure investment. As set out in its August 2006 statement to the Commerce Commission, the Government considers that this objective will be achieved by:

1. Regulatory stability, transparency and certainty giving businesses the confidence to make long-life investments.
2. Regulated rates of return being commercially realistic and taking full account of the long-term risks to consumers of under-investment in basic infrastructure.
3. Regulated businesses being confident they will not be disadvantaged in their regulated businesses if they invest in other infrastructure and services.

These statements call for regulatory controls which provide appropriate incentives for long-term investments. The Minister of Commerce, Hon Lianne Dalziel made clear in August 2006 that:

*“The provision of efficient infrastructure requires that businesses have the confidence and incentives to make investments in replacement, upgraded and new facilities and services...*

*Particular issues arise in the case of businesses which are or may be regulated under Parts 4, 4A or sections 70 to 74 of Part 5 of the Commerce Act. The way in which the prices, revenues and/or quality of goods and services produced by these businesses is regulated or controlled can affect their incentives to invest in new or upgraded infrastructure.”<sup>2</sup>*

The MED Discussion Document reiterates the primary importance of investment. However, the reforms proposed in the MED Discussion Document fail, in our view, to set out reforms that implement the Government’s investment goals.

The current purpose statement for ELB regulation (section 57E of the Commerce Act) makes no reference to investment. If the Government wishes to encourage investment then the purpose of Part 4A needs to be amended to reflect that intent.

### **1.3. Inappropriate Emphasis on Wealth Redistribution**

The current regulatory approach draws a distinction between improved economic efficiency (“net public benefits”) and consumer welfare (“net acquirer benefits”). In this context, the Commerce Commission has argued that a net public (producer and consumer) benefit test assigns no value to the removal of monopoly rents and their transfer from the suppliers of the services to the acquirers of such services.<sup>3</sup>

Much of the debate concerning the benefits of economic regulation (by the MED) has centred on the need to demonstrate direct transfers to consumers from producers. In this respect, the MED’s approach has focused on consumer benefits, accepting there are some, and possibly significant, efficiency losses in this approach.

There is no basis in economics for assuming that transfers from producers to consumers improve the long-term welfare of consumers. On the contrary, we would argue that such transfers may actually harm the long-term interests of consumers by reducing incentives for efficient investment and operating.

In the Discussion Document, the MED asserts that “analysis focused solely on economic efficiency will virtually always show net costs” (para 4). This claim arises from the work of the Commission into whether gas pipelines and the airport sector

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<sup>2</sup> On 7 August 2006 the Minister of Commerce issued a s26 statement of the Government’s economic policies concerning the incentives of regulated businesses to invest in infrastructure. [http://www.med.govt.nz/templates/MultipageDocumentTOC\\_\\_\\_\\_21483.aspx](http://www.med.govt.nz/templates/MultipageDocumentTOC____21483.aspx)

<sup>3</sup> Ms Paula Rebstock’s affidavit in the High Court case between Powerco Ltd and the Commerce Commission, para 6, as cited in para 10 of the affidavit in Reply of Kerrin Vautier, 27 April 2006.

should be regulated. The MED states (para 65) that “its methodology is likely to show that there will be net economic costs from regulating in virtually all cases”. The MED thus concludes that there are no efficiency gains to be had from regulation. However, the MED’s analysis does not take into account the Government’s objective to promote investment. The focus on distributional criteria ignores the need to allow companies to finance their activities and earn a reasonable return – without which their incentives to invest are significantly reduced.

The MED’s analysis also assumes demand is relatively inelastic and that economic efficiency will not be affected by economic regulation. However, we have seen in other jurisdictions that changes to service quality, reliability and technological innovation can affect demand for distributed energy. For example, the implementation of time of use meters in California and other jurisdictions has allowed demand to be more responsive to prices. Furthermore, innovation in captive energy sources – such as solar panels and wind-turbines – can also affect the demand for distributed energy.

The MED’s assumption that regulation does not affect allocative efficiency can also be challenged. Some regulators have allowed companies to implement demand-based pricing – so that consumers who value a service more (or are less willing to be cut off) can pay more for that service. Interruptible tariffs (which are usually discounted from standard tariffs) are the opposite of this. Such pricing can result in an improvement in economic efficiency as prices more closely reflect the value that consumers place on the service they receive.

Thus, at a fundamental level we are not persuaded that a) CBA with distributional weights are an appropriate basis on which to make policy interventions; b) efficiency gains are too small or negative; and c) that it is in the interests of consumers to focus solely on transfer of excess profits to consumers.

#### **1.4. Regime is Neither Cost Effective nor Light-Handed**

The current thresholds regime appears to be based on the premise that an ex-post regulatory regime can be developed which differs markedly from, and is more effective and cheaper than, ex-ante regulation.

However, this distinction is more apparent than real as it overlooks the fact that thresholds, to regulate prices (and other variables) – set in advance and based on industry conditions and regulatory objectives – are prescriptive. In this sense they are similar to ex-ante regulation universally deployed in advanced economies.

On the other hand the alleged attractions of the current thresholds regime are considerably less than claimed, and possibly illusory. Based on a review of the existing regime we find that there are severe disadvantages with the threshold approach in practice that impair the ability of regulation to deliver long-term benefits to consumers without severe costs to the industry.

Experience during the past six years has shown that what was intended as a light-handed and cost effective approach to regulation has in practice been shown to involve

costly litigation and lengthy delays associated with post-breach inquiries and negotiating administrative settlements.

The claim to light-handedness can also be challenged on the basis that once a threshold is triggered, the subsequent inquiry conducted by the Commerce Commission carries a significant regulatory burden and cost. These factors need to be considered before rejecting best practice regulation.

The MED Discussion Document does not do this. Without undertaking a proper and detailed assessment of how incentive regulation has worked in other OECD economies and whether it might be appropriate in the New Zealand context, the MED suggests:

*“While it appears that New Zealand is unusual in providing for a decision-making process, and in particular detailed cost-benefit analysis, on whether economic regulation should be imposed, the Ministry proposes that this should continue to be the case. Regulation incurs costs and may result in a net cost to the economy, and accordingly should be a last resort.”<sup>4</sup>*

In reaching this conclusion, the MED focuses purely on wealth transfer and does not even consider whether ex-ante regulation might improve the incentives for investment. In conducting its analysis in this way, the MED not only ignores the Government’s expressed objective of the need to promote investment but also does not consider around 15-20 years’ experience of incentive regulation across the world.

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<sup>4</sup> Paragraph 90, page 30 of the MED Discussion Document

## 2. Why Regulate Electricity Lines Services?

### 2.1. Problem of Natural Monopoly

We distinguish here between the problem of natural monopoly – where there are no competitors and no reasonable prospect of competition – from the problem of substantial market power which may, at the extreme, result in an effective monopoly.

The MED Discussion Document proposes various competition tests that might be employed to determine whether a firm may be regulated. These include substantive market power and natural monopoly tests which are applicable in evaluating market power.

In other regulatory regimes (Australia, Europe), the approach to dealing with the problem of monopoly has been to give economic regulators the duty to promote competition but to regulate if an operator is super-dominant or a monopoly. Since in many infrastructure sectors it is fairly obvious if an operator is dominant or super-dominant there is no need for cost-benefit analysis to support regulation. If, however, competition does evolve, one can accommodate this change by adding a requirement to the law that where competition is feasible and effective then the activities/operations can be de-regulated and subject to ex-post competition law.

The competition test can be applied to generate the case for regulation – one simply has to apply a dominance or SMP test together with a few more stringent requirements to show the inappropriateness of ex-post competition law. But there is a controversy as to whether a competition test alone is sufficient formally to pick up industries requiring economic regulation. What is needed in addition is not the competition test per se but a discussion about the effectiveness of different remedies. It is here that the so-called ‘monopoly argument’ marries with the competition test. In sectors where there is a permanent or transitory monopoly (practically natural monopoly) then economic regulation is required.

Electricity and gas lines businesses are natural monopolies and are treated as such in other advanced economies. The legislative framework should therefore distinguish between natural monopoly – where there is no reasonable prospect of competition – and other industries subject to competition where market power assessments may be required. In this respect we would suggest that Part 4 of the Commerce Act should be amended to distinguish between the treatment of natural monopoly industries (airports, electricity, gas, telecommunications) and other industries.

Natural monopoly means that it is significantly cheaper to have one network than two or more networks in the same geographical area. Thus monopoly provision is the most cost-effective way of supplying the network. This is the recognised basis for economic regulation of electricity and gas networks in most developed economies.

Regulation is necessary because effective competition is not possible or desirable. Network operators will thus have market power and are in a position to overcharge their customers, and do not face the disciplining forces of competition which encourage innovation, investment and efficient and reliable service. More specifically, monopolists can abuse their dominance by raising prices and/or restricting output, such that output and consumption are below economically efficient levels. Governments are therefore eager to protect consumers from the abuse of dominance.

However, regulation to curb the conduct of monopolists can compromise investment. Investors will be unwilling to commit to long-term investments unless they can be assured of reasonable returns over the economic life of their assets. Because natural monopolies often occur in strategically important industries such as energy and water governments have a tendency to intervene. In such circumstances, investors are concerned about expropriation of profits and will look for commitment from regulators and government that they will be able to earn reasonable returns.

If regulators and governments are concerned predominantly about short-run consumer welfare, then there can be tensions between regulatory objectives of promoting investment and protecting consumers. If, however, governments recognise that consumers' long-term interests are best served by financially viable companies operating efficient and reliable energy networks, the problem resolves itself and protecting consumers is synonymous with the promotion of efficient investment.

### **3. Policy Objectives of Economic Regulation**

The New Zealand Government has accepted the need for long-term investment. In framing the objective of competition policy within section 3 of the Commerce Act to support the “long-term interests of NZ’s consumers”, there is an explicit recognition that immediate consumer benefits may be deferred.

For example high costs due to present investment will result in future benefits (improvements in service quality and reliability, for example). The practical point that arises is how to manage the deferment of benefits. At what point will consumers share in the benefits of monopoly service provision? In addition, the extent to which any efficiency benefits should be shared.

In most OECD and EU jurisdictions, the objectives of economic regulation are simultaneously to protect consumers from abuse of monopoly power as well as to promote efficient operation and investment in network industries. A fundamental premise behind these objectives is that curtailing monopolies will generally enhance both aggregate social wealth and the consumers’ share of that wealth.

#### **3.1. Improving Economic Welfare**

A central feature of the debate in New Zealand concerns the objective of economic regulation. Unlike in other countries, the debate has centred around whether regulation should pursue economic objectives or distributive ones. This has been cast in terms of a conflict between traditional economic efficiency concerns and that of consumer welfare. And the latter has been cast in terms of redistributing income to consumers away from producers. This view has been fuelled by the Commerce Commission’s claim that a public benefit test would result in intervention showing net costs, and therefore being inefficient.

The nature of this debate and the empirical premise that regulation is inefficient is startlingly out of kilter with the policy debate in other countries. No regulatory regime in any other advanced economy focuses directly on economic efficiency or wealth transfers. Nor do Ministers in other jurisdictions have powers to make overt trade-offs between these two objectives.

The endorsement of the primary goal of regulation as being redistributive would not be endorsed by most economists and does not lie at the core of the objectives of regulatory systems around the world. Where there is a similarity is the focus on consumer welfare and protecting consumers’ interests. However we do not see the alleged inconsistency between economic efficiency and the long-term interests of New Zealand consumers as claimed.

In competitive markets, vigorous competition results in a redistribution of wealth between producers and consumers as prices come down. But it is competition which

drives this transfer. More efficient firms earn higher returns because they provide consumers with better quality service and/or product at a lower price. Hence, competitive markets result in wealth transfers *and* improved efficiency.

The principal role of economic regulation is to mimic a competitive market outcome in the absence of competition. To focus regulation purely on transfers of net wealth at the expense of efficiency would compromise that role. As Michael Porter has argued:

*“Productivity growth is central to antitrust because it is the most important determinant to long-term consumer welfare and a nation’s standard of living.*

*A preoccupation with short-term consumer welfare and price-cost margins overlooks the fundamental benefit of competition which is not to ameliorate short-run over-charging but to drive productivity growth through innovation.”<sup>5</sup>*

These considerations should be taken into account when designing a regulatory regime that attempts to mimic a competitive market outcome. The debate in New Zealand has been unnecessarily polarised and has focused too much on wealth redistribution, ignoring completely the need for regulation to promote investment and efficiency

### **3.2. Clarity of Purpose**

The debate surrounding economic regulation of lines businesses suggests that greater clarity is required about the objectives of regulation. A purpose statement that is clear, consistent with the purpose of economic regulation and aimed at achieving the Government’s goals for investment is urgently needed.

The current purpose statement under the Commerce Act has given rise to unnecessary confusion and litigation. The current emphasis on consumer benefits (albeit long-term benefits) has been interpreted as requiring a greater weight on consumers – such that a dollar in the consumer’s pocket is worth more than a dollar in the producer’s pocket. This is a licence for capricious intervention.

Ideally, a purpose statement should say that a natural monopoly service that faces no competition, and no reasonable prospect of competition, should be regulated with the aim of:

- providing long-term benefits for consumers;
- providing companies with incentives for investment;
- enabling companies to finance their efficient operating and investment activities; and
- ensuring that infrastructure investment supports the long-term needs of the New Zealand economy.

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<sup>5</sup> Michael Porter “Competition and Antitrust: Toward a Productivity-based Approach to Evaluating Mergers and Joint Ventures” (2001), 46 Antitrust Bull. 923.

Furthermore, the regulator should be given a role to monitor competition in the relevant market with the view to determining that, if competition develops and becomes effective, the service may be deregulated and subject to competition law.

### **3.3. Examples from Other Countries**

Most economic regulators have dual objectives of protecting consumers and ensuring that firms can finance their activities.

#### **3.3.1. England and Wales**

For example in England and Wales the 1989 Electricity Act (Section 3(1)), places the following duties on the Secretary of State and Director General of Energy Supply (DGES, the energy regulator):

- a) to secure that all reasonable demands for electricity are satisfied;
- b) to secure that licence holders are able to finance their activities; and
- c) to promote competition in the generation and supply of electricity.

Section 3(3) states that the DGES and Secretary of State have a duty:

- a) to protect the interests of consumers in respect of
  - (i) the prices charged and the other terms of supply;
  - (ii) the continuity of supply; and
  - (iii) the quality of the electricity supply services provided;
- (b) to promote efficiency and economy on the part of licensees and other service providers..

#### **3.3.2 Ireland**

The energy regulator in Ireland, the Commission for Energy Regulation, has similar objectives. Whilst its primary duty is to protect consumers, in doing so, it also needs to ensure continuity and reliability of supply as well enabling firms to finance their activities. Under the Energy Regulation Act 1999, the Commission and the Minister are required to carry out their functions (of regulation) in a manner which:

- (a) does not discriminate unfairly between holders of licences etc;
- (b) the Minister or the Commission, as the case may be, considers and protects the interests of final customers.

In carrying out the above duty, the Minister and the Commission must have regard to:

- (a) promoting competition;
- (b) securing that all reasonable demands of final consumers are met;

- (c) securing that licence holders are capable of financing their undertakings;
- (d) promoting safety and efficiency on the part of electricity undertakings; and
- (e) promoting the continuity, security and quality of supplies of electricity etc.

These practical examples from England and Wales and Ireland demonstrate that regulators generally have a duty to protect the interests of consumers as well as to ensure that regulated entities can finance their activities. There is no mention in either jurisdiction of the objective of wealth distribution between consumers and producers.

## 4. Achieving Effective Regulation

Regulatory objectives may be achieved within a wide range of regulatory procedures, as long as there are adequate restraints to prevent arbitrary administrative action. An effective regime needs:

- independence;
- transparency;
- accountability; and
- commitment.

### 4.1. Independence

Independence is at the heart of best practice regulation. Regulators, like central bankers, should be free from political influence in making decisions about prices and investments. Investors need assurances that the scope for political interference is minimised. However, political involvement cannot be removed altogether, for example, licences in other jurisdictions allow the Government to intervene in the case of bankruptcy or failure to provide adequate service. However, the basis of any intervention should be on technical and objective criteria. Utility industries, such as electricity and water, tend to be highly politicised because they are essential services. If governments are not taken out of the decision-making process there is a strong temptation for them to intervene based on short-term political considerations.

Other parliamentary democracies have already decided to control energy distribution services. The decision to do so is enshrined in primary legislation such as an act of Parliament. Hence, the *whether to control* decision has already been made by Parliament.

The situation in New Zealand is different, however. Before regulatory intervention can take place, a decision must be made on whether to control and then on the form of control. For this reason we believe that in discussing regulatory independence in the New Zealand context it is helpful to distinguish between:

- the decision whether to control;
- the form of control; and
- implementation of controls.

Parliament gives authority to Government to regulate a sector. Best practice regulation then requires the power to determine the form of control and the implementation of those controls to be separated from government and delegated to an independent authority.

Regulatory independence has many advantages, as set out below, so the important question is whether delegation to an independent entity results in a loss of accountability relative to ministerial decision-making.

Where a Minister undertakes regulatory tasks, the Minister is accountable to:

- a) Cabinet;
- b) Parliament;
- c) the courts, although this may be circumscribed by constitutional and other rules delimiting the respective roles of the judiciary and the executive; and
- d) the general public, both via the proxy of the media and directly at the time of an election.

Delegating regulation to a regulator at arms' length removes each of these mechanisms of accountability except accountability to the courts. To avoid creating an all-powerful regulator who is not answerable to anyone, it is vitally important that the regulatory system replicate such accountability as best it can. A careful structuring of rules and procedures for the regulator can ensure both accountability and independence.

Also, given the near certainty over which areas require regulation (it would be difficult to argue that electricity and gas lines businesses are not natural monopolies) the present approach seems to increase (not decrease) the regulatory burden and to unnecessarily politicise the process.

Regulation is a technical matter best left to specialised bodies to determine the practicalities within a broad remit set by Parliament. Most governments have moved to de-politicise regulation so that long-term considerations, which go beyond the electoral cycle, are at the forefront of regulation. Governments are subject to political pressure and short-term considerations. This means that they lack independence in deciding (and may have conflicting interests) when to intervene in matters concerning prices, revenues and investments. This is especially the case where distributional criteria are used. Therefore, allowing a minister to decide when to regulate a natural monopoly leaves open the possibility that this decision will reflect political rather than objective criteria.

Delegation to an independent agency has several advantages:

- It can avoid negative consequences of political lobbying;
- It may enable the regulatory system to focus on longer-term issues than may be possible within an electoral cycle;
- Delegation forces a higher level of transparency on regulation because it requires primary legislation that states general principles in a way that would not necessarily be observable with implicit regulation by a Minister; and
- The government-opposition nature of politics may lead to decisions being based on entrenched positions that may not be ideal for regulation.

However, these advantages from delegated regulation can only be obtained if the system of regulation is properly established. Amongst the potential dangers are:

- creating powerful regulators that are not accountable to anyone;
- establishing a costly additional layer of bureaucracy; and
- excessive zeal and unstoppable growth of regulation.

The regulator could, in theory, be made accountable to Parliament. This could operate in a passive or an active way:

- **Passive** – the regulator delivers an annual report to parliament. Desirable from the point of view of improving transparency and accountability and is standard practice in many jurisdictions.
- **Active** – the regulator appears before a parliamentary committee to present and discuss the report and the activities of the office. Also desirable but could be costly and could risk impartiality.

## 4.2. Accountability

Regulators must be open to scrutiny on the merits or substance of their decisions. In most common law countries regulators are subject to judicial review. However, judicial review does not provide an adequate check on regulators. This is because courts are usually reluctant to review the substance of regulatory decisions as they lack the technical expertise to do so. For this reason many countries, such as England and Wales, enable merits review of regulatory decisions.

Merits reviews are essential and recognised as such, for good regulation. Experience has shown that even a well intentioned regulator not subject to merits review can cut corners, become sloppy, fail to do its homework, and as a result, make bad decisions.

The case for merits review has been questioned by the New Zealand Government. The main objections are that:<sup>6</sup>

- it would allow those regulated to game the system and subvert the effectiveness of the regulator by delaying the decisions;
- courts are incompetent to adjudicate on complex economic issues; and
- judicial review is adequate.

These objections are not convincing. The concern over gaming the system is overblown and controllable by simple substantive and procedural safeguards. It is overblown because businesses do not engage in litigation lightly. It is costly, uncertain, diverts managerial time and attracts adverse attention (reputational risks). This is especially so for investor-owned and publicly listed companies.

The claim is also based on the assumption that an appeal is likely to generate a more favourable outcome than that of the regulator or that there are direct economic gains to the appellant. However, appealing a regulatory decision is a risky affair which may result in harsher sanctions.

Moreover, the attempt to use litigation as a device to stall implementation of otherwise meritorious regulation can be thwarted by requiring the enforcement of the regulator's decision pending appeal, and/or expediting proceedings for time sensitive decisions or having separate proceedings to see whether the equivalent of an interim injunction should be awarded for types of irreversible costs/regulation with claw-backs in the event the appeal fails.

Furthermore, regulated firms are repeat players – they have an interest in complying with the rules of the game if they are fair and sound, if only to avoid even harsher rules. An uncooperative stance will only be taken if there are private gains to those regulated. A rational litigator will only embark on such a course if the expected benefits are positive and outweigh the costs of litigation.

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<sup>6</sup> V. Heine, Reviewing the merit of merits reviews: Does New Zealand need them? Paper to 7<sup>th</sup> Annual Competition Law and Regulation Review, 26 and 27 February 2007, s Wellington.

What is often missing from the critics' analysis is that a firm can only expect a gain if there is merit to its appeal. And they also forget that this increases with the deficiencies in the regulators' decisions. Therefore, one of the advantages of merits review is it will be beneficial not just to the company but also to the regime as a whole. The learning and improvements made to regulatory methodology would warrant the additional time used to get this outcome.

Second, the lack of expertise of the appellate body is easily remedied. New Zealand has a long tradition with lay economist members of the High Court (Administrative Division) who sit with judges in competition cases involving technical economic arguments. We have seen Europe's judges and specialist tribunals routinely examine regulatory decisions and offering what many participants regard as fairer and better outcomes.

The value of merits review has been obvious in Europe. The European Commission has been rocked by merits review undertaken by the Court of First Instance over the last several years. This is an interesting and apposite example since it brings together an apparently elite division of a regulator which revealed poor quality decision-making. We refer here to the Merger Task Force ("MTF") of DG COMP which pioneered the use of economics and was set up to deal effectively with merger clearance. But in three successive appeals the CFI annulled the Commission's merger decisions for failing to satisfy the "requisite standard of proof". The judges indicated that the MTF had failed to establish their case, failed to properly analyse the facts, relied on theoretical speculation rather than factual assessments, and in some cases compromised the rights of the parties. These decisions not only remedied the problems thrown in the specific cases, but lead to organisational and legal reforms to address structural weaknesses of the regulators' procedures and competence.

### 4.3. Transparency

Transparency refers to decision-making being observable. It is important to distinguish transparency of process (rules, procedures and protocols observable) and transparency of reasoning (substantive basis for decisions is observable). There are also three distinct levels of transparency depending on the observers. The lowest level is if only the Minister or civil servants can see the decisions. The second level is if interested parties (e.g. regulated companies) can see reasoning. The highest level is enabling the general public to see the record.

To improve transparency, the Commerce Commission should have explicit (i.e. stated in law) requirements to:

- write, publish and disseminate **reasoned arguments**;
- establish **clear procedures** for dealing with most tasks, which are consistently used in a timely manner; and

- develop the **necessary technical expertise** and information base to inspire confidence in the basis for regulatory decisions.

Transparency, albeit costly, assists both accountability and credibility. As an agency establishes a body of reasoning, it will develop a clear reputation so that those affected will be able to predict the regulatory regime. Transparency also imposes a higher standard of reasoning on the regulator and, as such, is likely to increase the quality of decision-making.

Transparency requires the regulatory agency to have the capacity, skills and experience required to undertake the above tasks. For this reason, we would recommend that the Commerce Commission is adequately resourced, through a fee imposed on regulated businesses, to develop the capacity, skills and experience required to achieve the level of transparency needed under an economic regulatory regime.

#### **4.4. Regulatory Commitment**

Good regulation must draw a balance between certainty and flexibility. The former to give the stakeholders confidence in future decision-making; the latter to react to changes in economic and other factors that affect achievement of regulatory objectives.

Of particular concern to business, especially in industries which have long time horizons for investment, is some confidence that they will be able to recoup their costs and earn a reasonable return. Regulators (and government) want to encourage efficient investment. The way they do this is by creating a clear and stable environment which sets out clearly the regulatory framework which allows this. Annual reviews and constant revisions in the light of shifting objectives and distributive concerns are not conducive to regulation charged with encouraging large scale investment in infrastructure. This is as true as it is obvious.

In some jurisdictions, namely UK, Australia and Ireland, governments have strengthened commitment to the form of regulation. They have done this through the development of regulatory documents, such as licences, rules and codes, which set out regulators' objectives and duties and describe the approach and process that regulators must adopt in reaching their decisions. Licences can provide investors with a high level of confidence about the regulatory regime as they effectively reduce regulatory discretion. New Zealand currently has no formal commitment mechanisms. There are no formal agreements between the Commerce Commission and regulated entities regarding the way in which regulation will be implemented and the principles and criteria for regulatory decision-making. We would propose strengthening regulatory commitment with the view to enhancing confidence in the regime required to promote long-term investment.

## **5. The Form of Control**

### **5.1. Appropriate Incentives for Investment**

The current regime falls significantly short of meeting the Government's aim of promoting investment. As set out in its August 2006 statement to the Commerce Commission, the Government considers that this objective will be achieved by:

1. Regulatory stability, transparency and certainty giving businesses the confidence to make long-life investments.
2. Regulated rates of return being commercially realistic and taking full account of the long-term risks to consumers of under-investment in basic infrastructure.
3. Regulated businesses being confident they will not be disadvantaged in their regulated businesses if they invest in other infrastructure and services.

These statements call for regulatory controls which provide appropriate incentives for long-term investments.

### **5.2. Alternative Forms of Regulation**

The MED Discussion Document (Chapter 7) sets out a number of options for economic regulation. They are in brief:

1. Regulatory control (the MED does not say if this would be ex-ante or ex-post or incentive or another form of regulation).
2. Thresholds.
3. Commercial negotiation/arbitration.
4. Information disclosure/price monitoring.

The MED paper does not discuss the relative merits of regulation and thresholds approaches. As a result the current threshold approach is not justified or shown to be superior and its relative merits are not compared with the most common alternative – ex-ante regulation, as implemented in other OECD countries. Unfortunately, none of the regulatory options is evaluated against the Government's aim to promote investment.

#### **5.2.1. Regulation**

The MED states in para 137 that *"it is desirable to ensure that the most cost-effective type of regulation is implemented in a given circumstance"*. There is no mention of whether the most cost-effective regulation would achieve the Government's aims to promote investment in infrastructure.

### **5.2.2. Negotiate/Arbitrate Model**

The negotiate/arbitrate model is discussed in positive terms but there are important practical difficulties with its implementation. ELBs are unbundled from retail activities. Under a negotiate/arbitrate model, the lines companies would be consulting with final consumers about a network access tariff which is currently paid by retailers.

The problem with this model is that whether a price reduction is passed through to final consumers depends ultimately on competition in the retail supply market. Hence, even if consumers and lines companies agree a price reduction, consumers may not necessarily see that price reduction in their tariffs, unless they deal direct with the lines business. Other aspects of the negotiation model also need further consideration, such as whether the Commerce Commission has the capacity to take part in these bilateral negotiations and, if required, impose mandatory solutions on parties.

Negotiation models have worked well in upstream gas and oil businesses where, through joint venture and production agreements, there is a long history of bilateral negotiation between industry players. Whilst we are not dismissing the negotiate model altogether, we believe that it needs to be better thought through before it can be proposed as a viable alternative to, or an element of, the current regime. More importantly, the MED should consider whether the model is better suited to achieving the Government's aims compared with under the current regime or under other regulatory options.

### **5.2.3. Information Disclosure/Price Monitoring**

While the MED lists information disclosure, it is not (by itself) an alternative, self-contained regulatory option. Information disclosure and price monitoring are elements within all regulatory regimes and are not – by themselves – substitutable for other forms of regulation. Hence, this model is not a complete regulatory option. The Commerce Commission currently monitors prices, and companies are required to submit information, both in determining thresholds and in an ex-post breach inquiry. We do not therefore understand the basis for including this as another option.

Overall, more work needs to go into assessing viable regulatory options. One of the options is not a complete regulatory option, the other two (thresholds and ex-ante regulation) are not discussed and the fourth is not thought through properly. It is striking that the MED does not consider the most universally applied form of regulation – ex-ante incentive price control. There is no discussion of how it has been implemented in other jurisdictions or whether it might be suited to the New Zealand context. Finally, none of the regulatory options is evaluated against the Government's aim to promote investment.

### **5.2.4. Reliance on Benchmarks**

New Zealand's thresholds approach to regulation has been defended on the basis that it is relatively simple and low cost to implement. However, these purported advantages

need to be weighed against the significant weaknesses of this approach. Developing thresholds based on benchmarks is fraught with problems because no two companies face the same operating circumstances, no matter how similar they are. Companies also differ in their optimisation of tax and the way in which they capitalise operating expenditure.

Given the diversity of electricity lines businesses, any sort of averaging of data between the companies is likely to produce systematic and predictable biases which will inevitably generate regulatory inefficiency and conflict. Electricity distribution network costs are affected by the economics of density. Distribution entities operating in cities have very different cost structures to those in rural areas. The regulator would need to adjust for density/sparsity factors when setting appropriate individual thresholds. When the differences between companies are taken into consideration a thresholds approach might be as onerous (and yet less efficient) than a more intrusive price path set for each individual company.

Thresholds move prices away from efficient (i.e. cost reflective) levels. This is because prices based on hypothetical costs move out of line with companies' actual costs. Moreover, downward pressure on prices (through a backward-looking price cap) discourages future investment. An alternative to a thresholds approach is to allow prices to reflect companies' actual costs and investment requirements as well as providing incentives for improvements in operating efficiency going forward. Such an approach would allow for some comparisons of efficiency but prevent the benchmark from removing incentives to efficiency.

#### **5.2.5. Propose-Respond Model**

The MED has put forward elements of a model where line companies themselves can propose prices based on investment requirements and other elements of price control.

In this way the companies can make proposals based on their financing needs. This is not dissimilar to the way in which incentive regulation has been implemented in other jurisdictions where, as part of the regulatory review, companies make detailed submissions on their investment plans, financing arrangements and required returns.

We believe this approach has considerable merit and could help reduce the regulatory burden. It also encourages companies to provide detailed information to the regulator. In this respect a propose-respond model might improve the quality of decision-making and result in the regulator and companies working in a more co-operative manner. This model still requires a robust regulatory framework to be in place, however, so that there are clear guidelines on the information that companies are required to provide and the principles, criteria and processes that the Commission will use in evaluating the companies' proposals.

## 6. Conclusions

The current thresholds regime is creating uncertainty and putting investment at risk. Substantive changes are therefore required to create a more predictable regulatory framework aimed at meeting the Government's aims for promoting investment and providing long-term benefits for New Zealand consumers.

The current regime's focus on welfare redistribution as the principal aim (and benefit) of economic regulation ignores the need to encourage investment in monopoly networks. Other OECD countries have designed economic regulation with the aim not only of protecting consumers from abuse of dominance, but also to promote efficient investment in, and operation of, network businesses. These efficiency aims are synonymous with achieving long-term benefits for consumers.

The use of a competition test, to determine if intervention is warranted, is also of questionable value. Electricity distribution services are natural monopolies and are regulated as such in every other OECD country. For this reason we believe that Part 4 of the Commerce Act should be amended to distinguish between the treatment of natural monopoly, where there is no reasonable prospect of competition, from other industries where market power tests are appropriate to determine if intervention is required under the Commerce Act.

We have made a number of proposals which we believe would help make regulation more effective in achieving the Government's aims. In particular we have advocated the creation of an ex-ante regulatory regime which is independent, transparent and accountable and in which there is a high level of commitment by the regulator to use a prescribed approach – as set out in regulations, guidelines and processes.

To achieve this end, we have proposed:

- **A clear purpose statement** which recognises the need to protect consumers as well as enable investors to finance their efficient activities.
- **Clearly defined roles** of Government and regulator in the regulatory process.
- **Greater certainty** surrounding the form of regulation and the way in which it is implemented.
- **Ex-ante commitments** from the Commerce Commission to follow a set of principles, criteria and processes to be used in regulating electricity distribution services.
- **Incentives for investment.** Price controls should be forward-looking and related to companies' own costs and investment requirements.
- **Merits review.** The Commerce Commission's decisions should be subject to merits review.

- **Well resourced regulation.** The Commerce Commission should have the capacity (skills and resources) needed to implement effective economic regulation.

The current regime does not reflect international best practice and claims that it is light-handed and cost effective are debatable. Changes need to be made to provide companies with incentives to invest to meet the Government's stated aim to promote investment in electricity infrastructure.