

**Submission to the Ministry of Economic Development  
Review of Regulatory Control Provisions under the Commerce Act 1986**

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**Commerce Act Review**

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This submission is from

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I/ we do not wish to appear before the committee to speak to my/ our submission.

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**Summary**

- I. All proposed changes and improvements should be judged against the background that the regulatory body wishes to assure a high level of regulatory certainty. Certainty is a major aspect for companies under a control regime, and this should be given strong attention to ensure that there are the necessary incentives in place to promote timely investment in essential infrastructure.
- II. A regulatory-specific purpose statement is desirable as it increases certainty and comprehensibility about the design objectives for all affected parties. Consequentially, it is essential that its interpretation is unambiguous.
- III. We regard the Commerce Commission as an appropriate body for all decisions regarding the setting of the input methodologies. Due to the size of the New Zealand economy, the introduction of a new expert panel does not seem feasible. However, we recommend improving the credibility of the Commission's decisions by adding extra legislative tests and make the decisions subject to merits review.

- IV. Generally, the inclusion of merits review adds credibility and transparency to the regulatory process, creating incentives for the decision making body to achieve high quality outcomes. The benefits will compensate disadvantages such as higher costs. It should, therefore, be accessible for all substantial regulator decisions.
- V. We favour 'Option two': repealing Part 4A and amend Part 5 to allow the Commerce Commission to put sectors under regulatory control using comparative benchmarking, and provide for a 'propose/ response' model to give parties the opportunity to seek customised terms. Although this regime means less flexibility it creates more certainty for all affected parties.
- VI. We do not agree with the current determination of the X for the CPI-X price path. We recommend a CPI-X price path threshold with  $X=0$  for all ELBs for a transitional two years period starting in April 2009 until changes of the Part 4A are implemented. This would save time and cost for all affected parties.

The submission on behalf of **Eastland Network Ltd** is structured as follows:

In Part I we would first like to describe issues we face as an Electricity Lines Business (ELB) under the current regime. In Part II, we express our views related to the questions raised in the MED Discussion Document.

## **Part I**

1. The overall feeling is that the document has a very wide scope leaving it imprecise and ambiguous in some of the suggested options. However, we welcome the opportunity to propose changes and improvements to the current regime.
2. As a comparatively small ELB we particularly oppose the measures used to determine the X for the CPI-X price path under the current regime. Customer density and average consumption are considered as indices or a proxy for network efficiency. We have no influence on either the number of connected customers nor the quantity of their consumption. The present  $X = 2\%$  creates negative incentives on our investment decisions as we are not able to receive a fair return on investment on our assets at a time when replacement capital expenditure is significantly higher than depreciation. We do realise however that a transition to a more equitable regime will take time and therefore propose that a CPI-X price path threshold with  $X=0$  for all ELBs for a transitional two years period starting in April 2009 is put in place. This also takes into account time pressures between the planned reset of the current thresholds and the implementation of any changes to Part 4A which potentially make a reset redundant. To save the Commission and the ELBs from the costs and time intensive effort to reset the threshold for the next period starting April 2009, the recommended CPI price path threshold should be put in place until changes of the Part 4A have been decided on and are implemented.
3. Related to that, there is the issue that the current regime is based on backward looking data. There are no provisions to achieve ex-ante approvals for significant, necessary capital expenditures.

## **Part II**

### *Desired characteristics of a regulatory regime*

4. The described characteristics cover a wide range of objectives. It is noted that there seems to be a strong wish to design a regulatory regime which does not limit affected businesses more than necessary. One of the reasons stated, why a review of the regulatory control provisions of the Commerce Act was initiated, is to reinforce the

Government's objectives concerning infrastructure investment. Against this background the named characteristics generally suit the objectives. Great attention should be given furthermore to assuring a high level of regulatory certainty as it is a major aspect for companies under a control regime.

*Issues with the current regime*

5. Generally the identified issues cover the main problems of the current regime and are adequately described.
6. In particular, we would put emphasis on the major concerns related to the uncertainty resulting from breaching a price or quality threshold, the inability for firms to seek ex-ante approvals for major capital expenditure and being potentially targeted for minor or technical breaches of the current thresholds is of major concern. . They cause negative impacts on important investment decisions and reduce the certainty of earning a fair return on investment, potentially meaning that such investment is not made..

*Objectives of economic regulation*

7. We do not necessarily agree that a default regulatory regime needs to be available as it depends heavily on the type of monopoly and its market power. In this context, demand elasticities are also vital parameters in determining the actual influence of monopoly rents on consumer losses and economic benefits resulting from economic regulation. Even for Electricity Lines Businesses which have significant characteristics of a natural monopoly, it is arguably whether regulation should be imposed if economic efficiency in terms of economic cost and benefits are the primary measure. Additionally, because of New Zealand's population size and density many markets, where economic regulation is not desired, are likely to have monopolistic characteristics, but this in itself shouldn't give rise to regulation. A regulatory regime should be put in place only when there are no other more effective alternatives available.
8. In terms of promoting incentives for investing in infrastructure the regulatory regime should primarily focus on economic efficiency, and not a net benefit to acquirers test, Only efficient firms are likely to invest and extend their businesses which is ultimately in the interest of the end consumers. This implies that the regime should not hinder an adequate return of investment.

*Purpose Statement*

9. A regulatory-specific purpose statement is desirable as it increases certainty and comprehensibility about the design objectives for all affected parties. It is essential that its interpretation is unambiguous.
10. We recommend an alternative formulation as proposed by the Energy Networks Association (ENA) (changes are marked bold and underlined):

The purpose of this Part is, in markets where there is little or no competition **and** no prospect of competition, to provide for economic regulation **of goods and services** for the long term benefit of consumers of New Zealand. Any regulation under this Part should seek that suppliers:

- a) are limited in their ability to earn excessive profits;
- b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands;
- c) share the benefits of efficiency gains with consumers, including through lower prices; and
- d) have incentives to innovate and to invest including in replacement, upgraded and new assets and in related businesses.

Note: This Purpose Statement still leaves a lot of room for individual interpretation; e.g. what qualifies as “excessive profits”. How are ELBs supposed to pass through benefits when they have no control over the end consumer prices? How are consumer demands to be assessed?

*Decision on whether to impose regulation*

11. We agree with the Ministry that the decision-making process on whether economic regulation should be imposed should be kept in place. We support a competition criterion similar to Option A (MED Discussion Document p.32) as follows:

“There is little or no competition **and** no prospect of competition in the relevant market”.

The suggested “**and**” instead of “or” makes the competition test stronger and is in line with our proposed change in the Purpose Statement. Furthermore, as pointed out in the Discussion Document (p. 30), the competition test with an “or” leaves it relatively low and applies to many New Zealand markets where control is undesired, considering New Zealand’s population size and density. If it was left in place it would likely limit start-

ups of new innovative industries which may have monopolistic power for a limited time due to their nature of representing a new industry.

12. We support that one of the tests for whether control may be imposed should be where the long term benefits to acquirers **substantially** exceed direct and indirect costs. Although, further guidance on the interpretation of 'long term' benefits, 'substantially' and how 'exceeding of direct and indirect cost' is measured would be welcomed to limit the room for ambiguous interpretations.
13. The intention of regulatory control generally is to benefit the consumers. In this context an establishment by the Commerce Commission that benefits are passed through to end-users as a pre-condition for regulatory control, makes sense. However, ELBs have no influence on whether the benefits are passed through to the end costumers as this is the responsibility of the retail sector and needs to be recognised.
14. The case of a monopsony is a very rare occurring, a case-by-case assessment seems more appropriate than general provisions.
15. We agree that it is not necessary to introduce a legislative test for when regulation should be imposed.
16. We regard the Minister as an appropriate entity in deciding on whether or not certain goods or services should be imposed under Part 4, under the condition of obtaining a report from the Commission prior to the final decision. The Minister can then accept, reject or send back any recommendation from the Commission. If the decisions on whether and, if so, how to regulate were undertaken simultaneously it would most likely be less time consuming than the sequential process, and adds efficiency to the entire process. A firm's uncertainty based on an interim period between the decision to regulate and the decision on the methodology would also most likely be reduced.

#### *Types of economic regulation*

17. It is of interest for all affected parties that the regulatory body has a wide variety of methodology at its disposal. Both options offer more flexibility for case-to-case assessments where a control regime might not be the appropriate approach. As mentioned before, due to the size of New Zealand's economy monopolistic characteristics might apply to many markets. A lighter form of regulation can provide the necessary incentive to limit a firm's motivation to exercise market power.
18. In terms of reducing timely and costly decision-making processes, it seems appropriate applying specific, easier tests for cases where lighter handed regulation is required, and a going through the full length procedure would exceed the scope of desired outcomes.

At this point, we point out again our recommendation to change the competition criteria as mentioned above.

*Key input decisions*

19. We agree with the reasoning by the Ministry that certainty, transparency, predictability and quality of regulatory outcomes will improve if input methodologies, where applicable, are set in advance of an inquiry and follow a transparent consultation process. To maintain a minimum level of flexibility the input methodologies should be set once an inquiry for whether to regulate has been initiated.
20. It seems to be out of the range of feasibility to set generically methodologies that could apply to all potentially regulated sectors without discriminating individuality and special characteristics of the sectors respectively. The setting of fair input methodologies for only one sector represents a demanding task itself, thus a generic setting should not be pursued.
21. We regard the Commerce Commission as an appropriate body for all decisions regarding the setting of the input methodologies. Due to the size of the New Zealand economy, the introduction of a new expert panel seems not feasible. However, we recommend improving credibility to the Commission's decision by adding extra legislative tests and make the decisions subject to merits review.

*Regulatory control design issues*

22. It is arguable whether comparative benchmarking is an appropriate methodology for setting control terms on a diversified sector like the electricity distribution as it is comprised of firms of very different sizes, ownerships and geographic restrictions. A customised approach is thus preferred. Alternatively, a benchmarking process could be considered that sets different thresholds for different groups which comprise of companies of e.g. same size and ownership structure.
23. The regulation of a sector as a whole bears the great risk that firms within this sector are put under control although they show normal behaviour. If there are no provisions made for those cases we oppose to a change in the legislation allowing sectors as a whole to be regulated.
24. We strongly support the option for firms to propose their own control terms. It will minimise asymmetric information and incentives for gaming.
25. The Commission should be required to accept proposals that meet pre-set criteria. Some of the suggested reasonableness criteria, however, might discriminate the options for smaller businesses as they exceed somewhat their resources. As mentioned

before, it is not comprehensive how ELBs are supposed to assess and meet end-consumer demands as the structure of the electricity sector does not support interactions between distribution and end consumption. Furthermore, it is equivocal whether end-consumers possess the foresight and understanding of long-term investment decisions. Hindering investment decisions would not only affect the quality and reliability of the provided services but might also cause inevitably breaches of the thresholds.

26. We consider it appropriate for firms to have the ability to propose their own control terms within a statutory timeframe **before** the final declaration of control by the Minister. This approach has the advantage that the likeliness of firms being exposed to too tough control terms is reduced. Otherwise, the control terms would be based on incomplete information increasing the possibility of 'unfair' control provisions. In case of inappropriate control terms for a firm, it might suffer sufficient losses in the interim period between proposing individual terms and a final decision by the Commission.

*Possible packages of "how to regulate"*

27. We favour 'Option two': repealing Part 4A and amend Part 5 to allow the Commerce Commission to put sectors under regulatory control using comparative benchmarking, and provide for a 'propose' response' model to give firms the opportunity to seek customised terms. Although this regime means less flexibility it creates more certainty for all affected parties.
28. Smaller companies are likely to be more affected in terms of lacking the necessary human and capital resources to interact with the regime at full extent. For example, following through a process like a merits appeal is cost intensive especially when firms are required to pay for the evolving cost of the Commerce Commission as well. Smaller businesses are likely to abandon any attempts to propose a change of their respective control terms. This can have serious negative effects on investment decisions when they have to be delayed because of that.
29. We support a different regulatory regime for trust owned ELBs. Their ownership structure qualifies as a substitute for economic regulation. Therefore, alternative arrangements (i.e. ownership arrangements and negotiated agreements with costumers) should be provided for in a regulatory framework.

*Process for amending and enforcing control terms*

30. We support the suggested arrangements to allow a re-opening of control terms within a regulatory period only under exceptional criteria under the presumption that businesses have an ex-ante input opportunity into the setting of the control terms (propose/respond model). The term 'exceptional' circumstances, however, needs further precision and how those are to be identified.
31. Considering size of New Zealand and respective available resources, we agree to the Commerce Commission being the appropriate body for identifying breaches and enforcing penalties and/ or remedies. For minimisation the risk of insufficient checks and balances, additional legislative guidance and the requirement for separation between penalty design and enforcement should be provided as it also increases certainty, transparency and predictability for companies. In this context we propose to include merits review for accountability reasons.

#### *Accountability mechanisms*

32. The inclusion of merits review adds credibility and transparency to the regulatory process. It creates incentive for the decision making body to achieve high quality outcomes. The benefits supposedly compensate aligned disadvantages such as higher costs. It should, therefore, be accessible for all substantial regulator decisions.
33. To limit the possibility of gaming and tactical delays, we support the proposed option of introducing merits review by way of rehearing to control decisions made by the Commerce Commission/ regulatory body.
34. Introducing a specialist tribunal would add immense credibility to the merits review process. Moreover, it can create incentives for the regulatory body to reach high quality decisions in the first place to narrow the necessity for further investigations, and thus reduce the cost factor resulting of engaging an expert panel.