

Response to MED Review of the Regulatory Control Provisions under the Commerce Act

**From the Electricity Distribution
Lines Businesses in New Zealand**

6 July 2007

Covering letter to the submission

6 July 2007

Commerce Act Review

Ministry of Economic Development

PO Box 1473

Wellington

Response to the MED Review of the Regulatory Control Provisions under the Commerce Act 1986

Electricity distribution lines businesses (lines businesses) welcome the opportunity to submit on the proposed modifications to Part 4A of the Commerce Act and associated aspects of Part 5. As things stand Part 4A impacts almost exclusively on lines businesses. The Electricity Networks Association (ENA) represents lines businesses. The Board of the ENA established a working group representative of the interests of all lines businesses to develop this submission. Stuart Shepherd and Kieran Murray of LECG were engaged to support the development of the thinking contained in the submission.

This submission proposes a modified regime, using the framework adopted in the Ministry of Economic Development (MED) review document. The working group has drawn on its collective experience to focus on the practicability and efficiency of the design and implementation of regulation as it applies to the services provided by lines businesses.

This submission is made on behalf of the undersigned lines businesses. With a matter as complex as this there are a wide range of potential proposals and this submission represents the industry consensus at a high, and in principle, level. The lines businesses note that while this is a collective view based on the options proposed by the MED, individual lines businesses may also make individual submissions that offer more specific views or discuss other potential arrangements. Individual lines businesses all differ in terms of their geography, demographics, ownership and customer density. They also have different experiences with the existing regime. It is anticipated that individual submissions will augment some of the points made in this submission by taking into account their own unique perspectives.

The form of all of these submissions (i.e. a collective view and a number of individual company views to reflect lines businesses' unique perspectives) reflects the nature of the distribution businesses and, of course, the Act has to do the same. One of the perceived problems with the existing regime is that it is a "one size fits all" regime.

This submission defines the regime as three regulatory pathways to reflect the differences amongst lines businesses. The approach and the modifications recommended include clarity and consistency in defining the input methodologies to apply to the regulatory pathways.

We urge the MED to give this collective view considerable weight. Investment in the industry is required, regulatory certainty is paramount and a regime that fits all lines businesses is an essential step in achieving appropriate levels of investment in this critical infrastructure. This submission provides a view on a regime that would achieve this.

From the Electricity Distribution Lines Businesses listed overleaf

Alpine Energy Ltd
Buller Network Ltd
Centralines Ltd
Counties Power Ltd
Eastland Network Ltd
Electra Ltd
Electricity Ashburton Ltd
Electricity Invercargill Ltd
Horizon Energy Distribution Ltd
Mainpower NZ Ltd
Marlborough Lines Ltd
Nelson Electricity Ltd
Network Tasman Ltd
Network Waitaki Ltd
Northpower Ltd
Orion New Zealand Ltd
OtagoNet Joint Venture
Powerco Ltd
PowerNet Ltd
Scanpower Ltd
The Lines Company Ltd
The Power Company Ltd
Top Energy Ltd
Unison Networks Ltd
Vector Ltd
Waipa Networks Ltd
WEL Networks Ltd
Westpower Ltd
Electricity Networks Association
Transpower New Zealand Ltd (transmission lines business)

Letters from each lines business confirming its support for this submission are attached.

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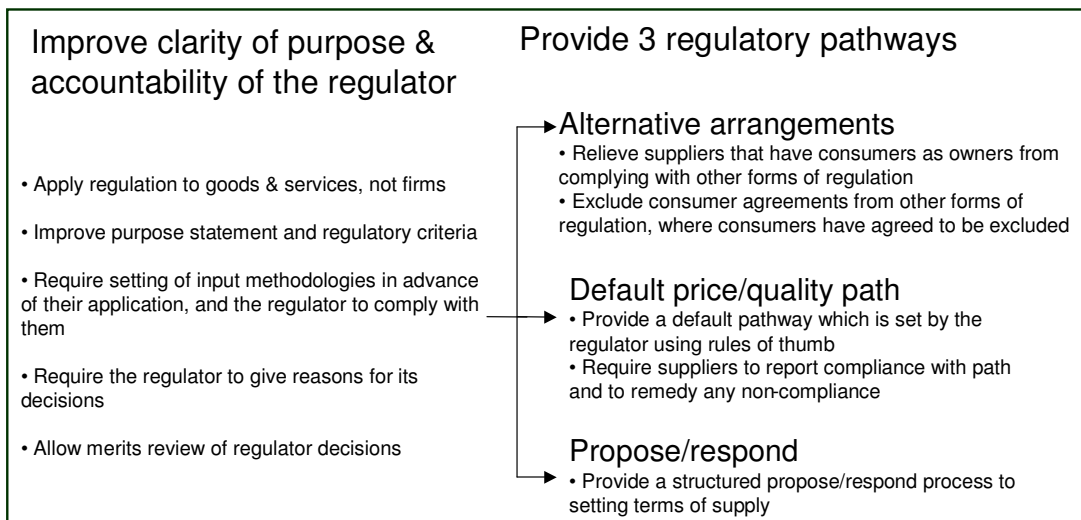
Summary & recommendations

This submission is from the electricity distribution lines businesses in New Zealand.

We welcome this review by the Ministry of Economic Development (MED), as it provides an opportunity to modify the current Part 4A regulatory regime in a way that retains its positive features and addresses the weaknesses that have emerged since its implementation.

Our submission focuses on the application of economic regulation to the electricity distribution service. It reflects the perspective of the businesses that supply this service, the key issues that need to be considered when designing and implementing regulation for this service, and experience with Part 4A of the Commerce Act over recent years.

Our recommendations are summarised in the illustration below.



Our recommendations, which build on the proposals in the MED paper, are set out in bold below.

Improve clarity of purpose and accountability of the regulator

Regulation to apply to goods and services, not firms

The MED paper assumes regulation would apply to goods and services. We agree and note this would improve significantly the focus of regulation, as Part 4A currently applies to firms (electricity lines businesses).

- **Economic regulation should apply to a defined (designated) set of goods and services.**

*Improved purpose statement*¹

The MED paper proposes some changes to the existing Part4A purpose statement. Our recommendations build on the MED’s proposal and would strengthen the competition test, clarify that regulation is to apply to goods and services (not firms), and include the “financial capability” of suppliers as one of the items that regulation should seek to ensure (recommended additions to MED’s proposal are underlined, deletions are in []).

The purpose of this Part is, in markets where there is little or no competition and no [or] prospect of competition, to provide for economic regulation of goods or services for the long term benefit of consumers of New Zealand. Any regulation under this Part should seek to ensure 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 and the financial capability to innovate and to invest including in replacement, upgraded and new assets and in related businesses.**

Improved regulatory criteria

The MED paper proposes the introduction of regulatory criteria and our changes build on that proposal. We envisage the regulatory criteria would need to be met when designating goods and services (criteria (a) to (d)), and when implementing each of the three regulatory pathways (criteria (c) and (d)) These criteria would enhance the investment environment by ensuring that regulation would not be able to be used to undermine the commercial viability of the supplier.

Goods or services may be regulated if, and to the extent that [economic regulation is necessary or desirable to]:

- [(a) Provide efficiencies in a market; or]**
- (a) There is little or no competition and no [or] prospect of competition in the relevant market; and**

¹ Additions to the MED proposal are underlined and deletions are in [].

- (b) No alternative arrangements exist, or are likely to arise, which achieve the same or similar long-term benefits to consumers; and
- (c) The regulation will in all the circumstances result, or be likely to result, in [provide] long-term benefits to persons acquiring the goods or service that substantially [clearly] exceed the direct and indirect costs of the regulation; and
- (d) The regulation will in all the circumstances result, or be likely to result, in the supplier of the goods and services having effective incentives and the financial capability to improve efficiency and provide service at a quality that reflects consumer demands, including to innovate and to invest in replacement, upgraded and new assets and in related businesses.

Input methodologies

The MED paper, rightly in our view, places considerable emphasis on the need to have a rigorous method for establishing input methodologies, and that they must be established in advance of their application. We consider that a robust process for setting input methodologies is fundamental to the integrity of the regulatory regime. As they are technical issues rather than policy matters, we consider that the input methodologies should be set by either an expert panel or the regulator, and not by the Minister.

- **The input methodologies should be set by either an expert panel convened for this purpose, or by the regulator.**
- **If an expert panel is adopted, the panel should be appointed by the Minister, in consultation with those affected directly by the regulation.**
- **In either case:**
 - **The input methodologies should be required to be set prior to any regulatory process in which they are to be applied, and should not be able to be changed within the course of that regulatory process, except in clearly defined situations (e.g. where the regulator and the entities involved agree to a change).**
 - **The body setting the input methodologies should not be able to exclude input methodologies proposed by those subject to regulation where the proposed methodologies are reasonable (relative to the purpose statement and regulatory criteria).**
 - **The input methodologies should be legally binding on the regulator.**

Regulator decisions subject to merits review

The MED paper proposes access to merits review for many regulator decisions. We agree with the use of merits review. The ability to challenge the decision of a regulator is a critical error correction mechanism and would strengthen investor confidence in the regulatory regime.

- **An appeal right to merits review should form part of the accountability of the regulator.**
- **Merits review should be by way of re-hearing by the High Court, consistent with the approach that applies already to some other decisions by the Commerce Commission.**
- **Merits review should apply to regulator decisions related to the setting of input methodologies and to implementing each regulatory pathway.**

Statutory obligation to provide reasons

Natural justice argues for an obligation on the regulator to provide reasons for its decisions, linking the rationale of the decision to the legislative mandates for regulation (i.e. the purpose statement, regulatory criteria and any matters it is required to take account of). Providing reasons is also consistent with access to merits review, as it enables affected parties and the appeal body to better assess the strength of the regulator's reasons for the decision.

- **There should be a statutory obligation on the regulator to provide reasons as to why it considers its decisions are consistent with the purpose statement, regulatory criteria and any matter it is required to take account of.**

Choice of regulator

The MED paper does not consider the possibility of the economic regulatory function being moved to the Electricity Commission, but Part 4A allows for this possibility. We consider this review should result in a conclusion on this matter in order to provide certainty for all parties involved.

- **The economic regulatory function should remain with the Commerce Commission, to ensure the regulator's independence from government (assuming the structure of the Electricity Commission is not open to change).**
- **The possibility of shifting the economic regulatory function to the Electricity Commission should be explored if, and only if, the structure of this Commission were changed to provide it with independence from government.**

Three regulatory pathways

The MED paper develops a number of possible forms of regulation, including information disclosure, a modified version of the current thresholds approach under Part 4A, negotiate/arbitrate, propose/respond and control. Under our recommendations information disclosure would apply in all circumstances (as it does in the MED proposals). We have developed three regulatory pathways which reflect (1) the nature of the suppliers in this sector (many firms and some owned by consumer trusts or similar entities) and support for consumer-negotiated agreements where these arise (2) modifications to the current thresholds regime and (3) a propose/respond approach.

Alternative arrangements

“Alternative arrangements” refer to arrangements that can be expected to be more effective in delivering long-term benefits to consumers than other forms of regulation. These arrangements include ownership and governance arrangements that incorporate consumer representation (e.g. consumer trust ownership and other community-based ownership arrangements), and agreements with consumers that meet certain tests. We recommend such arrangements should take precedence over other forms of regulation.

An arrangement for the supply of designated goods and services should be allowed as an alternative to other forms of regulation where:

- **Consumers of the designated goods and services hold effective control of the supplier (either directly or as the beneficiaries of an entity that does); or**
- **Community-based organisations (e.g. a community trust and/or local authority) hold effective control of the supplier and have arrangements in place to identify and reflect the long-term interests of consumers in the governance of the supplier; or**
- **The supplier of designated goods and services has an agreement with consumers for the supply of such goods and services and the consumers have agreed that the goods and services need not be subject to other forms of regulation; or**
- **The supplier or consumers of designated goods and services have demonstrated to the regulator that an arrangement is in place that achieves the same or similar long-term benefits to consumers as would be achieved by other forms of regulation.**

Where an alternative arrangement has been agreed:

- **A limited form of information disclosure should apply, with the purpose to enable monitoring of the arrangements by those involved in them.**

Default price/quality path

The MED paper proposes ways in which the current thresholds under Part 4A could be modified, or replaced. We recommend a set of changes as to how they are set, the language used to describe them and performance relative to them (which we consider an important issue), and greater clarity as to what happens in cases where a supplier operates outside them. We consider these changes would retain the positive features of thresholds and also incorporate the benefit of experience with them over recent years.

A default price/quality path should apply to all designated goods and services that are not subject to alternative arrangements, or for which the supplier has not entered into a propose/respond form of regulation (thus this would be the default pathway). This form of regulation should have the following features:

- **The default price/quality path would be set using rules of thumb rather than extensive, firm-specific analysis.**
- **Suppliers would be required to report compliance or otherwise with the default path (price and service quality), explain any non-compliance, and remedy non-compliance in future periods.**
- **It would not be unlawful to supply designated goods and services on terms other than the default price/quality path.**
- **In situations (that would need to be well defined) where a supplier supplied designated goods and services on non-complying terms and did not take remedial action, the regulator could require the supplier to enter the propose/respond process.**
- **Any situation that allowed the regulator to refer a supplier to the propose/respond process would expire if not acted on by the regulator within one year of it being reported.**

Propose/respond

The MED paper proposes a propose/respond model. We consider the propose/respond form of regulation has the potential to bring together, in an effective manner, the information the regulator has on appropriate input methodologies and their application, and the information held by the supplier on what is possible in terms of the supply of goods and services. Our recommendations aim to provide a process that would achieve this.

A propose/respond form of regulation should be provided with the following features:

- **An obligation on the regulator to enter a propose/respond process if requested by the supplier.**

- **The right for the regulator to require a supplier to enter the propose/respond process subsequent to supplier operating outside of its default price/quality path and not taking remedial action.**
- **An obligation on the regulator at the commencement of the process to identify to the supplier the input methodologies that must be complied with (we expect input methodologies, once set, would apply for extended periods of time).**
- **An obligation on the supplier to put forward a proposal, and to identify in the proposal the manner in which the supplier considers it complies with the input methodologies.**
- **An obligation on the regulator to respond to the supplier's proposal, including identifying whether or not it considers the input methodologies have been complied with, and if not, why not.**
- **An opportunity for the supplier to iterate with the regulator for a defined number of times.**
- **The provision for binding arbitration on any matters on which the propose/respond process does not reach a conclusion. The regulator and the supplier would have the right to appoint jointly the arbiters, and in the case of non-agreement to appoint an arbiter each.**
- **The arbiters would have the power (acting jointly) to accept the proposal of the regulator or the supplier on each outstanding matter, or to reject both proposals, and be required to provide reasons for their decisions. The arbiters would not have the power to modify proposals. The arbitration would continue until all matters are resolved.**
- **Timeframes for the above steps would be legislated for, in order to ensure the process is not unduly prolonged.**

Transitional arrangements

There is a potential clash in the timing of the intended reset of the current thresholds to apply from 1 April 2009, and the potential timing of the implementation of any changes to Part 4A.

We expect that if changes to Part 4A were made along the lines of our recommendations they would take about two years to implement. If legislation were passed in mid 2008, this suggests these changes could be implemented by 1 April 2011 at the earliest. It is critical any changes are implemented in an orderly fashion.

The work programme to implement our recommended changes to Part 4A would be very different from that to reset thresholds under the current Part 4A, and would have a different focus. We expect a large number of the smaller lines businesses would qualify for the alternative arrangements, some would operate under the default price/quality path and a very small number would opt initially for the propose/respond pathway. Thus, work by the Commission and lines businesses on resetting the current thresholds would be wasted if the changes were made, and therefore should be avoided.

To avoid potential wasted effort, and to ensure the Commission continues to fulfil its statutory duties should Part 4A remain unchanged or an orderly implementation if changes are made, we recommend the following transition arrangements:

- **The Commission should reset thresholds from 1 April 2009 for a two-year period.**
 - **the current price thresholds should be rolled forward on an undifferentiated basis of $CPI - X$, with $X = 0$. This undifferentiated basis, and $X = 0$, is recommended to avoid the need for extensive work to identify different values of X .**
 - **the service quality thresholds should be rolled forward at their current levels.**
- **The current Part 4A should stay in force until 31 March 2011 (or an equivalent set of transition arrangements be crafted into any amended Part 4A), whether or not changes arising from this review are passed into law. This would allow over two years (if legislated changes are passed in 2008) for an orderly implementation of the changes, which would contribute to certainty and investor confidence over the transition period.**

Introduction & issues to consider

1. This submission is from the electricity distribution lines businesses (lines businesses) In New Zealand. It is in response to the Ministry of Economic Development's (MED) discussion paper, "Review of Regulatory Control Provisions under the Commerce Act 1986" (MED paper) and is structured along the same lines as the MED paper with sections covering:
 - Introduction & issues to consider
 - Objectives of regulation
 - How to regulate
 - Accountability
2. The MED paper covers regulatory control provisions under Parts 4, 4A & 5. We (the submitters of this submission) operate lines businesses and are subject to Part 4A and potentially Part 5. Thus this submission focuses on Part 4A & 5 from the perspective of lines businesses.

Issues to consider

3. There are three sets of issues particular to lines businesses that need to be considered in this review: the nature of ownership in the electricity distribution sector and the number and size of businesses, the stage in the cycle of growth and renewal of distribution networks, and experience to date of the targeted control regime under Part 4A.

Nature of ownership and size of lines businesses

4. There are twenty-eight lines businesses in New Zealand and they vary significantly on a number of dimensions, for example:²
 - The number of ICPs³ range from 4,200 to 660,000.
 - System lengths vary from 240 km to 25,000 km.
 - System assets, valued at ODV, vary from \$20 million to \$2 billion.

² All data are from the PricewaterhouseCoopers "Electricity Line Business and Gas Pipeline Business 2006 Information Disclosure Compendium", February 2007

³ Installation Control Point

- Average consumer density per kilometre of line (ICPs divided by kilometres line) ranges from 3 to 37.
 - Nature of ownership ranges from consumer owned trusts, community trusts, local authority owned, and investor owned but unlisted, and partially listed. Appendix One lists the various lines businesses and the nature of their ownership. These differing structures have implications for pricing policies, access to capital and the extent to which some forms of economic regulation are relevant.
5. Any regulatory intervention that relies on benchmarking performance across this array of businesses will be fraught, and in our view should be used cautiously, if at all.

Stage in renewals cycle and growth

6. Lines businesses forecast capital expenditure of \$3.8 billion over the next ten years.⁴ This compares with their combined ODV of all system assets of \$6.2 billion.⁵ This forecast expenditure reflects a combination of growth in some networks (and not in others), and a substantial replacement programme in many networks.
7. Given this level of forecast capital expenditure, it is imperative that any regulatory regime provides investors with the confidence to invest. The economic consequences of getting this wrong are well known, and particularly so for such a widely used service as electricity. Thus the design of regulation must pass the investor-confidence test – from the perspective of those providing the capital.

Experience of targeted control

8. Part 4A came into force in 2001. The current thresholds for lines businesses applied from 1 April 2004.
9. In our view the primary strength of the design of Part 4A is that the thresholds potentially provide a screening mechanism rather than firm price caps, and if implemented in this manner would mean it would be reasonable to set them by some means other than extensive cost building block assessments (which would have been very costly for the regulator and industry). However, this strength has also led to weaknesses, as the absence of a requirement to undertake cost building block assessments has given the regulator significant latitude to exercise discretion, resulting in an uncertain regulatory regime.

⁴ Taken from 2006 asset management plans.

⁵ As at 31 March 2006.

10. From experience with the Part 4A regime to date, we consider this review needs to address the following issues:
- The purpose statement has conflicting objectives and has resulted in ambiguity as to its meaning. It has allowed the regulator wide discretion as to its interpretation.
 - The setting of thresholds has relied on benchmarking of historic performance across lines businesses. This was done without adequate normalisation for differing circumstances (which is a difficult task), and without taking into account forward-looking costs (e.g. capital expenditure forecasts).
 - The price thresholds incorporate revenue from transmission services, rather than being focused on only the electricity distribution service in the case of distribution lines businesses. The regulator attempted to neutralise the effect of transmission revenues and costs on the thresholds (by treating them as a pass-through), but the mechanism used has resulted in many inadvertent breaches arising from variances in forecast versus actual transmission revenues and costs (over which a lines business has very limited control).
 - The input methodologies for setting thresholds and investigating a lines business following a breach have been developed at the same time as the thresholds or the investigation, and are still not all in place (e.g. the disclosure requirements in relation to tax and the methodology for determining the weighted average cost of capital (WACC) have not been finalised). Moreover, methods used to measure profits have departed from those specified in information disclosure requirements. This approach has resulted, from a lines business perspective, in a capricious regime.
 - There is no forum in which to challenge a regulator decision that appears flawed.
 - The administrative settlement process has no formal structure. The regulator has not articulated its intentions clearly in these processes and thereby has created a settlement process in which the regulator both evolves the rules as the process proceeds *and* determines when a settlement offer is accepted. This results in the lines business having to try and second-guess what the regulator considers acceptable. This is highly inefficient and inequitable.
 - There is little guidance as to what may happen following a threshold breach. For the majority of breaches the regulator has chosen to neither take further action nor confirm whether further action will be taken, leaving the lines business in a highly uncertain situation. Table One sets out the number and timing of threshold breaches, and whether or not they have been resolved (“resolved” means either the Commission has cleared the breach indicating

no further action will be taken, or has agreed an administrative settlement that covers the breach).

Table One: Threshold breaches and extent of resolution⁶

When reported	2003	2004	2005	2006	2007	Totals
No. of breaches reported	13	37	14	30	33	127
No. of breaches cleared or settled	9	11	3	2	0	25
No. of breaches unresolved	4	26	11	28	33	102

Objectives of regulation

The purpose of regulation matters

11. The MED paper observes, correctly in our view, that:

Irrespective of the policy intent of economic regulation, it is unsatisfactory and inefficient for all parties for there to be uncertainty and ambiguity about that policy intent. The purpose of regulation, as conveyed in legislation, will affect both when and how regulation is imposed and must be unambiguous. (paragraph 83)

12. The legislative purpose permeates almost all aspects of regulatory design and regulatory decision-making.⁷ It is therefore important to be clear as to the purpose of economic regulation, and to ensure that the purpose is indeed achievable.
13. MED believes that economic regulation can achieve “clear economic benefits”. MED states economic regulation could potentially benefit the economy through:

⁶ Data sourced from lines business threshold compliance statements (2003 - 2007) and Commerce Commission media releases

⁷ The MED appears to use the terms “objective” and “purpose” interchangeably. As the intended output from this discussion is to craft the words that will form the legislative purpose statement, we use the term “purpose” rather than the term “objective”.

... improvements in the allocation of resources, any lowering of production costs and improvements in the incentives for appropriate investment. (paragraph 64)

14. In practice it is probably impossible to design and implement a system of economic regulation that increases economic efficiency in the manner described by the MED.⁸ Local evidence supports this view - in both price control inquiries undertaken by the Commerce Commission to date, it concluded economic regulation would result in *net economic detriments*.
15. We infer from the MED paper that at least part of the purpose of economic regulation is to provide consumer protection, which implies a distributional purpose (that is to re-distribute wealth between suppliers and consumers). Economic regulation that incorporates a distributional purpose raises the following issues for the design and implementation of that regulation:
 - The rules as to what amounts may or may not be re-distributed by the regulator need to be very clear and implemented in a manner that provides certainty. Without such clarity and certainty suppliers will under-invest as their investments will be vulnerable to capricious expropriation.
 - The decision-makers and their accountabilities need to be appropriate to the nature of the decisions. For example, decisions on the extent to which wealth is re-distributed should be subject to political accountabilities, whereas decisions to implement regulation should be undertaken by an expert body subject to appropriate accountability (such as merits review).
 - Alternative ways of achieving the distributional purpose should be considered. Potential alternatives include consumers being the beneficial owners of the supplier (ownership alternatives), and consumers and suppliers negotiating terms of supply that they find mutually acceptable (negotiated alternatives).
16. These issues, along with others raised in the MED paper, are considered throughout this submission.

Comments on purpose statement & criteria for regulation

17. The MED paper proposes the following purpose statement and criteria for when regulation may be imposed.

⁸ For a well-rounded discussion of the impact of regulation on economic efficiency see “Practical experience with price cap regulation: Report for the New Zealand Treasury”, David Ehrhardt, August 2000.

Purpose statement

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

Competition criterion

[Goods or services may be regulated if:]

Option A

There is little or no competition or prospect of competition in the relevant market.

Option B

The goods or services are supplied by a person or persons with a substantial degree of market power.

Efficiency and distributional criteria

Goods or services may be regulated if economic regulation is necessary or desirable to:

- (a) promote efficiencies in a market; or*
- (b) provide long term benefits to persons acquiring the goods or services that [substantially] [clearly] exceed the direct and indirect costs of regulation.*

18. Our proposed changes to the purpose statement and regulatory criteria are limited to those we consider are a minimum to address our concerns. In particular, we have retained the structure and content of the purpose statement as we understand there is limited appetite on the part of MED to change it.

Consumer interest is in regulated services, not firms

19. The MED paper assumes that regulation should apply to goods or services. We agree.
20. However, Part 4A is not framed in this way, as it applies to a defined set of businesses (i.e. large electricity line businesses). In practice the Commission has applied thresholds to a set of “specified services” supplied by lines businesses, which are:

...all goods and service, provided in New Zealand, that are electricity distribution or transmission goods or services or are directly related to the provision of electricity distribution or transmission...⁹
21. Some goods or services that fall within this definition may be excluded from the thresholds if the lines business (the burden of proof falls with the lines business) is able to demonstrate that there is workable or effective competition for those goods or services. Thus new electricity-related services that lines businesses bring to market are vulnerable to being subjected to the thresholds regime and, possibly, to control. Furthermore, there is no structured way to introduce new goods or services into the thresholds regime, or to change the price-quality mix of existing services. The result is a set of regulatory constraints which inhibit change and innovation, and which apply to a business rather than to a set of defined services.
22. Framing regulation in terms of the firm is at best an indirect means of protecting the consumer, because the consumer is interested in goods and services and not the firm. Regulation targeted at the firm, rather than the goods and services produced by the firm, is also unnecessarily damaging to economic efficiency, with potential adverse implications for the long-term interest of consumers, as it impinges on activities of the firm unrelated to the goods and services of concern.
23. We recommend the subject of Part 4A be changed from large electricity lines businesses to a defined set of electricity distribution services (which are referred to in this submission as designated services). This would be a similar approach to that already used in the Telecommunications Act 2001. We recommend this focus on goods and services be reflected in the purpose statement, as follows (proposed change underlined):

The purpose of this Part is, in markets where there is little or no competition or prospect of competition, to provide for economic regulation of goods or

⁹ Section 3 of “*Commerce Act (Electricity Distribution Thresholds) Notice 2004, Pursuant to Part 4A of the Commerce Act 1988*”, New Zealand Gazette, 31 March 2004

services for the long-term benefit of consumers of New Zealand. Any regulation under this Part should seek to ensure that suppliers:

The appropriate competition test

24. The Commerce Act is based on a presumption that competition is the most effective means of protecting the long-term interests of consumers, in markets where “workable” competition is feasible.¹⁰ As MED observes, competitive markets deliver benefits to consumers over time by creating incentives for firms to deliver the goods and services consumers want and to improve prices and quality. To compete profitably, firms in competitive markets must invest and innovate and reduce costs and prices and/or improve quality.¹¹

25. Currently, Part 4 of the Act (Part 4A has no such test) provides that goods or services may be controlled if:

The goods or services are, or will be, supplied or acquired in a market in which competition is limited or is likely to be lessened. (section 52(a))

26. MED proposes changing this criteria and suggests the following options (Option A is also incorporated in the proposed purpose statement):¹²

[Goods or services may be regulated if:]

Option A

There is little or no competition or prospect of competition in the relevant market.

Option B

The goods or services are supplied by a person or persons with a substantial degree of market power.

27. We recommend the adoption of option A: “there is little or no competition or prospect of competition in the relevant market”. On a plain reading, the words “little or no competition or prospect of competition” appear to capture the intent that economic regulation would apply only where the level of competition cannot be expected to protect the interests of consumers.

¹⁰ The Commerce Act recognises that textbook models of perfect competition are not feasible, and defines competition as “workable or effective competition”, in section 3(1).

¹¹ MED paper, paragraph 53.

¹² MED paper, paragraph 96.

28. We also recommend that the words “or prospect” be changed to “and no prospect”. It would not be appropriate to regulate a market that was not currently competitive, but would soon be competitive. It is the combination of little or no competition *and* no prospect of competition that gives rise to the possible need for economic regulation. This suggests the following change to the purpose statement (our suggested additions are underlined and deletions are in []):

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

Inclusion of financial capability criterion

29. The proposed additional limb (d) in the purpose statement focuses on the supplier’s incentives to innovate and invest. In order for such incentives to lead to innovation and investment the supplier needs to have the financial capability to do so. Adding “financial capability” to limb (d) would therefore strengthen the incentive issue already proposed, with a criterion that can be quantified. We note that the UK and Irish electricity regulation regimes have obligations on the regulator to ensure suppliers are able to finance their activities. We recommend limb (d) read:

(d) have incentives and the financial capability to innovate and to invest including in replacement, upgraded and new assets and in related businesses.

How to resolve ambiguity in the purpose statement

30. The proposed purpose statement has four limbs that read (with our proposed change):

...Any regulation under this Part should seek to ensure 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 and the financial capability to innovate and to invest including in replacement, upgraded and new assets and in related businesses.

31. The first three limbs are currently in the purpose statement of Part 4A, and the fourth would be a new legislative phrase. The first three limbs have been the subject of considerable debate in the implementation of Part 4A and associated judicial review proceedings.

32. The essence of this debate has been that the incentives referred to in (b) are diminished by ensuring (a) and (c) are achieved. This is because the incentives on a firm to improve efficiency and provide consumers with services at a quality that reflects their demand as per (b) are diminished if the profits from doing so are limited as in (a) or shared with consumers as in (c).
33. Put another way, as a matter of logic the three limbs cannot all be satisfied to their full extent simultaneously. This situation requires the achievement of one or more limbs to be traded off against the others, but the purpose statement (and Part 4A more generally) does not provide guidance on this trade-off. Thus the regulator is left with a wide discretion as to how to balance the three limbs and the weight it gives to each in its decision-making. This degree of discretion leads to a lack of certainty as to how regulation will be applied in any given set of circumstances.
34. The inclusion of the fourth limb adds to the ambiguity described above, as maximising (d) would be in conflict with (a) and (c) in a similar manner as (b) is. Thus these four limbs result in two pairs of common objectives, with each pair in conflict with the other, in that:
- (b) and (d) are common objectives related to incentives on the firm, and are thereby concerned with economic efficiency; and
 - (a) and (c) are common objectives related to sharing economic surplus with consumers, and are thereby distributional in nature.
35. The largest potential cost of economic regulation arises from removing incentives on the supplier to innovate and invest. It is in the supplier and consumers' long-term interests that this situation does not arise. Thus we recommend that the preservation of the incentives noted in (b) and (d) be one of the criteria for when, and the extent to which, regulation may be imposed, along the following lines:
- The form of economic regulation will in all the circumstances result, or be likely to result, in the suppliers of the goods and services having effective incentives and the financial capability to improve efficiency and provide service at a quality that reflects consumer demands, including to innovate and to invest in replacement, upgraded and new assets and in related businesses.¹³

¹³ We have drawn the phrasing “will in all the circumstances result, or be likely to result” from section 61 of the Commerce Act.

36. This approach would have the effect of reducing the current ambiguity by, in effect, ordering the limbs of the purpose statement. Regulation would not proceed unless the firm has effective incentives to undertake the items listed in (b) and (d), and where those objectives are achieved then limbs (a) and (c) could be achieved but only to the extent that the “effective incentives and financial capability” criterion allowed.

Acceptable level of benefits relative to regulatory costs

37. The MED proposes a criterion for when regulation may be imposed that reads:

(b) provide long term benefits to persons acquiring the goods or services that [substantially] [clearly] exceed the direct and indirect costs of regulation.

38. MED requests comments on whether the phrase “substantially exceed” or “clearly exceed” should be used in this criterion.
39. The relationship described by this phrase is that between the benefits to consumers relative to the cost to the economy for that benefit to be provided. Put another way, the question is what cost is appropriate to impose on the economy in order to re-distribute wealth to consumers by way of economic regulation. The answer to this question is essentially a judgment as to the desirability of the distributional outcome.
40. This relationship between a desired outcome and the economic costs (including indirect costs) of achieving it is routinely considered in public policy decision-making. For example, the New Zealand Treasury ¹⁴ provides for a figure of 20% to be applied to the cost of public sector projects funded by taxation to reflect the deadweight loss of taxation. If the economic costs of re-distributing wealth under economic regulation were significantly above the dead-weight costs of taxation, it raises the question whether it would be preferable to fund the proposed re-distribution from taxation, or by some other means. This level of cost to benefit ratio is better described as “substantially exceed ” rather than “clearly exceed”, and therefore we recommend adoption of “substantially exceed”.

Requirement to consider alternatives

41. There is no optimising function implicit in a distributional purpose as there is in an economic efficiency purpose. If the purpose of regulation were to enhance efficiency, implicit in that requirement is an obligation on the regulator to design and implement regulation in the most efficient (or optimal) manner, as the

¹⁴ See page 18 of “Cost benefit analysis primer”, New Zealand Treasury, December 2005, Version 1.12

implementation of regulation is a component of the overall economic efficiency purpose.

42. With a distributional purpose, the public policy aim should be to achieve the desired outcome at least cost. However, this “least cost” obligation is not implicit in the distributional purpose itself, and therefore should be stated explicitly.
43. One of the primary ways to minimise costs is to ensure that the most cost effective instrument has been chosen to achieve the desired outcome. We therefore recommend regulatory decision-makers, when contemplating whether to apply regulation to certain goods and services, should be required to state the reason (or outcome) that is desired, identify alternative ways of achieving that outcome, and assess those alternatives relative to the particular form of regulation being proposed. These alternatives should include other forms of regulation, other public policy instruments and commercial arrangements (e.g. consumer ownership and negotiated agreements with consumers).
44. This requirement to consider alternatives should be similar to that applying to the Electricity Commission when it is recommending regulations to the Minister of Energy (under sub-section 1 –3 of section 172F of the Electricity Act 1992).
45. We therefore recommend this approach be reflected in a criterion for when regulation may be imposed, along the following lines:
 - No alternative arrangements exist, or are likely to arise, that achieve the same or similar long-term benefit to consumers.
 - Sub-sections 1,2 &3 of section 172F of the Electricity Act be adopted (with edits as necessary to apply it to the relevant regulator) as a required set of procedures when considering alternatives to regulation.

Summary of amended purpose statement and regulatory criteria

46. Drawing together the suggested changes above, we recommend the following amended purpose statement and criteria for applying economic regulation (additions to that proposed by the MED are underlined, and deletions are in [])

Purpose statement

The purpose of this Part is, in markets where there is little or no competition and no [or] prospect of competition, to provide for economic regulation of goods or services for the long term benefit of consumers of New Zealand. Any regulation under this Part should seek to ensure 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 and the financial capability to innovate and to invest including in replacement, upgraded and new assets and in related businesses.

Regulatory criteria

Goods or services may be regulated if, and to the extent that [economic regulation is necessary or desirable to]:

[(a) Provide efficiencies in a market; or]

(a) There is little or no competition and no [or] prospect of competition in the relevant market; and

(b) No alternative arrangements exist, or are likely to arise, which achieve the same or similar long-term benefits to consumers; and

(c) The regulation will in all the circumstances result, or be likely to result, in [provide] long-term benefits to persons acquiring the goods or service that substantially [clearly] exceed the direct and indirect costs of the regulation; and

(d) The regulation will in all the circumstances result, or be likely to result, in the supplier of the goods and services having effective incentives and the financial capability to improve efficiency and provide service at a quality that reflects consumer demands, including to innovate and to invest in replacement, upgraded and new assets and in related businesses.

How to regulate

47. This section includes comments and recommendations on possible forms of regulation, the development of input methodologies, and transitional arrangements.

Forms of regulation

Current settings in New Zealand

48. Currently under Part 4A lines businesses are subject to a set of information disclosure requirements, to thresholds, and their goods and services may be placed under control pursuant to Part 5.
49. Other forms of economic regulation in New Zealand are:
- Information disclosure only. Examples include that applying to airports, and to gas networks other than those owned by Powerco Ltd and Vector Ltd.
 - Negotiate/arbitrate. An example of this can be found in the Telecommunications Act 2001 where a prerequisite for an access seeker to apply for a determination (which includes the price) for a designated service is that it must have first made reasonable attempts to negotiate the terms of supply of the service with the access provider.¹⁵ Thus in effect this approach is a negotiate/arbitrate arrangement, with control as the form of arbitration.
 - Administrative settlements. This approach has been used (or is being used) by the Commission to settle threshold breaches in the case of Unison Networks Ltd, Transpower New Zealand Ltd and Vector Ltd. In practice this approach is a form of propose/respond in that the settlement process typically involves the supplier proposing terms to the regulator, the regulator responding with desired changes, and the process iterating until a settlement is reached, or not.
 - Control. Examples include the gas network services provided by Powerco Ltd and Vector Ltd, and the designated services of Telecom NZ Ltd.
50. We have considered the current forms of regulation that operate in New Zealand, and those operating in the UK, Ireland, Australia and some states in the US, and recommend the following three forms of regulation for electricity distribution services:
- Alternative arrangements (e.g. consumer ownership and negotiated agreements)

¹⁵ See section 22(1) (c) of the Telecommunications Act 2001.

- Default price/quality path
 - Propose/respond
51. Each is described below.

Alternative arrangements

52. We consider there are arrangements currently in use in the electricity distribution sector, and others that could emerge, that achieve the purpose of regulation more effectively than imposing an intrusive form of regulation. Examples of such arrangements are:

- Ownership arrangements where consumers are the beneficial owners of the lines business, or where the owner is a reasonable proxy for consumer interests in a region (e.g. a community trust or local authority). These ownership arrangements substitute for economic regulation in other sectors in New Zealand (and in other jurisdictions) that have monopoly characteristics (e.g. in water and waste-water).
- Negotiated agreements with consumers. This arrangement is likely to be most relevant for large consumers, or clusters of large consumers. Where consumers and suppliers reach agreement on terms of supply (e.g. as a result of a tender process) it is inappropriate for these agreements to be struck down or modified by regulation. If so, there will be little incentive to attempt to negotiate them.

53. We consider there should be principles, set in legislation, against which any alternative arrangement is considered. We also anticipate that a limited form of information disclosure would apply to goods and services supplied under alternative arrangements, to enable monitoring of the arrangements by those involved in them. We recommend this approach take the following form.

An arrangement for the supply of designated goods and services should be allowed as an alternative to other forms of regulation where:

- Consumers of the designated goods and services hold effective control of the supplier (either directly or as the beneficiaries of an entity that does); or
- Community-based organisations (e.g. a community trust and/or local authority) hold effective control of the supplier and have arrangements in place to identify and reflect the long-term interests of consumers in the governance of the supplier; or
- The supplier of designated goods and services has an agreement with consumers for the supply of such goods and services and the consumers have agreed that the goods and services need not be subject to other forms of regulation; or

- The supplier or consumers of designated goods and services have demonstrated to the regulator that an arrangement is in place that achieves the same or similar long-term benefits to consumers as would be achieved by other forms of regulation.

Where an alternative arrangement has been agreed:

- A limited form of information disclosure should apply, with the purpose being to enable monitoring of the arrangements by those involved in them.

Default price/quality path

54. The default price/quality path would apply to all designated goods and services that were not subject to alternative arrangements, or for which the supplier had not entered into a propose/respond form of regulation (thus it would be the default form of regulation).
55. We envisage the default price/quality path would have a number of features of the current thresholds, but would also differ from them in important ways. We recommend the following design for the default price/quality path:
 - The default price/quality path would be set using rules of thumb rather than extensive, firm-specific analysis.
 - Suppliers would be required to report compliance or otherwise with the default path (price and service quality), explain any non-compliance, and remedy non-compliance in future periods.
 - It would not be unlawful to supply designated goods and services on terms other than the default price/quality path.
 - In situations (that would need to be well defined) where a supplier supplied designated goods and services on non-complying terms and did not take remedial action, the regulator could require the supplier to enter the propose/respond process.
 - Any situation that allowed the regulator to refer a supplier to the propose/respond process would expire if not acted on by the regulator within one year of it being reported.
56. We consider that this approach to a default price/quality path would address the key deficiencies of the current thresholds and provide a relatively low cost and effective “default” form of regulation.

Propose/respond

57. The propose/respond form of regulation would be available to suppliers that neither adopted the alternative arrangements nor considered the default price/quality paths appropriate for some or all of its designated services. It

would also be a form of regulation that the regulator could require suppliers to enter if they supplied goods and services on terms outside the default price/quality path and did not take remedial action.

58. We recommend the propose/respond form of regulation should have the following features:
- An obligation on the regulator to enter a propose/respond process if requested by the supplier.
 - The right for the regulator to require a supplier to enter the propose/respond process subsequent to the supplier operating outside of its default price/quality path and not taking remedial action.
 - An obligation on the regulator at the commencement of the process to identify to the supplier the input methodologies that must be complied with (we expect input methodologies, once set, would apply for extended periods of time).
 - An obligation on the supplier to put forward a proposal, and to identify in the proposal the manner in which the supplier considers it complies with the input methodologies.
 - An obligation on the regulator to respond to the supplier's proposal, including identifying whether or not it considers the input methodologies have been complied with, and if not, why not.
 - An opportunity for the supplier to iterate with the regulator for a defined number of times.
 - The provision for binding arbitration on any matters on which the propose/respond process does not reach a conclusion. The regulator and the supplier would have the right to appoint jointly the arbiters, and in the case of non-agreement to appoint an arbiter each.
 - The arbiters would have the power (acting jointly) to accept the proposal of the regulator or the supplier on each outstanding matter, or to reject both proposals, and be required to provide reasons for their decisions. The arbiters would not have the power to modify proposals. The arbitration would continue until all matters are resolved.
 - Timeframes for the above steps would be legislated for, in order to ensure the process is not unduly prolonged.
59. We consider this design of a propose/respond form of regulation would bring together in an effective manner the information the regulator has on input methodologies and their application, and the information the supplier has on what is possible in terms of the supply of goods and services.

Development of input methodologies

60. The MED paper lists the following items under input methodologies (paragraph 131):
- “the form of control (e.g. price/revenue cap or rate of return regulation);
 - how the weighted average cost of capital (WACC) will be calculated;
 - how assets will be valued (e.g. historical cost-based or replacement cost-based);
 - how common costs will be allocated (e.g. avoidable cost allocation or fully distributed costing);
 - the treatment of tax;
 - which costs may be “passed through”;
 - the appropriate reset period; and
 - circumstances for when the control terms may be re-opened during a regulatory control period.”
61. The MED proposes that these input methodologies should be required to be set prior to any inquiry or other decision-making process in which they are to be applied. We agree.
62. The current approach by the Commerce Commission, which is to develop and to in some cases change these methodologies within a decision-making process, is highly unsatisfactory.
63. The question as to who should set these input methodologies and their appropriate legal status is discussed in the section on accountability.

Transition arrangements

64. There is a potential clash in the timing of the intended reset of the current thresholds to apply from 1 April 2009 and the timing of the implementation of any changes to Part 4A (if changes are made).
65. The need for the Commission to reset thresholds in 2009 arises from the fact that the Commission gazetted the current thresholds as applying for a five-year period from 1 April 2004. There is no legislative requirement for the length of time that thresholds are to apply. For example, we note thresholds applying to Transpower are reset every year.

66. We understand any changes to Part 4A would be passed by mid-2008 at the earliest. We expect that if changes to Part 4A were made along the lines of our recommendations they would take about eighteen months to two years to implement. This suggests that such changes could be implemented by about mid 2010, and therefore could apply to the year commencing 1 April 2011 at the earliest.
67. The work programme to implement our recommended changes to Part 4A would be very different from that to reset thresholds under the current Part 4A, and would have a different focus.
68. The relevant input methodologies would need to be established prior to the setting of the default price-quality path. If they differ from those used currently by the Commerce Commission, work undertaken using previous methodologies would need to be redone.
69. We expect a large number of the smaller lines businesses would qualify for the alternative arrangements, some would operate under the default price/quality path and a very small number would opt initially for the propose/respond pathway.
70. Thus work by the Commission and lines businesses on resetting the current thresholds would be wasted if the changes were made. To avoid this, and at the same time ensure the Commission continues to fulfil its statutory duties should Part 4A remain unchanged, we recommend the following transition arrangements:
- The Commission should reset thresholds from 1 April 2009 for a two-year period.
 - the current price thresholds should be rolled forward on an undifferentiated basis of $CPI - X$, with $X = 0$. This undifferentiated basis, and $X = 0$, is recommended to avoid the need for extensive work to identify different values of X .
 - the service quality thresholds should be rolled forward at their current levels.
 - The current Part 4A should stay in force until 31 March 2011 (or an equivalent set of transition arrangements be crafted into any amended Part 4A) whether or not changes arising from this review are passed into law. This would allow over two years (if legislated changes are passed in 2008) for an orderly implementation of the changes, which would contribute to certainty and investor confidence over the transition period.

71. It would be within the statutory powers of the Commission to follow this transition path, but there are no provisions for the Minister to require it to do so. However, a relatively smooth transition is in the interests of the Commission, consumers and suppliers. It may be appropriate for the Minister to write to the Commission and suggest this transition path at the earliest opportunity.

Accountabilities

72. This section covers issues related to setting input methodologies, the accountability of the regulator, and the choice of the regulator.

Input methodologies

73. The input methodologies are a critical component to implementing economic regulation. The MED paper describes these as “technical-type parameters” (paragraph 130). We agree, as they are issues that need to be resolved to implement policy (rather than policy itself). This observation does not diminish their importance but does indicate the type of decision-maker that should set them.
74. In our view an expert body should set the input methodologies, and one that is accountable for ensuring they are set consistent with the purpose statement, the regulatory criteria, and the current state of knowledge relevant to the issue.
75. We consider there are arguments for and against this entity being the same as the regulator that is required to implement the input methodologies. Being separate from the regulator would likely strengthen the objectivity and transparency of the process. Being the same entity would help ensure they are set in a way that enables them to be implemented readily.
76. We consider it would be preferable for the input methodologies to be set by an entity separate from the regulator. However there is no current entity in the New Zealand public sector that is well placed to do this. It would be possible to convene an expert panel to set the input methodologies. We recommend this approach be explored.
77. We consider there should be an obligation on the entity setting the input methodologies to accept methodologies proposed by those subject to regulation which are reasonable, as assessed from the perspective of the purpose statement and the regulatory criteria. This would help address issues which have arisen with Part 4 and 4A where the regulator has had entrenched views on a particular

method for addressing an issue but for which there are technically sound alternatives that are preferred by those supplying the service (examples include using historic cost or ODV to value the asset base and the associated relevant WACC and recognition of revaluations as income, and the measurement of income tax).

78. We do not consider input methodologies should be determined by the Minister (whether on recommendation of the regulator or not) as they are not policy issues. Whoever sets the input methodologies should be subject to merits review, as this is the appropriate form of accountability for a technical responsibility of this nature.
79. We consider the input methodologies should be required to be set prior to any regulatory process in which they are to be applied, and should not be able to be changed within the course of that regulatory process, except in tightly defined situations (e.g. where the regulator and the entities involved agree to a change). To support this approach, we consider the input methodologies should be legally binding on the regulator.
80. In summary we recommend:
 - The input methodologies should be set by either an expert panel convened for this purpose, or by the regulator.
 - If an expert panel is adopted, the panel should be appointed by the Minister, in consultation with those affected directly by the regulation.
 - In either case:
 - The input methodologies should be required to be set prior to any regulatory process in which they are to be applied, and should not be able to be changed within the course of that regulatory process, except in clearly defined situations (e.g. where the regulator and the entities involved agree to a change).
 - The body setting the input methodologies should not be able to exclude input methodologies proposed by those subject to regulation where the proposed methodologies are reasonable (relative to the purpose statement and regulatory criteria).
 - The input methodologies should be legally binding on the regulator.

Accountability of regulator

81. Appropriate accountability of the regulator is critical to provide predictability and stability in economic regulation. We consider the regulator needs to be accountable in the following ways.

Clear and unambiguous purpose statement and regulatory criteria

82. We have covered in this submission ways to improve the clarity of the purpose statement and reduce its ambiguity through the application of regulatory criteria. These criteria should be enshrined in legislation.

Independence from government

83. Clear accountability for implementing economic regulation, consistent with the purpose statement and regulatory criteria, requires the absence of obligations to other possible objectives, including government policy that has not passed the scrutiny of Parliament.
84. Thus we consider it is fundamental to good regulatory design that the regulator is an entity independent of government, and that any instruction from government occurs in a structured and transparent manner (e.g. by way of section 26 statements under the Commerce Act).

Subject to merits review

85. We agree with the MED that an appeal right to merits review should form part of the accountability of the regulator.
86. We recommend merits review be by way of re-hearing. This is consistent with the form of merits review already applying to the Commerce Commission's clearance and authorisation responsibilities, and has the desirable feature of encouraging participants to provide information in the initial regulatory processes.
87. We recommend merits review apply to all substantial decisions of the regulator, as the benefits of merits review can be expected to substantially out-weigh the costs.¹⁶ This would include merits review applying to the setting of input methodologies and the implementation of the three regulatory pathways.

Statutory obligation to provide reasons

88. We consider there should be a statutory obligation on the regulator to provide reasons as to why it considers its decisions are consistent with the purpose

¹⁶ For a cost/benefit assessment of allowing merits review, see "Costs and benefits of appeals on merit: Economic regulation of electricity lines businesses", Kieran Murray & Sally Barnes of LECG, 19 January 2007

statement, regulatory criteria and any other matters it is obliged to take account of. A statutory requirement to provide reasons would:

- Be consistent with common law duties in relation to administrative law that favour reasons being provided as a matter of natural justice and efficiency; and
- Assist parties when considering whether to appeal a decision, and the appeal process, as it would ensure transparency of the rationale used by the regulator.

Choice of regulator

89. The two possible candidates for the function of economic regulator for electricity distribution services are the Commerce Commission and the Electricity Commission. Their advantages and disadvantages are:¹⁷
- The Commerce Commission has experience in related regulatory activities (e.g. economic regulation applying to telecommunications and inquiries under Part 4), and has built up experience in the implementation of Part 4A over recent years.
 - The Commerce Commission is independent of government policy.¹⁸
 - The Electricity Commission has experience and responsibilities in other aspects of the electricity sector.
 - The Electricity Commission is not independent of government policy.¹⁹
90. If the structure of the Electricity Commission is not open to change, we recommend this economic regulatory function remain with the Commerce Commission, to ensure the regulator is independent from government policy.
91. If the structure of the Electricity Commission is open to change and if it were changed in a manner that provided this Commission independence from

¹⁷ For an assessment of the two Commissions as economic regulators see “Comment on the possible transfer of jurisdiction to the Electricity Commission of Part 4A powers related to Transpower”, by Stuart Shepherd, Kieran Murray & Daniel Garrett of LECG, 19 December 2005

¹⁸ The Commerce Commission is listed as an “Independent Crown Entity” under the Crown Entities Act 2004 and the Minister has no powers to direct it on matters of government policy other than to the limited extent prescribed in section 26 of the Commerce Act 1986.

¹⁹ The Electricity Commission is listed as a “Crown Agent” under the Crown Entities Act 2004 and is subject to direction from the Minister regarding the Commission giving effect to government policy.

government policy, then we consider there would be merit in exploring the possibility of shifting this economic regulatory function to it.

Appendix One – Nature of ownership of lines businesses

Lines Business	Nature of ownership	Number of ICPs ²⁰
Buller Electricity	100% consumer-trust	4,000
Centralines	100% consumer-trust	8,000
Counties Power	100% consumer-trust	35,000
Electra	100% consumer-trust	40,000
Mainpower New Zealand	100% consumer-trust* ²¹	31,000
Marlborough Lines	100% consumer-trust	23,000
Network Tasman	100% consumer-trust	34,000
Network Waitaki	100% consumer-trust	12,000
Northpower	100% consumer-trust	51,000
Scanpower	100% consumer-trust	7,000
The Lines Company	100% consumer-trust	26,000
The Power Company	100% consumer-trust	32,000
Top Energy	100% consumer-trust	28,000
Unison Networks	100% consumer-trust*	105,000
Waipa Networks	100% consumer-trust	22,000
WEL Networks	100% consumer-trust*	79,000
Westpower	100% consumer-trust	12,000

²⁰ As at 31 March 2006, and rounded to the nearest thousand

²¹ A * denotes that the consumer-trust and network footprints do not match entirely.

Lines Business	Nature of ownership	Number of ICPs
Alpine Energy	Consumer-trust & 3 local authorities	29,000
Aurora Energy	100% local authority	76,000
Eastland Network	100% community trust	25,000
Electricity Ashburton	Local authority & consumers	16,000
Electricity Invercargill	Local authority	17,000
Horizon Energy Distribution	Community trust & private investors	24,000
Nelson Electricity	2 lines businesses, both owned by consumer-trusts	9,000
Orion New Zealand	2 local authorities	181,000
OtagoNet Joint Venture	3 other lines businesses, 1 owned by local authority, 2 by consumer-trusts	14,000
Powerco	Private investors	304,000
Vector	Consumer-trust & private investors	660,000

Appendix Two – Questions & answers

	Question	Response
C1 -1	Do you have any comments on the desirable characteristics of a regulatory regime as outlined in this Chapter?	We agree with the characteristics listed. It is important trade-offs between them are made with reference to the particular issues faced by the sector being regulated.
C3 - 1	Does the above list capture the main issues with the current regulatory regime?	See additional points in paragraph 10.
C3 - 2	Are these issues adequately identified and described?	
C3 - 3	Are there any other issues with the current regime that are not listed above and should be considered as part of this review?	
C4 - 1	Do you agree that a regulatory regime needs to be available to address issues in markets with monopoly characteristics?	Yes, if more effective alternatives are not available.
C4 - 2	Do you consider that the sole or primary objective of a regulatory regime should be economic efficiency or consumer protection (distribution), or do you consider that both should be taken into account?	We consider the objective of regulation should be economic efficiency but accept the MED proposal implies a distributional objective also.
C5 - 1	In your opinion, is a regulatory-specific purpose statement desirable?	The purpose statement needs to be unambiguous and focused on the intended objective of regulation; whether it is regulatory-specific is less important.
C5 - 2	If so, do you agree with the proposed regulatory-specific purpose statement, or do you prefer an alternative formulation? If so, please suggest specific wording.	See paragraphs 17 – 29 for comments and recommended changes.
C6 - 1	Do you agree with the proposed criteria for deciding on whether regulation <i>may</i> be imposed?	See paragraphs 30 – 45 for comments and recommended changes.
C6 - 2	If you agree that one of the tests for whether control may be imposed should be where the long term benefits to acquirers <i>exceed</i> direct and indirect costs, do you consider that such benefits should (a) ‘ <i>substantially</i> ’ or (b) ‘ <i>clearly</i> ’ exceed costs, or should there be some other guidance on weighting?	Benefits should “substantially exceed” costs. See paragraphs 37 - 40 for comment.
C6 - 3	If you agree that one of the tests for whether control	If the distributional objective

	Question	Response
	may be imposed should be where the long term benefits to acquirers exceed direct and indirect costs, should those benefits be considered regardless of whether acquirers acquire the goods and services <i>directly or indirectly</i> , or should it be necessary to establish that benefits <i>will</i> be passed on to end users (or consumers or end-acquirers)?	is to protect end-consumers (which we understand it to be) then costs and benefits should be assessed from their perspective.
C6 – 4	Should the current provisions in the Act allowing control to be imposed in the interests of <i>suppliers</i> (to a monopsonist) be retained?	No firm view, as we focused on changes to Part 4A and related aspects of Part 5.
C6 – 5	Do you agree that there should not be a legislative test for when regulation <i>should</i> be imposed?	No firm view, as we focused on changes to Part 4A and related aspects of Part 5.
C6 – 6	Do you agree that the Minister should remain the decision-maker on whether control should be imposed under Part 4, but that that the Minister must receive a report and recommendation from the Commerce Commission before making a decision?	No firm view, as we focused on changes to Part 4A and related aspects of Part 5.
C6 – 7	Do you agree that the decisions on <i>whether</i> and, if so, <i>how</i> to regulate should be undertaken simultaneously rather than sequentially?	No firm view, as we focused on changes to Part 4A and related aspects of Part 5.
C7 - 1	Do you agree that it is desirable to widen the scope of the Commerce Act by providing for regulatory options other than control, specifically: <ul style="list-style-type: none"> • negotiation/arbitration and • price monitoring/information disclosure? 	Yes, and we have included these options in our recommended Part 4A. See paragraphs 52 – 59 for comments.
C7 - 2	Do you consider that specific, easier tests should be provided to determine whether lighter-handed types of regulation, such as information disclosure, may be imposed, such as: <ul style="list-style-type: none"> • meeting the competition criteria only • requiring qualitative (rather than quantitative) cost-benefit analysis? 	No firm view, as we focused on changes to Part 4A and related aspects of Part 5.
C8 - 1	Do you see value in having key input decisions set as a stand-alone process in advance of an inquiry and recommendation to regulate? If so, should they be set for a specific sector once an inquiry has been initiated, or set generically irrespective of whether or not an inquiry has been initiated?	It is critical they are set in advance of any regulatory process in which they are to be used. See paragraphs 73 – 80 for comments.
C8 - 2	Is it practical, or possible, to set generic methodologies that could apply to all potentially regulated sectors?	No firm view, as we focused on changes to Part 4A and related aspects of Part 5.
C8 - 3	Do you consider that input methodologies should be set: <ul style="list-style-type: none"> • as guidelines by the Commerce Commission; 	They should be set either by an expert panel or the Commission, and be legally

	Question	Response
	<ul style="list-style-type: none"> • as Rules by the Minister following a recommendation from the Commission; or • another option (please specify)? 	binding on the Commission. See paragraphs 73 – 80 for comments.
C9 - 1	Should specific provision be made (e.g. in Part 5) to allow the Commerce Commission to use comparative benchmarking as a methodology for setting control terms?	Not for electricity distribution services.
C9 – 2	Should specific provision be made to allow the Minister to request the Commission to consider whether economic regulation may be imposed on a <i>sector as a whole</i> (rather than each individual firm within a sector) and if so, should provision be made for cost benefit analysis on this matter to be undertaken in <i>qualitative</i> (rather than quantitative) terms?	No firm view, as we focused on changes to Part 4A and related aspects of Part 5.
C9 – 3	Is there value in allowing firms to propose their own control terms for the Commission’s consideration (‘propose/respond’ model)?	Yes, and our recommendations for propose/respond reflect this. See paragraphs 57 – 59.
C9 – 4	If firms are able to propose their own control terms, should the Commission be required to accept proposals that meet pre-set criteria? Do you have any comment on the proposed ‘reasonableness criteria’?	Yes the Commission should be required to accept such proposals. See paragraphs 57 – 59 as to how this could work.
C9 – 5	If firms have the ability to propose their own control terms, should this proposal take place before or after declaration of control by the Minister (note that in section 9.3 the paper proposes different sequences for control of individual firms compared to sector control)?	No firm view, as we focused on changes to Part 4A and related aspects of Part 5.
C10 – 1	With regard to the Part 4A thresholds regime do you favour: <ul style="list-style-type: none"> • retaining the threshold regime and making it more generic (that is, applicable to sectors other than electricity lines businesses), or • repealing Part 4A and amending Part 5 to allow the Commerce Commission to use comparative benchmarking to set terms and conditions for control while allowing firms to seek customised control terms. 	Our recommendations include improvements to the thresholds regime and a propose/respond approach for firms to seek customised control terms. We have no firm view on whether thresholds should be applicable to other sectors.
C10 – 2	In your opinion, are there other options for addressing the issues with the Part 4A thresholds regime?	Yes. Our recommended changes as a package address the current issues with the Part 4A thresholds.

	Question	Response
C10 – 3	Are small businesses within a sector likely to be disproportionately affected by the requirements of the regulatory regimes proposed in this document? What are the likely <i>incremental</i> costs of complying with the current Part 4A and proposed alternative regimes? How could these costs be minimised?	Small lines businesses struggle with the current Part 4A and this would continue under the MED proposals. Our recommendations for alternative arrangements would address this issue for community-owned lines businesses, which include most of the smaller lines businesses. See paragraphs 52 & 53 for comment.
C10 – 4	Should local community owned trusts be subject to a different regulatory regime than larger non-trust electricity lines businesses?	
C11 - 1	Do you agree that control terms should not be re-opened within a specified control period, other than under exceptional circumstances? If so, do you agree with the exceptional circumstances suggested in this Chapter?	Our recommended propose/respond approach would enable suppliers to re-open control terms if they considered it necessary. See paragraphs 57 – 59 for comments.
C11 - 2	Are the current provisions relating to penalties in the Act for breaches of control terms (s70C) satisfactory or should additional guidance be provided?	No firm view.
C12 - 1	Do you consider that it is desirable to provide for merits review of regulatory decisions or does judicial review provide sufficient constraints on regulatory decisions?	We recommend merits review be accessible for all substantial regulator decisions. It should be by way of re-hearing by the High Court, similar to the appeal approach used for other Commission decisions currently. See paragraphs 85 – 87 for comments.
C12 - 2	Do you agree with the document’s conclusions that, if merits review is provided for, it should only apply to control decisions made by the Commission and be limited to the form of ‘appeals by way of re-hearing’ where new evidence can be introduced only if it is fresh and material and it could not have been submitted at the original decision-making stage?	
C12 - 3	What is your preferred composition of any merits review body, taking into account New Zealand’s small size and limited resources?	
C13 - 1	Submitters are requested to provide specific, quantitative information on costs and benefits wherever possible to assist the Ministry in undertaking any cost benefit analysis.	We would be happy to provide this information once the issues that require quantitative cost/benefit analysis have been specified clearly.