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6 July 2007

Commerce Act Review
Ministry of Economic Development
P O Box 1473
Wellington

Dear Sir/Madam

Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document (April 2007)

As you will be aware, Orion New Zealand Limited (Orion) has participated in the Electricity Networks' Association (ENA) deliberations into the above Discussion Document, and is party to the ENA submission of 6 July 2007.

In addition to this submission, Orion has also requisitioned an independent report from NERA. This report, including a section on merits review which has been prepared by Dr Mark Berry, is attached.

The authors of this NERA report have practiced extensively in the field of regulation in the UK, Australia and New Zealand. NERA has represented Orion in all matters to date pertaining to the evolution and application of Part 4A of the Commerce Act. They are, therefore, well qualified to express an independent view on matters raised in the Discussion Document, particularly in relation to issues relating to electricity lines business regulation.

As was foreshadowed in the ENA submission, it is inevitable in a complex area such as this that additional submissions made by, or on behalf of, individual members of ENA may differ in some respects to the ENA submission. The expression of a wider range of views, than just those views contained in the ENA submission, will hopefully further assist the Ministry in deciding upon the next steps in this current review process.

The attached report from NERA differs in some respects to the views expressed in the ENA submission. For example on substantive matters, NERA prefers to address the purpose statement problem, which is also identified in the ENA submission, by way of a short legislative provision along the lines of section 18 of the Telecommunications Act. Further, NERA also explores the possibility that some features of the current threshold regime may be preserved.

For the most part, however, the differences of view in the NERA and ENA submissions are largely procedural. For example:

1. NERA suggests that it may be more efficient to set the default price path, and to issue the Commerce Commission Guidelines on input methodologies, contemporaneously. The ENA submission prefers that such Guidelines are set in advance of the default price path. Such differences in approach will not, over time, result in substantive differences as to the proper content of the Guidelines; and
2. NERA's proposal is based on the assumption that the Commerce Commission remains the central decision-maker, whereas the ENA submission anticipates additional independent review bodies and arbiters. Again such differences are not of substantive significance.

The ENA submission, and the NERA report, are at one on the need for full merits review.

We hope that you will find the additional views of NERA to be of assistance in your deliberations. We would be happy to make arrangements for you to meet with the authors of the NERA report if that would be of assistance.

Yours faithfully

A handwritten signature in blue ink, appearing to read 'Roger Sutton', with a long horizontal flourish extending to the right.

Roger Sutton
Chief Executive Officer

Encl...

6 July 2007

**Response to MED Discussion Document:
Review of Regulatory Control Provisions
under the Commerce Act 1986**

A Report for Orion New Zealand Limited



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Summary of Recommendations

Experience with the application of the thresholds regime contained in Part 4A of the *Commerce Act 1986* (the Act) has highlighted a number of **pressing priorities for change**, many of which are recognised by the Ministry of Economic Development (MED) in its Discussion Document. In particular:

- § The regime is electricity specific.
- § Considerable uncertainty surrounds the existing Part 4A purpose statement.
- § Threshold determinations are retrospective in nature and consequently disadvantage firms with significant forward-looking capital requirements.
- § There is presently significant scope for unanticipated and unintended breaches of both the price and quality thresholds, including from inaccurate CPI forecasts.
- § Post-breach processes are opaque and whilst some precedent has been generated the regime has nevertheless fallen significantly short of its potential to build precedent-setting experience and this is unlikely to change absent reform:
 - decisions on key input methodologies have not been delivered in a timely fashion and in some cases *not at all*, compounding the level of regulatory uncertainty; and
 - administrative settlements have been structured so as to avoid giving rise to any regulatory precedent and so they inhibit the development of regulatory certainty and so maturity of the regime.

We believe that a regulatory framework that is **broadly consistent with Option Two** as presented by MED, but with significant modifications will substantially improve upon the existing regime. In general, we do not consider that either Option One or Option Two have been developed in sufficient detail as a result of the review process. Consequently, we would recommend the following measures that, in culmination, should address the uncertainties surrounding Option Two as presently formulated:

1. A **simpler, more refined purpose statement** should be developed for Parts 4 and 4A that focuses on efficiency for the long term benefit of New Zealand consumers and relies less heavily on quantitative cost-benefit analysis. Specifically:

- (1) 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 prices and/or service quality in those markets for the long-term benefit of consumers in New Zealand.
- (2) In determining whether or not, or the extent to which, one or more forms of economic regulation will or will be likely to result in the long-term benefit of consumers in New Zealand, consideration must be given to the efficiencies that will result or be likely to result from such regulation.

2. The test for **whether goods and services should be regulated** should flow logically from the purpose statement and this assessment should be undertaken simultaneously with the decision of *how* to regulate. The decision-maker should be the Commission provided that

decision is subject to merits review. The assessment should also consider multiple potential forms of regulation *under the same test*, with the appropriate form of regulation determined by reference to the *degree of market power* involved. Specifically:

Goods or services may be regulated if:

- (1) There is little or no competition or prospect of competition in the relevant markets; and
- (2) Economic regulation of prices and/or service quality in those markets will or will be likely to result in the long-term benefit of consumers in New Zealand; and
- (3) In determining whether or not, or the extent to which, one or more forms of economic regulation will or will be likely to result in the long-term benefit of consumers in New Zealand, consideration must be given to the efficiencies that will result or be likely to result from such regulation.

3. More generally, there should be **merits review by way of rehearing** for a broad spectrum of regulatory decisions under the Act (including decisions by the Commission in the context of the ‘propose-respond’ framework) in the way that there is such a right to appeal under section 91(1). The existing High Court model can be adapted to meet the needs of merits review for regulatory decisions. The issue of the new appellate tribunal can be revisited at a later time if compelling reasons emerge for its introduction.
4. We propose a **regulatory framework that comprises two pathways: a default price threshold** and a customised proposal based upon a **propose-respond model**. The salient features of the framework are as follows. At the beginning of each 5-year regulatory period, each business would have the option of *irreversibly* deciding to:
 - § comply with a binding **default price path** that would comprise a lagged ‘CPI – X’ price path for the 5-year regulatory period, whereby the X-factor would be based on industry-wide total factor productivity (TFP) trends; or
 - § submit a **customised proposal** (based upon a propose-respond model) to the Commission within 90-days of the Commission announcing the default price path, that would be prepared consistently with **key input methodologies** specified by the Commission, to which the Commission would have 90-days to respond comprehensively.

Businesses would be afforded **20-days** to seek **merits review by way of rehearing** in the High Court following the Commission’s ‘response’ to its proposal. This can be relied upon to ‘bed down’ the Commission’s input methodologies over time. At the conclusion of any merits review proceedings, each business will either be subject to the default price path, or its own customised control terms. At the beginning of the next regulatory period all businesses would then initially **revert to a revised default price path**, before deciding once again whether to submit a customised proposal to the Commission.

To assist the **transition between regimes**, in the interim the Commission should **maintain the existing thresholds** for lines businesses. This would avoid businesses and the Commission alike having to undertake the two processes simultaneously in an environment where the decisions being debated may ultimately prove irrelevant. Whilst this transitional period may take one- to two-years it would ensure a comprehensive assessment is undertaken of the future legislative framework, thereby minimising the risk

of subsequent unintended consequences. **Twelve months** from the date at which amending legislation takes effect, the Commission should be required to:

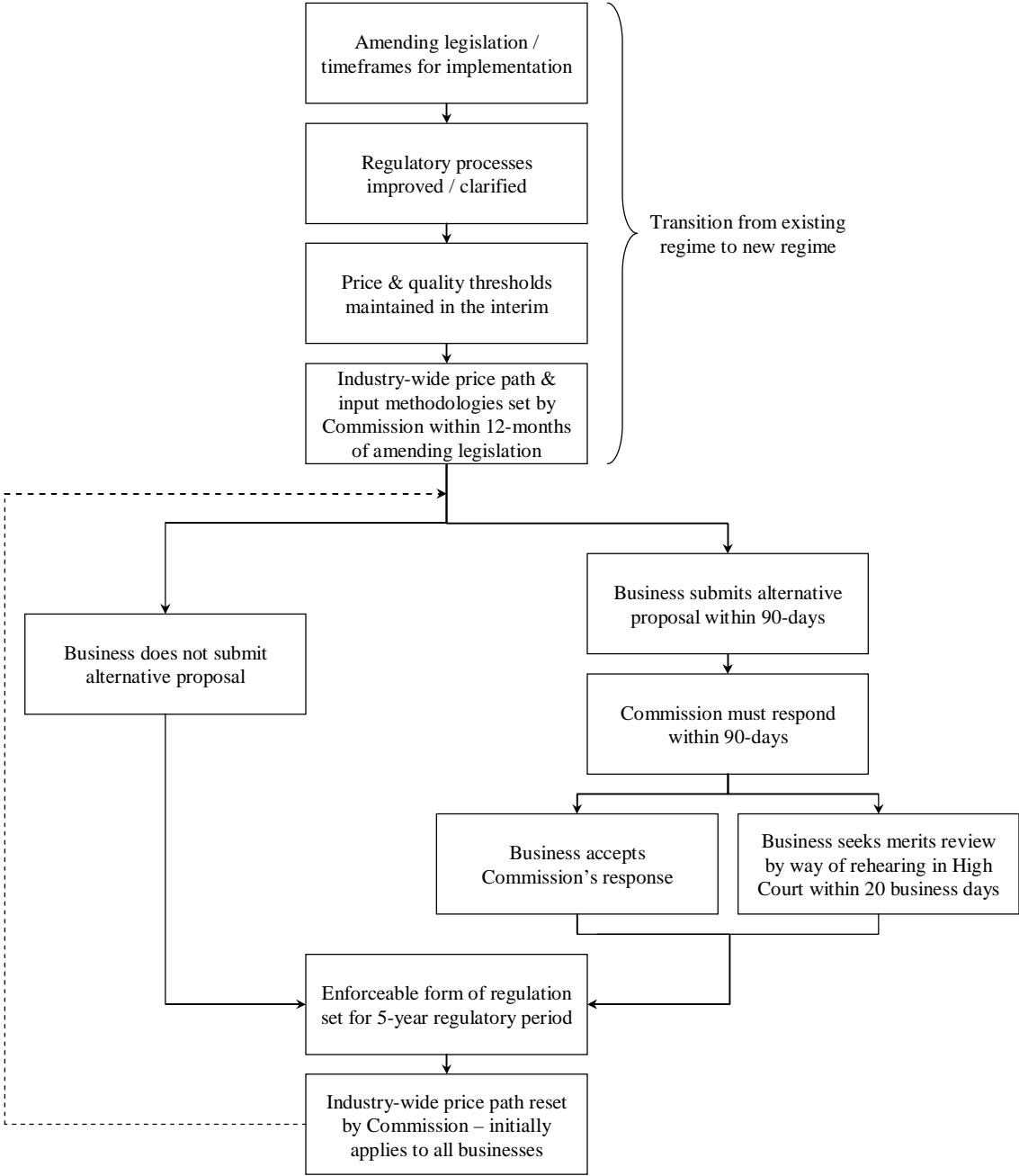
- § determine the **initial industry-wide default price path** to apply for the first five-year regulatory period; and
- § publish following adequate consultation its **Guidelines on the key input methodologies** it expects businesses to employ if they opt to submit their own customised proposal, including on the form of regulation to apply to each service, WACC and approaches to asset valuation.

The **procedures** that the Commission must follow when making regulatory decisions generally should also be clarified and improved during this timeframe. In particular, the legislative scheme should require the Commission to give comprehensive reasons for all of its decisions that relate to all the evidence they have received through any consultations.

5. As a logical **next step**, MED should undertake a more detailed **second round of consultation**, including a more thorough canvassing of potential alternative regulatory frameworks and detailed implementation and procedural issues before robust decisions can be made about the future of regulation for electricity lines businesses.

Figure 1 below summarises our proposed regulatory framework for ELBs, including suggested timeframes for implementation and a transition path between the existing regime and the new.

Figure 1. Summary of Proposed Regulatory Framework for ELBs



1. Introduction

This report has been prepared by NERA Economic Consulting (NERA) on behalf of Orion New Zealand Limited (Orion) in response to the review being undertaken by MED into the regulatory control provisions of the Act. The MED notes in its Discussion Document that experience with two regulatory control inquiries (airports and gas pipelines) and the application of the Part 4A regime has highlighted a number of issues that warrant attention. It proposes a number of fundamental changes to Parts 4, 4A and 5 of the Act in an attempt to address these issues. These can be broadly summarised as follows:

- § a proposed purpose statement for Part 4 and a revised purpose statement for Part 4A that include both efficiency and distributional objectives;
- § proposed changes to the threshold test for *whether* regulation ‘may’ be imposed;
- § that the control decision-maker will set ‘input methodologies’ as ‘Regulations’ (if set by Minister on recommendation from the Commission) or mandatory ‘Guidelines’ (if set unilaterally by the Commission) governing control decisions;
- § two potential options are proposed regarding the potential future for the current ELB-specific arrangements under Part 4A, including its associated threshold regime:

Option One: Part 4A retained and made generic so as potentially to encompass other sectors such as gas pipelines and allow for other regulatory options, eg, negotiate/arbitrate, price monitoring, etc, where appropriate.

Option Two: Part 4A repealed and replaced with the ability to put sectors under an amended Part 5 control regime that:

- allows the Commission to specify the regulatory framework, eg, no regulation, negotiate/arbitrate, control, etc; but
- allows an individual service provider to propose its own control terms, which must be accepted by the Commission within 90-days provided the proposal is ‘reasonable’; and
- the introduction of ‘merits review’ of final control terms.

The purpose of this report is to examine the analysis underpinning the MED’s recommendations with a view to assessing their appropriateness and to propose recommended alternative measures where improvements are possible. The remainder of this report is structured as follows:

- § section two discusses experience with the Part 4A threshold regime to date, identifies its key advantages and disadvantages, and highlights the consequent priorities for regulatory change;
- § section three evaluates the extent to which the MED proposals as presently formulated are likely to address these priorities;
- § section four proposes a common purpose statement for Parts 4 and 4A that reflects the overarching objective of economic regulation – the long-term benefit of New Zealand consumers – and consequent criteria for deciding whether to regulate;

- § section five outlines a regulatory framework that is broadly consistent with Option Two as presented by MED, but with modifications that would substantially improve upon the existing regime Part 4A regime; and
- § section six assesses the proposed changes to regulatory accountability mechanisms, including the application and form of merits view.

2. Priorities for Change

In this section we discuss experience with the Part 4A threshold regime to date, including its key advantages and disadvantages, and the consequent priorities for regulatory change. First, there are clearly some desirable aspects of the thresholds regime that should be retained to the greatest extent possible, including:

- § thresholds work well in the sense that ELB's are afforded a degree of flexibility to conduct their operations as they see fit, provided they remain within price and performance thresholds; and
- § the regime is also a relatively cost-effective way of conditioning the behaviour of electricity lines businesses - the threshold element in particular involves the commitment of less resources on the part of both the regulator and regulated business than would otherwise be involved in implementing a universal control regime.

However, the existing Part 4A thresholds regime undoubtedly suffers from a number of serious shortcomings, many of which the MED identifies in its Discussion Document. These represent **pressing priorities for change**. In particular:

- § the regime is electricity specific;
- § considerable uncertainty surrounds the existing Part 4A purpose statement;
- § threshold determinations are retrospective in nature and consequently disadvantage firms with significant forward-looking capital requirements;
- § there is significant scope for unanticipated and unintended breaches of both the price and quality thresholds, including from inaccurate consumer price index (CPI) forecasts;
- § post-breach processes are opaque, and whilst some precedent has been generated, the regime has nevertheless fallen significantly short of its potential to build precedent-setting experience and this is unlikely to change absent reform:
 - decisions on key input methodologies have not been delivered in a timely fashion and in some cases *not at all*, compounding the level of regulatory uncertainty; and
 - administrative settlements have been structured so as to avoid giving rise to any regulatory precedent, and thereby inhibit the development of regulatory certainty and so maturity of the regime.

The following sections highlight these key shortcomings in the present thresholds regime and the consequent priorities for regulatory change.

2.1. Electricity Specificity

MED recognises that one of the potential disadvantages of the Part 4A regime is that it is currently specific to electricity lines businesses. Provided the regime were substantially improved, it would be advantageous to broaden its scope so as to allow other sectors to be brought under its umbrella, including, for example, gas pipelines. Indeed, as section 5 explains, arguably a large number of changes should be made to the existing regime to bring it into line with best regulatory practice. In other words, whilst it makes sense to broaden the

scope of the regime to encompass other sectors, this broader regime *should not be the existing Part 4A regime*.

2.2. Part 4A Purpose Statement Unclear

We agree with the MED that it is unclear whether the purpose statement contained in s57E of Part 4A of the Act contemplates a pure efficiency-based assessment, or whether distributional issues are also significant. We also agree with MED that:

- § if efficiency is the primary goal, then the costs of regulation will in just about all cases outweigh benefits, which should not include wealth transfer; and
- § if distribution is the primary goal then the opposite will be true, because wealth transfers will form the bulk of the ‘benefits’ of regulation.

This uncertainty constitutes a significant shortcoming since irrespective of whether the future framework for ELB regulation effectively involves universal control, the purpose statement will remain the critical reference point for decisions on input methodologies and other important elements of the regime, as sections 4 and 5 below attest. Additionally:

- § MED’s ‘Option One’ contemplates expanding Part 4A to encompass other sectors that are not presently regulated, eg, gas pipelines; and
- § MED proposes a purpose statement for Part 4 that is based largely upon the s57E purpose statement.

In other words, even if uncertainty as to whether the control decision should include any weight for transfers from producers to consumers is no longer a ‘live issue’ in the context of deciding whether to regulate *ELBs*, there will nonetheless be adverse consequences for critical aspects of the regime. Moreover, the uncertainty caused by the existing purpose statement (or variants on it) will have a detrimental effect on *other sector-level investigations* conducted by reference to identical or similar threshold tests.

2.3. Retrospective Focus

One of the most significant shortcomings of the current regime is the retrospective nature of the thresholds element, which the MED has recognised. In particular, the methodology employed by the Commission for setting price thresholds does not involve any forward-looking assessment of expenditure requirements, which disadvantages lines businesses with significant needs in this regard. Indeed, a business that must significantly increase its capital expenditure is likely to breach its threshold. This is not a regulatory environment for fostering efficient investment and dynamic efficiency.

This would be less problematic if post-breach processes were well specified, since lines businesses would then be better placed to predict the outcome of breaches. Specifically, if a business were assured that it would not be ‘punished’ for undertaking an efficient investment it would not hesitate to do so. However, as outlined below, post-breach processes are highly opaque and so businesses may be reticent to undertake efficient augmentations for fear of being drawn into a long and costly process, with the ultimate risk of financial penalty. Moreover, a business may not *even know* that it has breached a threshold until it is too late.

2.4. Scope for Unintended Breaches

In order for price and quality thresholds to work effectively it should be clear for each business whether it is complying with its thresholds or not. However, several aspects of the existing thresholds are designed in such a manner as to preclude businesses from possessing this certainty, creating significant scope for unintended breaches. By way of illustration:

- § to comply with its price threshold when formulating tariffs a lines business must forecast the CPI – if inflation is significantly lower than expected then this may result in a breach; and
- § likewise, when formulating its tariffs a lines business must incorporate transmission charges – if the actual transmission cost is *lower* than expected this may result in an over collection of notional revenue and a consequential breach.

In none of the highlighted situations is the business in a position to anticipate a breach and consequently take preventative action. Again, this would be less problematic if post-breach processes were clear and businesses knew beforehand that they would not be penalised for unintended or purely technical breaches.

2.5. Opaque Post-breach Processes

The regulatory processes and the methods applied during post-breach investigations and subsequent analyses of whether control should be implemented are not well specified. First, as the MED notes, Commission decisions on *whether* to impose control following a breach investigation do not include a definitive statement on *how* control will be imposed.¹ Instead, the Commission must assume a *hypothetical* form of control when investigating the potential costs and benefits of control. Not only is this approach somewhat artificial, but also the efficacy of the decision of *whether* to impose control would be questionable if a different form of control from that assumed in the original analysis were ultimately put in place.

There is a consequently a heavy focus on ‘deal making’, with all beach investigations to date involving administrative settlement processes populated with disclaimers that the terms agreed upon are not to be viewed as indicative of the form of regulation that the Commission would implement under control. The consequence is that these settlements offer no assistance in the form of regulatory precedent for other ELBs and so prevent the development of regulatory certainty and thus the maturity of the regime.

Post-breach processes are also drawn out, giving rise to prolonged periods of uncertainty for the affected business. The Vector and Transpower breach inquiries are both yet to be finalised, with each well into its second year. The sole post-breach inquiry that *has* been finalised took over twenty months. The Commission announced its intention to declare control of Unison on 9 September 2005 and finally accepted an administrative settlement on 11 May 2007, as the below table indicates

¹ We note also that there is presently a belief that ‘control’ under Part 5 must differ from the established price thresholds and be ‘heavier handed’, ie, it should amount to a ‘punishment’. We are unclear as to the basis for this conclusion, but to the extent that it is correct this should be changed so as to allow compliance with existing price thresholds as a potential form of control.

Time-line of Unison Post-Breach Inquiry Process

Intention to declare control	9 September 2005
Conference on intention to declare control	November - December 2005
Administrative settlement offered	September 2006
Public consultation on administrative settlement	November 2006
Administrative settlement accepted	11 May 2007
Total Elapsed Time	> 20 months

The opaque and drawn-out nature of post-breach processes reduces the certainty and predictability of the Part 4A regime. The nature of the regulatory threat is therefore not particularly well understood, substantially hindering the effectiveness of the regulatory framework. Businesses are not well placed to predict the bounds of what is and is not acceptable conduct, and thus to take action to avoid such conduct. The prospect of the regime delivering dynamically efficient investment is therefore damaged over the longer term.

In these respects, the Part 4A regime has not turned out the way that industry participants envisaged that it would, which highlights the desirability of adequately settling detailed regulatory process issues in advance. Certainly few industry participants would have anticipated post-breach processes in the order of *twenty months*. If the existing regime is to be retained the control options and processes need to be far clearer in the event of a breach. However, as section 5 explains, a *substantially different* regulatory regime in which the administrative settlement process is removed entirely would be a preferable way of addressing these shortcomings.

2.6. Summary

There are some desirable aspects of the thresholds regime that should be retained to the greatest extent possible. It affords businesses a desirable degree of flexibility and is relatively cost-effective. However, at present these desirable aspects are substantially off-set by a number of shortcomings that hinder the regime's ability to deliver efficient outcomes and these give rise to **pressing priorities for change**, ie:

- § the regime is electricity specific;
- § considerable uncertainty surrounds the existing Part 4A purpose statement;
- § threshold determinations are retrospective in nature and so disadvantage firms with significant forward-looking capital requirements;
- § there is significant scope for unanticipated and unintended breaches of both the price and quality thresholds, including from inaccurate CPI forecasts;
- § post-breach processes are opaque and whilst some precedent has been generated the regime has fallen significantly short of its potential to build precedent-setting experience and this is unlikely to change absent reform:
 - decisions on key input methodologies have not been delivered in a timely fashion, prolonging the extent of regulatory uncertainty; and

- administrative settlements have been structured so as to avoid giving rise to any regulatory precedent and thereby inhibit the development of regulatory certainty and so maturity of the regime.

In sum, significant changes are required to the existing Part 4A regime. In the following section we evaluate the extent to which the changes proposed by MED in its Discussion Document are likely to address these identified shortcomings, and discusses the consequent priorities for legislative and regulatory change.

3. Evaluation of MED Proposals

MED identifies a number of important shortcomings in the existing thresholds regime applying to lines businesses. However, the two options it presents to remedy those shortcomings are not presented in sufficient detail to gauge their potential impact upon ELBs. In a number of instances it is very difficult to evaluate the proposals comprehensively since many critical aspects of their detailed operation are either glossed over or simply not addressed. Consistent with this theme, MED's proposed legislative amendments to the purpose statements and test for whether regulation may be imposed adopt critical terms that are decidedly unclear.

Moreover, not only are the MED options insufficiently articulated, but also in many respects they appear not to recognise a number of practical issues of regulatory design that will need to be managed before there could be any confidence that the reforms contemplated would bring about material improvement. In particular, there is little examination of detailed implementation issues, or a robust analysis of what the proposals are intended to achieve relative to the status quo, for example:

- § there are many aspects of the proposals that are not sufficiently well developed so as to have any confidence they would result in workable outcomes, including the proposed 'two-step approach' under MED Option Two; and
- § ELBs are regulated now, with price thresholds scheduled to be reset to take effect in 2009, yet the fundamental question of the transition from the old regime to the new is not addressed in any meaningful way.

We recognise that the two options presented by MED are preliminary in nature. However, the fact remains that unless the precise bounds of those options are clearly specified from the outset, and unless they are openly, transparently and consistently implemented, long-run distortions to pricing and investment decisions are likely to eventuate. In our view, there is a strong case to be made for clarifying these issues up front, rather than leaving critical issues unresolved and running into unintended outcomes when a regime is implemented.²

Indeed, experience with the Part 4A framework to date that has (at least in part) given rise to the current MED review provides a cogent illustration of the unintended consequences of inadequately specified regulatory processes and principles.³ Accordingly, in the following sections we highlight the opaque or otherwise problematic aspects of the MED proposals. We conclude that before robust decisions can be made about the future of regulation for ELBs, a more detailed **second round of consultation** is required with a view to resolving these issues. In sections four and five we outline our alternative proposal in this regard.

3.1. Proposed Purpose Statement Unclear

The purpose or objective statement of any regulatory law is by far its most important provision since uncertainty surrounding the objectives of regulation affects virtually every

² For a more detailed examination of procedural issues, see section 5.2 below.

³ See for example the discussion of post-breach processes in section 2.5.

other aspect of a regulatory regime. It is instrumental in the initial determination of whether regulation should be applied, as well as any subsequent changes to the form of regulation and the formulation of key input methodologies. We agree with the MED that the prime objective of reviewing the regulatory control provisions of the Act is to ensure that economic regulation in New Zealand is consistent with providing for the long-term benefit of consumers within New Zealand. We also agree that:

- § if efficiency is the primary goal, then the costs of regulation will in just about all cases outweigh benefits, which will not include wealth transfer; and
- § if distribution is the primary goal then the opposite will be true, because wealth transfers will form the bulk of the ‘benefits’ of regulation.

However, we *do not* agree that a workable solution is likely to arise from the MED’s conclusion that ‘both economic efficiency and distributional objectives are important and should be considered in the judgement on whether or not to regulate in any particular circumstance.’⁴ Such ambiguity will not assist the Commission. Moreover, as MED itself recognises,⁵ if it is simply deemed that both goals are important, the Minister may ultimately have to make a value judgment, thereby downplaying the role of any initial assessment by the Commission. The proposal to base a Part 4 purpose statement on s57E of Part 4A is especially problematic because this provision has already suffered from the very multiple goal problems the MED describes.⁶

Moreover, as the following sections explain, the identification and measurement of wealth transfers is likely to prove an impracticable task for the Commission to undertake. In our view, the additional clauses in MED’s proposed purpose statement are likely to give rise to further ambiguity rather than clarity, and the purpose statement is likely to encourage undue emphasis on the quantification of costs and benefits.

3.1.1. Identification of wealth transfers impracticable

It is extremely difficult to isolate the welfare impact of regulation upon New Zealand *consumers* as distinct from New Zealand *producers* since effects on the latter in their capacities as land owners, workers and investors will flow through to the former. Attempting to identify and measure wealth transfers between the two is therefore infeasible in practice, since the effects upon producers and consumers are ultimately indistinguishable: every producer is also a consumer.

Many consumers of regulated services will also be employees and shareholders of the companies in question. A significant proportion of stock in regulated businesses may also be owned by institutions tasked with investing people’s financial assets – these people will also be consumers of regulated services.⁷ By way of illustration, consider the following example

⁴ MED Discussion Document, p25.

⁵ MED Discussion Document, p24.

⁶ The MED analysis arguably is internally inconsistent in this regard; for example, incentives to improve efficiency and to invest conflict with requiring firms to share such efficiency gains with consumers.

⁷ A significant proportion of these shareholders may not be New Zealanders. In other words, there will be both foreign producers *and* consumers.

taken from a NERA report submitted to the Commission in response to its investigation into the regulation of mobile termination (MTR), in which it sought to count wealth transfers from producers to consumers as benefits from regulation:⁸

‘[C]onsider the impact upon the ‘end-users’ of Telecom’s mobile telephony services. Many of these “end-users” will also be employees and shareholders of the company. Indeed, Telecom employs approximately 0.25 per cent New Zealand’s workforce and comprises approximately 25 per cent of the market capitalisation of the NZSX50 index. Likewise, a significant proportion of Telecom stock is owned by financial institutions tasked with investing people’s financial assets – these people will also be ‘end-users’ of telecommunications services.’

It follows that the Commission cannot be confident that it has identified ‘end-users’, much less maximised the economic benefit accruing to this group. To do so with any precision is simply infeasible since there is ultimately no way to distinguish between welfare impacts upon producers and ‘end-users’. For every dollar a person gains in his capacity as an ‘end-user’ of mobile telephony services following regulation, that person may lose more or less than a dollar in his capacity as employee, land-owner or shareholder. The Commission’s methodology would conclude that such a person was better off, despite the fact that he may be indifferent or possibly worse off following regulation.’ (internal footnotes omitted)

Likewise, if the Commission followed the MED’s advice that ‘both goals’ are important and must be considered, and so tried to measure wealth transfers over the long-term, it could have no confidence that it has identified consumer surplus as distinct from producer surplus and thus the appropriate quantum.⁹ Accordingly, the implementation of MED’s proposed methodology with its clear emphasis on quantification, might conclude that New Zealand consumers would be better off following regulation, despite the fact that they may be indifferent or possibly worse off.

3.1.2. ‘Laundry lists’ do not provide clarity

The MED’s proposed purpose statement for Part 4 goes against the evident trend in regulatory design away from lists of independent objectives and towards the inclusion of a single, overarching objective with an efficiency focus. Long ‘laundry lists’ of multiple conflicting objectives are unlikely to improve the certainty and predictability of regulatory outcomes, as both the Australian Ministerial Council on Energy (MCE) Expert Panel (the Expert Panel) and the Australian Export and Infrastructure Taskforce (AIET) have noted recently.

Australia’s recent energy market reforms should serve as an instructive case study for MED. Like Part 4 of the *Commerce Act 1986*, until recently the *National Electricity Law* (NEL) did not contain an express statement of objectives. Rather, the objectives of the regime were ascertained principally from the ‘market objectives’ and ‘Code objectives’ contained in the

⁸ NERA (2005) *Wealth Transfers in Cost Benefit Analysis: A Report for Auckland International Airport Ltd*, January 2005, p9.

⁹ We note of course that this was the approach employed by the Commission in its investigation into MTR, but in our view this approach is fundamentally misconceived, for the reasons outlined above.

National Electricity Code. Each comprised a long list of multiple objectives, as set out below:

‘The objectives of the national electricity market (called “*market objectives*”) are as follows:

- (1) the market should be competitive;
- (2) customers should be able to choose which supplier (including generators and retailers) they will trade with;
- (3) any person wishing to do so should be able to gain access to the interconnected transmission and distribution network;
- (4) a person wishing to enter the market should not be treated more favourably or less favourably than if that person were already participating in the market;
- (5) a particular energy source or technology should not be treated more favourably or less favourably than another energy source or technology; and
- (6) the provisions regulating trading of electricity in the market should not treat intrastate trading more favourably or less favourably than interstate trading of electricity.

The objectives for the Code (called “*Code objectives*”) are as follows:

- (1) to provide a regime of “light-handed” regulation of the market to achieve the market objectives;
- (2) to provide for a set of market-oriented rules authorised by the ACCC governing market operations, power system security, network connection and access and network services pricing;
- (3) to provide a cost-effective framework for dispute resolution;
- (4) to provide for adequate sanctions in cases of breaches of the Code;
- (5) to provide efficient processes for changing the Code;
- (6) in particular, to provide for the following in respect of technical and market operations:
 - (a) responsibilities of all Code Participants;
 - (b) detailed market rules, including bidding, dispatch, spot price determination and settlements arrangement;
 - (c) detailed operational requirements, including power system operations and power system security, emergency operations, metering and maintenance scheduling;
 - (d) terms and conditions of access and technical standards that will apply for connection to the network; and
 - (e) the methods to be used for pricing network services.’

The Expert Panel saw considerable merit in departing from such lists of objectives. Whilst it noted that statements of objectives included in energy sector regulatory legislation take various forms, it recognised that ‘there is an evident trend away from lists of independent objectives and towards the inclusion of a single, overarching objective with an efficiency focus.’¹⁰ It noted, for example, that in commenting on the Australian Government’s proposed

¹⁰ Expert Panel on Energy Access Pricing (2006) *Report to the Ministerial Council on Energy*, April, p31.

inclusion of a purpose statement in the general access framework contained in of Part IIIA of the *Trade Practices Act 1974*, the AEIT had cautioned that:¹¹

‘It is important that this economic efficiency interpretation is the overriding objective of access regulation and that alternative ‘laundry lists’ do not distract from the consistent application of this central objective.’

The AEIT had supported the inclusion of a single overarching objective in infrastructure regulatory regimes, as opposed to multiple conflicting objectives which allow greater discretion and potentially lead to inconsistency in approaches to regulatory functions. The following purpose statement was subsequently incorporated into Part IIIA that closely reflected the AEIT’s recommendation:

‘The objects of this Part are to:

- (a) promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and
- (b) provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry.’

The Expert Panel similarly favoured the introduction of an overarching purpose statement that would be consistent across both the electricity and gas regimes, with an efficiency focus. The Panel recommended the following objects clause, which has since been incorporated into Australia’s *National Electricity Law (NEL)*:¹²

‘The purpose of this law is to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of supply of the national electricity system.’

The *Utilities Act 2000* in the United Kingdom (UK) contains similarly concise overarching purpose statements that set out the principal objectives that the Secretary of State and Gas and Electricity Markets Authority must adhere to in regulating UK gas and electricity markets. Specifically, sections 4AA(1) and 3(A)(1) state respectively:

‘The principal objective of the Secretary of State and the Gas and Electricity Markets Authority (in the Act referred to as “the Authority”) in carrying out their respective functions under this Part is to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas so conveyed.’

‘The principal objective of the Secretary of State and the Gas and Electricity Markets Authority (in the Act referred to as “the Authority”) in carrying out their respective

¹¹ Export Infrastructure Taskforce, 2005, Report to Prime Minister, May, p40.

¹² See: NEL section 7. An equivalent clause appears in section 20 of the Exposure Draft of Australia’s *National Gas Law (NGL)*, available at <http://www.mce.gov.au>. There are further examples of concise overarching purpose statements in the Australian rail sector, including, s2(1) of Queensland’s *Transport Infrastructure Act 1994* and s2A of Western Australia’s *Railways (Access) Act 1998*.

functions under this Part is to protect the interests of consumers in relation to electricity conveyed by distribution systems, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the generation, transmission, distribution or supply of electricity.’

In our opinion, there is strong reason to believe that by lengthening the Part 4A purpose statement, MED’s proposal will give rise to further uncertainty and increase the scope for disagreements on interpretation and application – hence the preference for more concise ‘purpose statements’.¹³ Compounding the scope for uncertainty is the fact that several aspects of the ‘laundry list’ of goals included in the proposed Part 4 purpose statement are particularly unclear, including the definitions of:

- § “limited” in sub-section (a);
- § “excessive profits” in sub-section (a);
- § “incentives to improve efficiency” in sub-section (b); and
- § “efficiency gains” in sub-section (c).

Although some of these terms are relatively clear at the level of principle, the degree to which they should be given effect typically means different things to different people in different contexts. Notwithstanding their prominence in its proposed purpose statement, and thus the overall regulatory framework, these practical challenges are not recognised in the MED Discussion Document. To the extent MED prefers its formulation of the purpose statements irrespective of these shortcomings, the definitions of these terms should at the very least be spelled out clearly and concisely at the outset.

3.1.3. Undue emphasis on quantification

We believe that it is preferable to avoid forms of purpose statement that suggest an emphasis on cost benefit analysis (CBA) as the *modus operandi* for decision-making. There is no doubt that quantitative analysis can be a *useful tool* in informing regulatory decisions. However, it is not the *only* tool and it is certainly not suitable for resolving each and every decision a regulator could conceivably encounter. In particular, CBA is not well suited for trading-off the various goals of implementing regulation, such as the short- to medium-term allocative impacts of wealth transfers versus the longer term dynamic impacts on investment incentives.

This is especially the case where a regulatory purpose statement is unclear or contains a ‘laundry list’ of multiple conflicting goals. In these instances there is a clear temptation to give undue weight to matters that are more readily quantified – such as the wealth re-distribution impact of near term price changes. However, most economists agree that it is the *longer-term* – albeit less readily quantifiable – *dynamic* impacts that are of paramount importance. Seeking to quantify each and every impact of implementing regulation, including all forward-looking costs and benefits, may not improve the quality of decisions on whether to regulate. Indeed, it could conceivably *hinder* that decision-making process.

¹³ Likewise, augmenting the existing test for *whether* regulation should be applied with terms such as ‘substantially/clearly exceeds indirect costs’ is unlikely to result in a workable solution. These terms themselves lack precision and are likely to create further uncertainty rather than provide clarification.

Moreover, since much of this quantification exercise inevitably involves a degree of subjectivity, a Minister may ultimately reach a different view based on different considerations as to the relative weightings to be assigned, say, to allocative versus dynamic impacts (assuming Ministerial involvement). To the extent his or her reasoning may differ, this reduces the relevance of the initial quantitative assessment. Indeed, *no other jurisdiction* of which we are aware adopts an economic CBA to control decisions, as Littlechild (2004) explains:¹⁴

‘[T]he logic of this approach demands that detailed welfare calculations be done, no matter how reliable or otherwise they can ever hope to be ... It also requires calculating not only the costs and benefits of the present allocation of resources, but also predicting what the alternative allocation of resources would be and what the costs and values of the resulting outputs would be ... this is by no means a straightforward task, and for the most part not one that regulators of other utility sectors have taken on board.’

That is not to say that decisions about whether to regulate should be *any less rigorous*, consider a narrower range of matters or data, or eschew all quantification. Instead, it simply recognises that important considerations may simply be unquantifiable, and therefore that CBA will not be able to offer helpful guidance in all cases. A reluctance to rely on CBA does not further imply that the scope for discretion and judgement on the part of the decision maker (either the Commission or Minister) when evaluating the likely impacts of regulation should be altered. Indeed, there will *always* be a significant role for quantitative analysis and for decision makers to weigh allocative and dynamic impacts – quantified or otherwise. As section 4 explains further, the key is to develop a purpose statement that provides a *clear an indication as possible* to the decision maker regarding what it intended in this regard.

3.1.4. Summary

The purpose statement proposed by MED, which is based on s57E, is unlikely to clarify the uncertainties surrounding the overall objectives of the Part 4 and Part 4A regimes. In our view, neither requiring decision-makers to consider an extensive ‘laundry list’ of potentially conflicting objectives, nor expecting a comprehensive CBA of all considerations is likely to facilitate more effective decision-making. Indeed, the CBA approach that has become increasingly established in New Zealand over the years is, as far as we are aware, without precedent internationally.

In our opinion it is preferable for regulatory matters under the Act to be governed by a common, concise purpose statement covering both Parts 4 and 4A. This *should* serve to reduce the current uncertainty surrounding the legislation and is consistent with the lessons learned from recent Australian experience. We propose such a purpose statement in section 4.1 below together with what we believe to be a superior alternative approach to assessing whether and how to administer regulation in section 4.2.

¹⁴ Littlechild., S, (2004) “Mobile Termination Charges: Calling Party Pays vs Receiving Party Pays”, CWPE 0426, April, pp14-15. In this regard, we also note that for whatever reason a quantitative CBA was *not* undertaken prior to the inception of Part 4A, which would seem to imply it is not essential, particularly when considered in light of international practice.

3.2. Different Threshold Test for Lighter-Handed Regulation

We agree with MED that it is appropriate to have a regulatory framework that allows the most cost effective form of regulation to be put in place, including lighter-handed forms of regulation. We also agree that it is counterintuitive to undertake a comprehensive, quantitative CBA for lighter-handed forms of regulation such as negotiate/arbitrate or information disclosure. However, MED's proposal that *different threshold tests* and approaches apply for light-handed forms of regulation vis-à-vis heavier-handed forms of price control is unlikely to represent a feasible solution.

In our view, it is equally counterintuitive to undertake a quantitative CBA for lighter-handed forms of regulation as it is to apply *separate tests* for lighter-handed versus heavier-handed forms of regulation. Not only does it effectively involve presupposing the type of regulation, but also it raises the possibility of multiple – potentially conflicting – analyses. Consider an investigation into whether a *negotiate/arbitrate* model should be implemented, followed by an investigation into whether *price control* should be implemented using a stricter threshold test. If both forms of regulation are estimated to deliver similar net benefits, no clear decision will be forthcoming.

Such outcomes would create considerable uncertainty and unnecessarily increase regulatory costs. It also serves to reinforce the limitations inherent in making regulatory decisions based primarily, if not exclusively, on the strength of CBA. CBA-dominated approaches are not seamlessly adaptable to each and every regulatory decision, despite their extremely wide application in New Zealand.

This shortcoming in the MED proposal is ultimately a symptom of a deficient purpose statement and an inappropriate test for implementing regulation. As section 4.2 below explains, in our view it would be preferable to have a more focused test for whether to impose regulation, and which flows logically from the purpose statement. This would then allow the decision on *whether* and *how to* impose regulation simultaneously to consider *multiple* potential forms of regulation *under the same test* by reference to the degree of market power involved.

3.3. 'Input Methodologies' Set in Advance

We agree that there may be potential benefits from specifying input methodologies in advance, following a transparent consultation process. In particular, it might reduce the scope for 'regulatory surprises', thereby reducing uncertainty for ELBs and improving incentives to invest efficiently – objectives rightly recognised as virtuous by MED in its Discussion Document.¹⁵ This proposal seems in part directed at concerns that the Commission has not adequately developed its framework for control of ELBs, or its approach to the price threshold reset scheduled to take effect in 2009 – the key input decisions at issue being the WACC methodology, taxation issues and approaches to asset valuation.

¹⁵ Indeed, there arguably should be no basis for a breach assessment until there is a degree of certainty around these key criteria – the requirements of the regulatory framework should be clearly articulated.

However, while these implied criticisms are valid, the practicability of certain aspects of the MED proposal is questionable. Indeed, it is likely to be difficult to legislate to force the Commission or the Minister to *commit* to methodologies (or, at least methodologies specified to a greater extent than is already the case) in advance, assuming that is what is contemplated. If those methodologies can be refined or changed from time to time (as they surely will need to be), then whatever has been committed to will only be binding insofar as it has not yet been altered by a subsequent decision.

Indeed, an element of innovation and flexibility in regulatory methods is desirable so that a regulator can from time to time identify necessary changes, and develop a range of different solutions consistent with emerging best regulatory practice. In other words, whilst it is desirable for a regulatory framework to provide an *indication* of intended input methodologies, it is likely to be undesirable (and impracticable) to *commit irreversibly* to particular methodologies. This intrinsic trade-off between certainty and discretion could be given greater recognition in the Discussion Document than is presently the case.

More fundamentally, whilst it provides an indicative list of ‘key input methodologies’ these are described at a very high-level, and so it is not clear on *precisely what is meant* by ‘input methodologies’. For example, would the specification of input methodologies involve decisions on what the weighted average cost of capital (WACC)/asset valuation level should be, or would it simply involve decisions on the WACC model (such as the capital asset pricing model (CAPM) for the equity component) or asset valuation method (such as optimised depreciated replacement cost (ODRC)) to be applied?¹⁶ Without further particulars surrounding MED’s thinking on this issue it is hard to know what effect the proposed ‘Regulations’ and ‘Guidelines’ might have in practice.

Finally, if input methodologies are to be *prescribed* in Regulations by the Minister (rather than being Guidelines), then this could effectively take the decision-making function away from the Commission. In our view, this would be undesirable from the perspective that economic regulation is generally better given effect to by bodies that are independent from day to day political influence. For the reasons outlined in section 4.2, the best body to make these decisions is likely to be the Commission, provided that these decisions are ultimately subject to merits review.¹⁷

On balance whilst we agree with MED’s *broad intention* in seeking to specify key ‘input methodologies’ in advance, aspects of its intended approach may be impracticable. As section 5 below explains, a preferable approach would be for the Commission to be required to issue non-binding Guidelines¹⁸ outlining its position on particular input methodologies, which could then form the basis for proposals in the context of a ‘propose-respond’ model. Merits review of customised control decisions can then be relied upon to ‘bed down’ those

¹⁶ Decisions that have effectively already been made under the current regime, but with significant remaining uncertainty as to their application.

¹⁷ Case law can then be relied upon to bed down any methodologies that have not been developed in a proper or timely manner. Whilst an independent body (such as the AEMC in Australia) is also conceivably sound, it would impose substantial additional costs.

¹⁸ Much like its existing Optimised Deprival Value (ODV) Handbook for Electricity Lines Businesses.

methodologies over time. This appears to be consistent with what MED is seeking to achieve, albeit through different means.

3.4. Two-step Approach to Control

Under Option Two, it is contemplated that firms (including ELBs) will be afforded the opportunity to propose their own *customised* control terms within 90-days of the Commission releasing its sector or firm control terms. In principle this would be a desirable development. However, a number of fundamental features of the Commission’s proposal remain unclear, including for example:

- § are proposals ‘irreversible’, ie, could a firm opt subsequently to revert back to the default form of control in preference to the Commission’s ‘response’?;
- § are proposals ‘bound’ in their duration by the regulatory period, ie, if the default form of control is to apply for 5-years must customised control terms be for an equivalent period?; and
- § assuming that the default and customised regulatory periods do coincide, what happens to firms subject to customised control terms at the end of the regulatory period, ie, do all firms revert back to the default form of regulation at the start of the subsequent period?

If the MED contemplates that such proposals would be *reversible* it is unlikely to be able to mitigate the risk of frivolous counter-proposals from businesses by “forcing them to share costs, complying with input methodologies and complying with ‘reasonableness’ criteria”. Each of these constraints is likely to present great difficulties in putting into practice. By way of example, irrespective of the specified WACC methodology there will likely be plausible reasons to argue for a higher return – ‘reasonableness’ is inevitably subjective.

Realistically, if the MED proposal were implemented absent an irreversibility requirement, every business is likely to ‘roll the dice’ on the first occasion – and very likely every subsequent occasion – to see if it can get a better outcome, potentially overwhelming the Commission. This is because the potential financial benefits of a less onerous X factor (in a CPI-X control environment) are almost always likely to outweigh the administrative costs of preparing a proposal (including any Commission costs it may be forced to share). In the context of ELBs, the Commission could conceivably be faced with 29 proposals in the space of 90-days, in relation to which it must evaluate and then respond. Its resources are likely to be considerably stretched in managing such an influx.

Other than specifying the initial 90-day window, the MED Discussion Document is also silent regarding the regulatory control periods to apply to customised proposals. Specifically, it does not state whether customised control is intended to apply *only for the regulatory period*, or whether a firm would be free to propose customised terms that *extended beyond* the current regulatory period. One consequence of allowing misaligned regulatory timeframes is that 29 ELBs could conceivably each have their own regulatory reset date. This would likely be impracticable from the Commission’s perspective in light of the potential synergies obtainable from considering applications simultaneously.

MED touches upon the third issue outlined above when it recognises the potential risk of a large proportion of firms proposing customised terms, thereby undermining the cost-

effectiveness benefits of the default' form of regulation.¹⁹ The extent of this risk depends in large part upon the nature of the regulatory reset. If all firms revert to the default form of regulation at the beginning of the next regulatory period, the default form of regulation is likely to have a more meaningful role. On the other hand, if firms must submit another proposal – the relevance of the default form of regulation would diminish over time as more firms move from the regime.²⁰

3.5. Transition Issues

The MED Discussion Document makes very little reference to practical issues surrounding transition between the current framework and the new. This is a shortcoming in the proposals as presently formulated. In particular, the Discussion Document leaves unanswered a number of essential questions, including:

- § if Option One is pursued then what happens between now and when price thresholds are reset, taking effect in 2009 insofar as ELBs are concerned?;²¹
- § if Option Two were implemented unmodified ELBs would fall under sector control, but:
 - when would this new regime be introduced?;
 - would the price threshold reset come first, and if so, how would this relate to Option Two, eg, would the thresholds derived during the reset become the controlled price/quality terms?;
 - is it appropriate to convert the current threshold regime terms into control terms?; and
 - if ELBs' ability to propose alternate customised terms will depend on the "reasonableness criteria", when/how will this be developed (eg, WACC, asset valuation, etc), in the context of current regulatory time frames?

It is critical to note that the present review process is taking place at a time that the Commission and ELBs are necessarily turning their minds to the threshold reset, scheduled to take effect in 2009. Indeed, the Commission recently issued a discussion paper in which it outlined its intended approach to the threshold reset.²² It is conceivable that whilst the MED evaluates the Part 4A regime in one forum, the Commission could significantly adjust its approach to setting thresholds and thus the very nature of that regime in the meantime.²³ MED appears not to have turned its mind to the parallel nature of these two review processes.

Given the potential for decisions being debated in one forum to be greatly affected by decisions made in the other, it is highly undesirable for the MED review process not to take account of this interaction. One pragmatic suggestion would be for the Commission to

¹⁹ In the MED proposal this is comparative benchmarking. As outlined in section 5, we would favour a default price path.

²⁰ In section 5 we introduce a propose-respond model that builds upon MED's Option Two, and addresses the issues outlined above.

²¹ Presumably not much would change - although the early step of input methodologies will not have been adhered to.

²² Commerce Commission (2007), *Regulation of Electricity Lines Businesses; Reset of Thresholds Process Paper*, June.

²³ In other words, the future of the Part 4A regime could depend in large part on the approach adopted by the Commission when it comes to reset thresholds. The Commission is yet to give any guidance regarding its thinking on the issue, compounding this uncertainty.

announce that it will maintain the existing thresholds until such time that amending legislation comes into effect, at which point it would have, say, 12-months to implement the new regime.

Extending the application of the existing thresholds in this fashion would allow all parties to focus exclusively on the MED review process and better facilitate the methodical implementation of appropriate legislative and regulatory changes. Moreover, given the indicative Government timeframe for the completion of the MED review and subsequent introduction of amending legislation we expect that the current thresholds would only need to be extended until, say, 2011 at the latest. These transition issues need to be clarified before any robust decisions can be made about the future regulatory framework.

3.6. Amendment of Control Terms

It is not clear from chapter 11 of the MED document what assumption it is making on the length of regulatory periods. For example, does MED contemplate 3-year, 5-year or other regulatory terms across various industries? For the reasons outlined in 3.4 above this is of particular relevance to the operation of any 'propose-respond' framework. It is significant because MED proposes only a very limited basis for reopening control terms in the regulatory period; namely, force majeure events and the abandonment of substantial capital expenditure plans.

By contrast, the practice in Australian electricity *distribution* regulation is to allow for a price cap determination to be revoked under a broader range of circumstances. Specifically, clause 6.2.5(e) of the National Electricity Rules states that a revenue or price cap determination can be revisited when:

- § the regulatory cap was set on the basis of false or materially misleading information provided to the jurisdictional regulator; or
- § there was a material error in the setting of the regulatory cap and the prior written consent of parties affected by any proposed subsequent re-opening of the regulatory cap has been obtained by the jurisdictional regulator.

Likewise, for prescribed (controlled) electricity *transmission* services in Australia, clause 6A.7 of the Rules provides for a revenue cap to be reopened where an event occurs that sufficiently impacts on the financial viability of the business, or its scope to respond to unforeseen circumstances. Specifically, when:²⁴

- § an event occurs that could not have been foreseen by a service provider;
- § in response to that event, the service provider must invest in a project without which network reliability or system security would be compromised;
- § the project requires capital expenditure exceeding 5 per cent of the service provider's regulatory asset base in the year of the event;

²⁴ The Australian Energy Regulator may also revoke and remake a revenue determination *in its entirety* in the event a determination was set on the basis of false or misleading information, or where a material error has been made (Rule 6A.15).

- § the project requires capital expenditure that the service provider cannot otherwise reasonably fund within the period; and
- § there is no existing allowance (including in the contingent projects allowance) for that project.

In our view, strict criteria for revisiting control terms coupled with an extended regulatory period would be undesirable since it may result in considerable financial detriment to a regulated business, and preclude it from undertaking efficient investment when required. This aspect of the MED proposal consequently requires clarification. This issue is particularly relevant given the backward looking focus presently employed when establishing price thresholds and the associated uncertainty surrounding threshold breaches, although we propose a potential solution to this issue in section 5 below.²⁵

3.7. Conclusion

The MED Discussion Document recognises a number of important shortcomings in the existing thresholds regime applying to electricity lines businesses. However, its proposed options for addressing those shortcomings do not amount to workable solutions as presently formulated. In particular, MED does not provide sufficient detail on matters that could have a significant effect upon ELBs for there to be any confidence that its proposals would not amount to a retrograde step. Specifically:

- § there is minimal examination of detailed implementation issues, or a robust analysis of what the proposals are intended to achieve relative to the status quo;
- § in a number of instances it is difficult or simply not possible to provide a comprehensive response to the MED proposal since many of the critical issues relating to the detailed operation of the proposed regimes are either glossed over or not mentioned at all; and
- § the MED appears not to recognise a number of practical issues of regulatory design that will need addressing before there could be any confidence that its proposed reforms would bring about material improvement.

If these critical issues are not clear from the outset, and the regulatory framework does not involve clear procedural requirements, or those processes have not been openly, transparently and consistently implemented, long-run distortions to pricing and investment decisions are possible. Accordingly, a logical next step is for MED to undertake a more detailed **second round of consultation**, including a more thorough canvassing of potential alternative regulatory frameworks and detailed implementation and procedural issues before robust decisions can be made about the future of regulation for ELBs.

In our opinion, most if not all of the problematic aspects of the MED proposals can be readily addressed as we discuss in the following sections. Many of the issues outlined in this section are a direct consequence of difficulties surrounding MED's proposed purpose statements, its consequent proposed test for when regulation may be applied and the absence of clear procedures governing critical aspects of the regime. In the following sections we examine

²⁵ We propose that businesses be permitted to submit customised pricing proposals, in which they could conceivably tailor such proposals to deal with such contingencies.

these issues and then propose an alternative regulatory framework that builds upon MED's Option Two.

Recommendation: MED should undertake a more detailed second round of consultation, including a more thorough canvassing of potential alternative regulatory frameworks and detailed implementation and procedural issues, before robust decisions can be made about the future of regulation for ELBs.

4. Whether to Regulate

MED's conclusion that the criteria contained within Part 4A for determining the *objective* of regulation and the consequent test for *whether* and *how* regulation should be implemented should be clarified, is sound. However, as the previous section explained, the MED proposals in these respects are unlikely to amount to workable solutions in their current form. By way of brief recap:

- § the proposed Part 4 purpose statement does not provide clarity and goes against the evident trend away from lists of independent objectives – instead, the proposal will very likely give rise to further uncertainty and increase the scope for disagreements; and
- § augmenting the consequent test for whether to regulate with terms such as 'substantially/clearly exceeds indirect costs' is unlikely to provide clarity, particularly since the test does not reflect the proposed purpose statements.

We recognise that 'whether' to regulate ELBs is no longer a live issue – presumably regulation will continue without the need for further inquiry. However, the purpose statement and consequent test for determining the form of regulation will have significant and important effects on *how* regulation is applied. In particular, any subsequent *changes* to the form of regulation, the formulation of key input methodologies and regulated price and non-price terms and conditions will be greatly affected.²⁶ Accordingly, in this section we propose what we consider to be more effective solutions to the issues that MED highlight.

4.1. Objective of Regulation

The purpose statement of any regulatory law is by far its most important provision. This aspect of the MED's proposal requires more careful analysis and scrutiny than any other. The emphasis and direction of such statements provides the basis for deciding all other ambiguities or trade-offs that might arise in the application of economic regulation. As section 3 outlined, MED's proposed purpose statements *do not* provide clarity and go against the evident trend away from lists of independent objectives and towards the inclusion of a single, overarching objective with an efficiency focus. To recap:

- § a workable solution is unlikely to arise from MED's conclusion that both efficiency and distributional goals are 'important' and should be considered;
- § the identification and measurement of wealth transfers between consumers and producers is likely to prove impracticable in any event; and
- § the additional clauses in MED's proposed purpose statement will likely create more confusion than clarity.

In our opinion, it is preferable for regulatory matters under the Act to be governed by a *common, concise* purpose statement, ideally in harmony with other regulatory purpose statements and with the purpose of the Act as a whole. We believe that such a purpose statement should have three key elements:

²⁶ This is especially so if a propose-respond model is implemented, as outlined in section 5 below.

- § it should be expressed as a single, composite objective rather than a series of related but discrete objectives (or ‘laundry list’);
- § its primary focus should be economic efficiency; and
- § its ultimate purpose should be expressed in terms of the long-term interests of New Zealand consumers.

The purpose statement contained in s18 of the *Telecommunications Act 2001* exhibits all of these features and therefore serves as a useful starting point.²⁷ Indeed, there is no obvious reason for there to *be* a significant difference in the purpose statements governing the regulation of telecommunications markets as distinct from other infrastructure services. Moreover, a statement modelled along the lines of s18 of the *Telecommunications Act 2001*, would provide a welcome degree of consistency across regulatory legislation. Accordingly, we would propose a purpose statement along the following lines:

- (1) 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 prices and/or service quality in those markets for the long-term benefit of consumers in New Zealand.
- (2) In determining whether or not, or the extent to which, one or more forms of economic regulation will or will be likely to result in the long-term benefit of consumers in New Zealand, consideration must be given to the efficiencies that will result or be likely to result from such regulation.

By focusing on efficiency in its entirety and on its ultimate objective – the long term benefit of consumers – the uncertainty surrounding Parts 4 and 4A could potentially be significantly reduced. The benefit of a more generic purpose statement is that it does not necessarily force those applying it to identify each individual element of efficiency and then further to identify and quantify a separate transfer component.²⁸ These components are not neatly separable as MED implies. In this way, decisions can focus on the relative weight and effect of the short- to medium-term allocative effects and the longer-term dynamic effects of regulatory decisions, which is what the theory of economic regulation calls for.

Stepping back from a CBA-dominated framework does not mean decisions about whether to regulate necessarily become less rigorous, or consider a narrower range of matters or data, or eschew all quantification. Rather, undertaking such a change would simply give recognition to the fact that important considerations will often not be susceptible to quantification, and so CBA will not deliver a robust answer in all cases.

It should also be recognised that such an approach would *not* substantially alter the scope for discretion and judgement on the part of the decision maker when evaluating the likely effects

²⁷ It is worth noting that the purpose statement contained in s18 of the *Telecommunications Act 2001* was fashioned to apply to both questions of *whether and how* to regulate.

²⁸ We note that the Commission has held that the purpose statement contained in section 18 of the *Telecommunications Act 2001* does contemplate the consideration of wealth transfers, and a cost-benefit analysis to determine the “whether” to regulate. However, this point has not been tested in a New Zealand court and is live for future dispute. For the reasons outlined in section 3.1, in our view, the approach employed by the Commission with respect to wealth transfers and to CBA more generally is inappropriate.

of regulation. Indeed, as section 3.1 explained, there will continue to be a substantial role for weighing allocative and dynamic impacts – quantified or otherwise. The proposed purpose statement would create *a far clearer framework* for making that decision by focussing on the long-term nature of consumer interests, thereby recognising that the *dynamic element of efficiency* is of paramount importance.

We recognise that MED’s proposal *also* uses the long-term benefit of New Zealand consumers as a reference point. However, our suggested purpose statement has the advantage of not also incorporating a ‘laundry list of objectives’ that may lead to controversy and confusion. It would also have the advantage of better aligning the regulatory control provisions of the Act with comparable legislation both in New Zealand and abroad, increasing the scope for instructive precedent to be gleaned on common regulatory issues, including:

- § the recently agreed objectives of both the *National Electricity Law* and the proposed *National Gas Law* in Australia, where an extensive debate was held regarding the appropriate formulation of purpose statements;
- § the telecommunications specific access regime in Part XIC of the *Trade Practices Act 1974* in Australia;
- § the general access regime contained in Part IIIA of the *Trade Practices Act 1974* in Australia; and
- § the aforementioned *New Zealand Telecommunications Act 2001*.

An economic regulation-based purpose statement that focused simply on efficiency for the long term benefit of consumers would also be consistent with the purpose of the Act as a whole, ie, competition for the long term benefit of consumers. In this regard we note that the Commission has held in the past that the approach taken under the general purpose statement contained in s1A (which treats wealth transfers as a matter of indifference) is *not* intended to apply to the control provisions of the Act on the basis that competition law and regulatory control have a different philosophical base, eg, during its MTR investigation the Commission stated that:²⁹

“Control as a regulatory mechanism has a different philosophical base from competition as a regulatory mechanism. It is precisely because there is a concern about monopoly profits, and a lack of competition to drive them out, that control might be justified.”

In our opinion, this is not a valid distinction. Competition and economic regulation are different means for achieving the same end – an efficient allocation of resources. Competition is the dynamic process whereby firms strive against each other to secure customers for their products.³⁰ Workable or effective competition is said to exist when each market participant is constrained in its price and output decisions by the activity of other market participants. These constraints convey signals to firms that enable them to discover

²⁹ Commerce Commission (2004), *Telecommunications Act 2001: Schedule 3 Investigation into Regulation of Mobile Termination, Draft Report*, 18 October, p11.

³⁰ Collins Dictionary of Economics, Second Edition, 1993, p80.

which goods and services consumers wish to buy, and how those goods and services can be efficiently produced and allocated.

Economic regulation – most often in the form of controls on price and non-price terms of supply – is an attempt to mimic some of the disciplines of a competitive market where actual competition is not present or feasible. Specifically, regulation seeks to prevent or prohibit the exercise of substantial market power, not as a means to itself, but to enhance the long-term interests of consumers through an improvement in resource allocation. Regulation can be thought of as a substitute for competition, where the prospect of competition or entry is ineffective or limited.³¹

In other words, the goal of control or economic regulation more generally is identical to that of competition. Attributing different objectives to competition and regulation is a fundamental misconception. In our view, aligning a concise overarching purpose statement for the regulatory control provisions of the Act with the purpose of the Act as a whole represents a key advantage of the purpose statement proposed above.

In sum, regulatory matters under the Act should be governed by a *common, concise* purpose statement, in harmony with other regulatory purpose statements and with the purpose of the Act as a whole, which is the promotion of efficiency for the long-term benefit of New Zealand consumers. In the following section we propose a revised test for deciding *whether regulation may be implemented* that flows logically from this purpose statement, and a modified approach to the assessment of the appropriate *form* of regulation.

4.2. When May Regulation be Implemented?

In our view there needs to be greater clarity governing the criteria for when regulation may be implemented, including in relation to the timing of decisions, the manner in which the assessment is made, and the ultimate responsibility for such decisions. In this section we propose an improved test for whether goods or services may be regulated and suggest that the Commission should be the ultimate decision maker, albeit subject to merits review.

4.2.1. Proposed criteria

The test of whether goods or services may be regulated should flow logically from the purpose statement outlined above. Consequently, we would suggest a remodelled test along the following lines:

³¹ Regulation is, however, an imperfect substitute for competition. Regulation can never perfectly replicate a perfectly competitive market and brings with it regulatory costs. Its virtue lies in its ability to improve upon the market situation that would have arisen *but for* regulation.

Goods or services may be regulated if:

- (1) There is little or no competition or prospect of competition in the relevant markets; and
- (2) Economic regulation of prices and/or service quality in those markets will or will be likely to result in the long-term benefit of consumers in New Zealand; and
- (3) In determining whether or not, or the extent to which, one or more forms of economic regulation will or will be likely to result in the long-term benefit of consumers in New Zealand, consideration must be given to the efficiencies that will result or be likely to result from such regulation.

As with our proposed purpose statement, criteria in this form would better align the threshold test for when regulation may be implemented with existing New Zealand legislation and practice in Australia, including:

- § the *National Electricity Law* and the proposed *National Gas Law* in Australia;
- § the telecommunications specific access regime in Part XIC of the *Trade Practices Act 1974* in Australia; and
- § the New Zealand *Telecommunications Act 2001*.

These criteria would also be consistent with the purpose of the Act as a whole, ie, competition for the long term benefit of consumers.

4.2.2. Timing of decisions on *whether* and *how* to regulate

We agree with MED that it is desirable to undertake the decision of *whether* to and *how* to regulate simultaneously. Simultaneously deciding whether and how to implement regulation has the added advantage of allowing a decision maker also to consider the *form of regulation* that would be most appropriate.

4.2.2.1. Simultaneous decision preferable

There are compelling reasons to believe that the decisions of *whether* to and *how* to regulate should be undertaken simultaneously. In the context of Part 4A, the Commission's present practice of investigating the potential costs and benefits of control whilst being precluded from presupposing the precise form that control will take is artificial. Indeed, as section 2.4 explained the efficacy of the decision on *whether* to impose control is questionable if a different form of control from that assumed in the original analysis were put in place. Moreover, the lengthy nature of the process, coupled with the tendency towards administrative settlements results in a framework that generates little regulatory precedent.³²

³² This means there is little certainty for regulated businesses regarding the nature and extent of the regulatory threat, and so the precise line between acceptable and unacceptable conduct. This applies particularly in relation to capital investments that, whilst necessary, may result in threshold breaches. See section 2.4 for a more thorough discussion.

Combining these decisions is an important *first step* in addressing these issues.³³ Although we agree that a potential consequence of combining the two processes is that the decision of *whether* to control may take longer, it should nonetheless reduce the length of the process *overall*. It is hard to imagine that the decision process could be significantly longer than, say, the 20-month duration of the Unison settlement process. Simultaneous decisions would also entail significant benefits from improved predictability. Moreover, as the following section explains, simultaneously deciding *whether* and *how* to implement regulation better allows a decision maker to consider multiple *forms of regulation*.

4.2.2.2. Choice of appropriate form of regulation

Combining the decisions on *whether* and *how* to implement control better allows the decision on the *form* of regulation to be made by reference to *the degree of market power* that is involved. This assessment can be made by reference to *the same test* outlined in section 4.2.1 above. Specifically, in deciding upon the appropriate form of regulation, the Commission should have regard to the presence and extent of *market power* possessed, and the likelihood of its misuse, by the owners, operators or controllers of the facilities in question.³⁴ The following non-exhaustive factors are likely to be instructive in each instance:

- § **barriers to entry** – the presence and extent of barriers to entry in the market in which the services to potentially be subject to regulation are provided;
- § **network externalities** – the presence and extent of interdependencies between the services to be provided by each owner, operator or controller of the facilities in question;
- § **existing regulation or arrangements** - regulation should only be implemented where there is clear evidence of a significant and sustained market failure, and where such regulation would improve upon any existing arrangements - there must therefore be a review (not necessarily a complex review) of existing sector specific regulatory frameworks or arrangements before regulation is introduced;
- § **countervailing buyer power** – the extent to which market power possessed by owners of the relevant services is likely to be mitigated by countervailing power possessed by the users of those services;
- § **substitution possibilities** – the presence and extent of substitutes, and the elasticity of demand for the services in question; and
- § **information asymmetry** – the extent to which users and prospective users of the services to be subject to regulation are likely to have adequate information as a basis for negotiations with owners.

Once again, the guiding principle for this assessment is the **purpose statement**. It is in the long-term interests of New Zealand for regulation only to be applied where there is clear evidence of a significant and sustained market failure, and for the form of regulation to be the

³³ However, as section 5.2 below argues, it is necessary also to clarify and improve the procedures that the Commission must follow during a control investigation (or in responding to a proposal from a business if a ‘propose-respond’ option is implemented).

³⁴ This decision might be made in the context of a sector-level investigation into a previously unregulated industry, or when the Commission formulates key input methodology Guidelines to apply to a ‘propose-respond’ framework, as outlined in section 5 below.

minimum intrusion necessary to allay that market failure. The factors outlined above should therefore facilitate a swift ‘narrowing in’ on those forms of regulation that are likely to be appropriate in the market circumstances in question, eg, ‘negotiate/arbitrate’ frameworks could presumably be quickly dismissed as an appropriate form of regulation for most electricity distribution services.³⁵ They also enable the identification of services, or sub-sets of services for which lighter-handed forms of regulation could potentially apply.

By way of illustration, the Australian Energy Market Commission (AEMC) recently rolled back the scope of ‘heavier-handed’ price regulation for electricity transmission services by specifying certain services for which lighter-handed ‘negotiate/arbitrate’ pricing frameworks were a feasible alternative based on the relevant market power characteristics, specifically:³⁶

- § services that exhibit strong economies of scale and externalities such that competition is unlikely to be feasible, and are provided to a large number of small customers with relatively uniform preference characteristics are likely to be better suited to ‘heavier-handed’ forms of price control and continued to be ‘prescribed services’, eg, most ‘use of system’ services; and
- § services that are dedicated or requested by specific parties, or characterised by either a lack of homogeneity or material countervailing buyer power possessed by a small number of large customers might be better suited to lighter-handed forms of regulation such as negotiate/arbitrate frameworks and so these are ‘negotiated services’, eg, connection services provided to large customers.

The approach is also consistent with international precedent. It is the most commonly employed means throughout Australia for determining whether to regulate, and the most appropriate form of regulation in particular circumstances. By way of example, it was the approach recommended by the Expert Panel in its recent report on energy access pricing in Australia, wherein it concluded:³⁷

‘Economic regulation may be applied in these circumstances with the objective of providing incentives for more efficient investment in and operation of the services while containing the costs and inefficiencies that can arise from the exercise of market power. However, the regulatory response should be commensurate with the extent of market power that is involved and the costs and inefficiencies that can result from its exploitation.’

It was subsequently employed by the AEMC in determining the form of economic regulation to apply to various electricity transmission services (its recent ‘Chapter 6A’ review).

³⁵ We note again that ‘whether’ to regulate ELBs is no longer a live issue, hence the Commission would not contemplate ‘negotiate-arbitrate’ models when determining ‘whether’ to regulate. However, it may be relevant for the ‘how’ to regulation question, particularly if a ‘propose-respond’ model were introduced that required the Commission to provide Guidelines on the forms of regulation that would apply to certain regulated services thereby allowing firms to submit customised proposal along these lines. For further details, see section 5 below.

³⁶ See: Australian Energy Market Commission, “Rule Determination: National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18” 16 November 2006 (‘AEMC Final Rule Determination’). This document serves as a useful ‘blueprint’ for the approach set out in this chapter. Again, since the ‘whether to regulate’ question has been resolved, such ‘rolling back’ would only take place in the context of a ‘propose-respond’ model, as outlined in section 5.1 below.

³⁷ MCE Expert Panel Final Report, p41.

Consistent with the Expert Panel's recommendation, the AEMC focused on the *degree of market power* in each instance:³⁸

'The form of regulation has been specified by taking into account the level of market power of the service provider and any countervailing power associated with each of the defined services...

'...the challenge for policy and regulatory decision-makers is to determine the appropriate balance between the costs to efficiency from the exercise of market power (which may vary from case-to-case) and the costs of the form of regulation adopted to address it.'

In sum, the decisions on *whether to* and *how to* impose regulation should be undertaken simultaneously and should consider multiple potential forms of regulation *under the same test*, which should flow logically from the purpose statement. The appropriate *form* of regulation should be commensurate with the *degree of market power* involved. This approach should allow a form of regulation to be implemented by the Commission that is appropriate in all the circumstances, whether the assessment is being made in the context of a 'propose-respond' model or when deciding whether to impose control in an unregulated industry.

4.2.3. Who should decide?

We believe it would be a retrograde step for ELBs to have the Minister deciding when and on whom control should be applied. This may be appropriate for one-off inquiries into unregulated industries, such as the previous inquiries into airports and gas pipelines. However, it would add a significant degree of delay and uncertainty to the regime applying to electricity lines businesses, where it seems that MED envisages that some form of control would apply to all lines businesses.

Moreover, from a practical perspective, if the Commission is the entity undertaking the analysis of the control question, and this question is being assessed against clear, concise criteria then, procedurally, it will be very difficult for the Minister to reach a different decision – unless he or she invites a further round of submissions, which itself would give rise to significant uncertainty and delay. If the Minister is effectively going to be a 'rubber stamp', it would be simpler to give the Commission the task, and look to achieve the greater accountability that appears to be sought by subjecting that decision to merits review.³⁹

4.3. Summary

A sharper, more refined purpose statement should cover Part 4 and 4A and focus on *efficiency for the long term benefit of New Zealand consumers*. Decisions can then focus on the relative weight and effect of the short- to medium-term allocative impacts and the longer-term dynamic impacts of regulatory decisions, which is what the theory of economic regulation calls for. The test of *whether* goods or services may be regulated should flow

³⁸ AEMC Final Rule Determination, p40.

³⁹ For a more detailed discussion of accountability mechanisms, including the role of merits review, see section 6 below.

logically from this purpose statement and should be undertaken simultaneously with the decision of *how* to regulate.

The assessment of whether and how to regulate should consider multiple potential forms of regulation *under the same test*, and be determined by reference to the *degree of market power* involved. The decision should be made by the Commission, and should be subject to merits review. In our opinion, this alternative proposal would deliver a number of key benefits:

- § it departs from the Commission’s present practice of initially focusing on a single hypothetical control option in deciding whether to impose control from which it may subsequently depart when it comes to implement control;
- § it represents a significant improvement upon the MED proposal that alternative lighter-handed forms of regulation be evaluated under a different threshold test – a proposal that we consider impracticable for the reasons discussed in section 3.2;
- § it would enable a move away from the rigid application of CBA that is necessarily highly dependent upon whether wealth transfers are counted as benefits;
- § it would allow a form of regulation to be implemented that is commensurate with the degree of market power involved by focusing on those forms of regulation that are likely to be appropriate in the market circumstances, and better enable the identification of services, or sub-sets of services for which lighter-handed forms of regulation could potentially apply;⁴⁰ and
- § the approach is more consistent with international precedent, including approaches employed in Australia to the regulation of energy and telecommunications.

In sum, we believe that these alternative legislative and regulatory amendments would represent a significant improvement upon the existing Part 4A regulatory framework and also the MED proposal. In the following section we propose an alternative framework for administering regulation of ELBs that builds upon MED’s Option Two.

⁴⁰ We note again that ‘whether’ to regulate ELBs is no longer a live issue, hence the Commission would not contemplate ‘negotiate-arbitrate’ models when determining ‘whether’ to regulate. However, if a ‘propose-respond’ model were introduced it might find itself assessing a customised proposal from a firm that suggested lighter-handed forms of regulation for certain services. See section 5.1 below.

Recommendation: A sharper, more refined purpose statement should cover Part 4 and 4A and focus on *efficiency for the long term benefit of New Zealand consumers*. The test of *whether* goods or services may be regulated should flow logically from the purpose statement and should be undertaken simultaneously with the decision of *how* to regulate. That assessment should consider multiple potential forms of regulation *under the same test*, with the appropriate form of regulation determined by reference to the *degree of market power* involved. The decision should be made by the Commission provided that decision is subject to merits review.

5. How to Regulate

To recap, MED presents two potential options in its Discussion Document regarding the potential future current ELB specific arrangements under Part 4A, including its associated threshold regime:

- Option One: Part 4A retained and made generic so as potentially to encompass other sectors such as gas pipelines and allow for other regulatory options, eg, negotiate/arbitrate, price monitoring, etc, where appropriate.
- Option Two: Part 4A repealed and replaced with the ability to put sectors under an amended Part 5 control regime that:
- allows the Commission to set the regulatory framework, eg, no regulation, negotiate/arbitrate, control, etc; but
 - allows an individual service provider to propose its own control terms, which must be accepted by the Commission within 90-days provided the proposal is ‘reasonable’; and
 - the introduction of ‘merits review’ of final control terms.

We believe that a regulatory framework that is **broadly consistent with Option Two** as presented by MED, but with significant modifications would substantially improve upon the existing regime. In general, as outlined in section 3, we do not consider that either Option One or Option Two are presented with provide sufficient detail on matters that significantly effect ELBs as a result of the review process. Consequently, in this section we outline the broad parameters of our alternative regulatory framework and propose a means by which to ease the transition between regimes. We begin with a high-level overview of our proposal, and provide further details on each aspect in subsequent sections.

5.1. Overview of Proposed Regulatory Framework

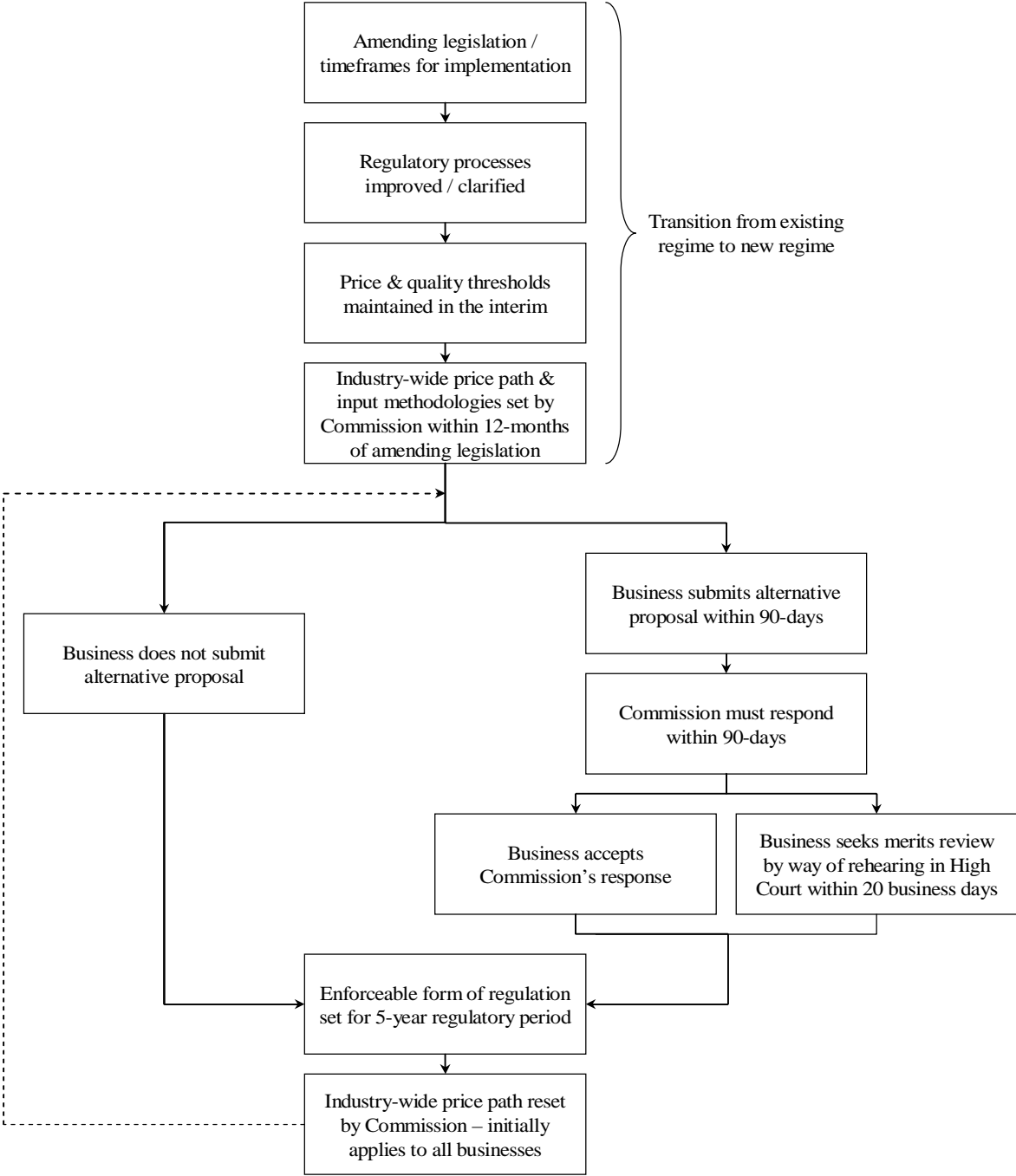
In a similar fashion to MED’s Option Two, we propose a regulatory framework that would comprise two regulatory pathways: a **default price threshold** and a customised proposal based upon a **propose-respond model**. By way of broad overview, the salient features of the proposed framework are as follows:

- § to assist the transition between regimes, the Commission should **extend the existing thresholds** for lines businesses;
- § **twelve months** from the date at which amending legislation takes effect, the Commission would be required to:
 - determine the industry-wide **default price path** to apply for the initial 5-year regulatory period – this decision would *not* be merits reviewable; and
 - publish **Guidelines on the input methodologies** it expects businesses to employ if they opt to submit a customised proposal as an alternative to adhering to the default price path – these Guidelines would also *not* be merits reviewable.
- § the **default price path** for all firms would comprise a lagged ‘CPI – X’ price path for a 5-year regulatory period, whereby:

- the X-factor would be based on industry-wide total factor productivity (TFP) trends;
 - the price path would be binding, as opposed to a ‘threshold’, and so breaches would result in an enforcement of the path price and potentially a penalty; and
 - a quality threshold would also exist, including continuous disclosure requirements.
- § businesses would then have **90-days to submit a customised proposal** to the Commission as an alternative – such proposals would:
- comprise a comprehensive ‘building block’ assessment of forward-looking costs;
 - be irreversible, ie, a business would not be permitted to revert to the default price path following the Commission’s ‘response’, although that response *would* be subject to merits review;
 - be limited to the duration of the regulatory period and so expire on the same date as the default price path; and
 - be guided by the Commission’s input methodology Guidelines;
- § the Commission would have **90-days to respond** to such a proposal and be required to:
- provide comprehensive reasons for all of its decisions by addressing and providing sufficient justification for decisions on all material aspects of the proposal; and
 - accept proposals that were reasonable in light of the input methodologies that it had established.
- § businesses would be afforded **20-days to lodge an application** for merits review by way of rehearing with the High Court following the Commission’s response;
- § at the conclusion of any merits review proceedings, each business would either be subject to the default price path, or its own customised control terms;
- § during the five-year regulatory period, the Commission would be required to update its input methodology Guidelines in line with developing best regulatory practice and/or to reflect decisions made by the High Court in respect of those methodologies in a merits review; and
- § at the beginning of the *next* regulatory period all businesses would revert back to the revised default price path in the first instance, at which point each would again need to elect whether to propose its customised terms.

Figure 1 below summarises this proposed regulatory framework for ELBs, including suggested timeframes for implementation and a transition path between the existing regime and the new.

Figure 1. Summary of Proposed Regulatory Framework for ELBs



In the following sections we provide a more detailed account of this proposed framework, including the transition from the existing Part 4A framework, its implementation, operation, and the reset process.

5.2. Transition from Old Regime to New

The present review process is taking place at a time that the Commission and ELBs are necessarily turning their minds to the threshold reset set to take effect in 2009. Indeed, the Commission recently issued a discussion paper in which it outlined its intended approach to the threshold reset.⁴¹ Given the undesirable consequences of running these two processes in parallel, our pragmatic suggestion as outlined in section 3, is to maintain the existing thresholds until such time that amending legislation comes into effect, at which point the Commission would have, say, 12-months to implement the new regime.

In the meantime, a number of other things would need to happen before that regime could successfully be implemented, including the specification of input methodologies by the Commission and a significant clarification and improvement in the procedural requirements placed upon the Commission when making decisions generally. Alternatively, to the extent that MED preferred some other derivation of Option One or Option Two, a considerable amount of clarification would be required regarding the detailed operation of such a regime in order to avoid undesirable consequences. We discuss each of these possibilities below.

5.2.1. Guidance to and from the Commission

To facilitate the transition between the old regime and the framework outlined above, considerable guidance would be required from the Commission regarding the input methodologies it would require business to conform to when submitting proposals under the ‘propose-respond’ pathway. In addition, considerable benefit could be obtained from also clarifying and improving upon the procedural requirements to which the Commission must adhere when making regulatory decisions generally.

5.2.1.1. Guidance *from* the Commission on input methodologies

Before it announces the default price path to apply to ELBs the Commission would be required to consult upon and publish **non-binding Guidelines** on key input methodologies that it would expect firms to employ when formulating customised proposals. For the avoidance of doubt, these Guidelines would not represent a binding long-term commitment on the part of the Commission to a particular methodology and they would not be subject to merits review.⁴²

Of course, before finalising these Guidelines – or finalising any subsequent amendments – the Commission would necessarily be expected to undertake an **open and transparent consultation process**. Moreover, the legislative scheme should require it to give comprehensive reasons for all of its decisions that relate to all the evidence is received

⁴¹ Commerce Commission (2007), *Regulation of Electricity Lines Businesses; Reset of Thresholds Process Paper*.

⁴² However, as outlined in section 6 below, the substance of these Guidelines subsequently would be subject to challenge by way of merits review in the context of the propose-respond framework. If in the course of a merits review of a Commission’s ‘response’ decision the Court reaches findings contrary to the substance of the Commission’s input methodology Guidelines it would then be incumbent on the Commission to consequently reflect those changes in those Guidelines prior to the beginning of the next regulatory period.

through such consultations and address all material aspects of submissions presented to it.⁴³ The Guidelines would necessarily cover such matters as:

- § the **form of control** that the Commission considers should apply to the regulated services, with this assessment made by reference to *the degree of market power* that is involved with the services in question,⁴⁴ for example:
 - for services for which there is significant potential for the exercise of market power, the Commission may require firms to propose a weighted average price cap form of price control, based on the ‘building block’ methodology; and
 - for services for which there are likely to be fewer market failure concerns, the Commission may allow firms to propose a commercial negotiation form of regulation, eg, for connection services provided to large customers;
- § how the **weighted average cost of capital** will be calculated;
- § **asset valuation methodologies**, eg, historical cost based or replacement cost based;⁴⁵
- § how it would deal with **incentives for quality**;
- § which costs would be eligible for ‘**pass through**’;
- § the **treatment of tax**; and
- § the circumstances in which customised control terms may be **re-opened** during a regulatory control period.

All input methodologies would need to be determined in a manner consistent with the **purpose statement** specified in section 4 and thus allow for economic regulation that is in the long-term interest of New Zealand consumers. Accordingly, input methodologies should require a business to structure a proposal such that, overall, the price and non-price terms and conditions would be expected to deliver a reasonable return on its invested capital, commensurate with the risk profile of the businesses. The Commission would then be bound to accept all proposals that were reasonable in light of those methodologies.

Of course, even if a firm complies with all of the Commission’s Guidelines, there will likely be scope for the Commission to exercise its judgement regarding what is and is not reasonable insofar as the *application* of that methodology is concerned. This is entirely appropriate and serves to prevent firms seeking an unreasonably high expected rate of return. For example, a firm may propose a regulatory WACC that has been estimated in accordance with the general parameters of, say, the Capital Asset Pricing Model (CAPM), but nonetheless be excessive if inappropriate inputs are incorporated into the calculation.

⁴³ For a more comprehensive discussion of procedural requirements in this regard, see section 5.2.1.2 below.

⁴⁴ As outlined above, the question of *whether* to regulate ELBs is no longer a live issue.

⁴⁵ In the context of any form of control implemented by reference to forward-looking costs (as distinct from, say, negotiate/arbitrate frameworks) we would favour a methodology based upon the Optimised Depreciated Replacement Cost (ODRC) asset valuation principle. ODRC is perfectly consistent with the fundamental economic principle that prices should reflect the opportunity cost of the resources displaced in providing services in the relevant market. Consistent with its role as the reference point for the costs faced by a hypothetical new entrant, ODRC-based asset values also promote economic efficiency by ensuring that the final price of electricity competes appropriately with alternative forms of energy.

Equally, in the event that a business believes that the Commission's application of a key input methodology in its response is incorrect or unreasonable, it is able to seek **merits review** of the Commission's *entire control decision* by way of rehearing in the High Court. As part of that process the business would be at liberty to challenge the formulation or application of the Commission's input methodologies. The Commission should then subsequently revise its Guidelines in line with any Court ruling for application at the beginning of the *next* regulatory period. The framework therefore allows for flexibility in input methodologies and provides for merits review to 'bed down' such methodologies over time.

We recognise that a potential consequence of the availability of merits review is the emergence of discrepancies in the application of input methodologies between businesses. For example, following a merits review several businesses could conceivably end up with a higher regulated WACC than those businesses that elected to accept the Commission's response. We believe the best way to address such discrepancies is to wait until the next reset and allow the Commission to update its approach at that time, rather than seeking to revisit the methodologies applied to businesses that 'accepted' its 'response' to somehow allay perceived equity concerns.

There are two primary reasons for this. First, it seems quite unlikely that significant differences would emerge from firm-to-firm. From a procedural perspective, there is likely to be a considerable degree of overlap in the issues being reviewed at any reset. Hence it is likely that the High Court would seek to adjudicate and rule on cases simultaneously. As such, the Court would seem unlikely to decide that a wide range of different approaches should apply across the regulated businesses – particularly if the bench is staffed with suitably qualified experts in the relevant fields.⁴⁶ For example, whilst it might apply, say, a higher WACC than the Commission, it would likely apply the same figure to *all* businesses that sought review, rather than a unique figure to *each* business.

Second, revisiting responses that businesses accepted is potentially inequitable for those businesses that sought merits reviews. Merits review is *not a costless exercise*. Those businesses that chose not to bear the costs of taking a case to Court arguably should not stand to benefit. This is particularly the case if merits review is by way of rehearing (which we propose it should be) since the risk is not asymmetric. The Court could conceivably impose a *worse* outcome upon a business that the response initially proffered by the Commission. Those businesses should therefore be made to wait until the next regulatory period for any High Court ruling to filter through to the Commission's approach.

Finally, in addition to specifying key input methodologies in Guidelines for use in the 'propose-respond' framework, the Commission should be encouraged to steer market conduct more generally through the use of pro-active discussion papers and guidance on how businesses should behave. This would be preferable to the alternative of doing so retrospectively in the context of, say, a sector-wide inquiry or a breach inquiry, with the benefit of hindsight. As a general rule, the more open and transparent the Commission can be regarding its thinking on issues that might affect businesses, the more predictable the regulatory regime will be.

⁴⁶ See chapter 6 for further discussion of lay experts.

5.2.1.2. Guidance to the Commission on procedural requirements

We consider that there would be considerable benefits from providing additional guidance *for* the Commission regarding the procedures it should follow when making regulatory decisions *generally*. In particular, the legislative framework should be designed in such a way that the Commission is required to give reasons for its decisions that are sufficiently comprehensive to address all the evidence it has received through any consultations.⁴⁷ This would have the following benefits:

- § a reduction in the incidence of ‘regulatory surprises’, and thus the time and effort devoted by regulated companies to avoiding exposure to these surprises, rather than focusing on running their businesses efficiently;
- § a reduction in the Commission’s ability to focus on analysis that supports its own position, notwithstanding well reasoned alternatives, which in turn reduces the scope for ‘sub-optimal’ outcomes, or costly appeals and judicial reviews;
- § regulated companies would not be discouraged from submitting useful information that contradicts the Commission’s own analysis, because they can be assured that their evidence will be taken into account; and
- § the Commission would be explicitly required to address all of the salient points put forward in customised proposals and to provide adequate justification for departing from such proposals.

In our view, none of these suggestions are controversial and all are consistent with best regulatory practice. Indeed, provided the Commission is leaning towards soundly based decisions, dealing with these additional procedural requirements should be simple and serve only to improve the effectiveness of the regulatory regime ultimately set in place.

5.2.2. Attention to Detail

If MED preferred some other derivation of Option One or Option Two, a decision must be made regarding the extent to which the details of that framework, including regulatory processes, are consulted upon and made explicit from the outset. If a regulatory framework does not exhibit clear process requirements from the beginning, or those processes have not been openly, transparently and consistently implemented, a regulator risks long-run distortions to pricing and investment decisions.

Consequently, we believe that there is a strong case to be made for clarifying upfront these unavoidable issues arising from the specific details of any proposal. Even though this may come at some cost in terms of the implementation timetable, not addressing implementation detail now will often incur greater costs than the pro-active option and may result in unintended outcomes. The existing Part 4A thresholds regime did not adequately deal with these fundamental issues and therefore has fallen significantly short of best regulatory practice. The Government has recognised as much in commencing the present review.

⁴⁷ As section 2.5 explained, the Commission often tends not to address all of the salient points put forward by firms in a way that might give meaningful future guidance.

Indeed, myriad aspects of the existing thresholds regime illustrate the potential costs of leaving important process questions unresolved prior to the inception of a regulatory framework. For example, had post-breach processes and potential control options been clear from the outset:

- § many of the costs involved with extended administrative settlement processes might have been avoided, including any consequent pricing and investment distortions;
- § the Commission may have been encouraged to address all of the salient points put forward by firms in a way that would give more meaningful future guidance; and
- § more definitive guidance on a greater number of key input methodologies might have been delivered by the Commission, and in a more timely fashion.

In our opinion, the MED risks repeating this mistake if it does not undertake a second, more detailed, round of consultation of the reform proposals. The suggestions put forward in the MED Discussion Document are simply not developed in sufficient detail on matters that are vital to any amended regime. This gives rise to the risk of future unintended consequences. In particular, there is minimal examination of detailed implementation issues in the Discussion Document, or a robust analysis of what the proposals are intended to achieve relative to the status quo.⁴⁸

We consider that there would be considerable benefits to be obtained from providing significantly closer attention to these critical detailed implementation issues up-front, irrespective of the regulatory options ultimately decided upon. The time and effort invested into clarifying the detailed aspects of the regime can be thought of as a cost that must be incurred in order to achieve the clarity required for a regulator to administer regulation openly, transparently and consistently. This will better ensure a smooth transition between regimes and the effective operation of the framework in the longer term.

5.3. Default Price Path

There are some desirable aspects of the thresholds regime that we believe should be retained to the greatest extent possible. If designed appropriately, an industry-wide **default price path** could retain and improve upon the low-cost, light-handed nature of the thresholds regime. Under the default price path *all firms* would be permitted to increase their tariffs by ‘CPI – X’ in each year of a 5-year regulatory period. The price path would have the following features:

- § the X-factor would be based on industry-wide total factor productivity (TFP) trends, and so would involve no assessment of individual firms’ forward-looking costs and profitability, and thus no P_0 adjustment;
- § the price path should be designed in such a way that it would be clear to businesses whether they were complying with it or not, eg, tariffs should be based on a *lagged CPI* rather than a forward-looking *projection* of the CPI;

⁴⁸ See discussion in section 3 above.

- § the price path would be *binding*, and as distinct from the present price threshold, breaches would result in an *enforcement* of the path price rather than an administrative settlement process, and potentially a penalty depending on the nature of the breach; and
- § the Commission should also specify an accompanying *quality* threshold to ensure that businesses do not sacrifice service levels to improve their profitability whilst ostensibly complying with the price path – this should include continuous disclosure requirements.

Once a firm elects to adhere to the default price path during the regulatory period, that decision should be irreversible. In other words, a business that opts *not* to propose customised control terms would not be afforded an opportunity to do so again until the *following* regulatory period. This precludes the situation whereby a firm that has obtained a high rate of return as a result of being on the default price path for, say, the first three-years of a regulatory period can effectively ‘bank’ that return and seek to obtain higher retail tariffs under customised control in the final two-years in order to undertake significant capital expenditure.

Creating a binding 90-day window also prevents a constant stream of submissions over the regulatory period that the Commission would then have to deal with on an ad-hoc basis. Indeed, whilst there is undoubtedly a risk of the Commission’s resources being stretched at the conclusion of the 90-day window (a risk MED recognises), there are also clear *advantages* from assessing multiple applications and thus dealing with common issues simultaneously. As outlined further below, making a decision to put forward a customised proposal irreversible might go some way to reducing the Commission’s workload.

It is largely to maintain the sanctity of the initial 90-day window that the default price path should be *enforceable*. In other words, in the event of a breach a business should be forced to comply with the price path, rather than entering an administrative settlement process, or the ‘propose-respond’ framework. If a business knows that it can potentially escape the default price path at some later date by deliberately breaching, the initial 90-day window for the decision to put forward a customised proposal would have little meaning and its incentives for efficiency throughout the entire regulatory period would be compromised.

5.4. Propose-respond framework

We agree with MED that it would be a desirable development for lines companies to be afforded the option of submitting a **customised proposal** to the Commission within **90-days** of the announcement of the default price path. Such proposals should also be irreversible in order to prevent businesses from engaging in opportunistic conduct. In other words, once a business submits a proposal it should be prevented from opting to revert to the default price path in preference to the Commission’s ‘response’. This should limit the scope for frivolous proposals from business seeking to game the Commission. Rather, businesses would be encouraged to invest considerable effort into ensuring a proposal is robust, so as to avoid an undesirable outcome.

Customised proposals would necessarily be guided by the Commission’s input methodology Guidelines, which would necessarily specify the *form* of regulation, approaches to WACC, asset valuation and other key inputs. Proposals would also be limited to the duration of the

regulatory period and so expire on the same date as the default price path. For the vast majority of services provided by lines businesses,⁴⁹ customised control proposals would be expected to comprise a comprehensive ‘building block’ assessment of the forward-looking costs associated with delivering those services over the course of the regulatory period. This is quite unlike the default price path, which eschews consideration of such matters, thereby remaining light-handed and cost-effective in nature.

Submitting a customised proposal may therefore be a particularly attractive option for businesses with substantial forward-looking capital programs since their proposals could be calibrated to account for such requirements. In this manner, the proposed regulatory framework potentially addresses the shortcomings associated with the retrospective nature of the existing thresholds framework for those businesses most affected, whilst retaining the key advantages of the existing threshold regime for those businesses less affected.

The Commission would have **90-days to respond** to such a proposal. As section 5.2.1.2 explained, the success of such a regime depends in large part upon the robustness of the regulatory procedures that the Commission must follow when formulating this response. Specifically, the legislative scheme should require the regime to provide comprehensive reasons for its decision, and to address and provide sufficient justification on all material aspects of the proposal. The Commission should also be compelled to accept any proposal that is reasonable in light of the input methodologies that it has established, although there will inevitably be scope for the Commission to exercise its judgment on the issue of ‘reasonableness’.

This assessment would again be fundamentally informed by the **purpose statement**. Ultimately, the Commission must assess whether businesses’ application of the specified input methodologies deliver price and non-price terms and conditions that are likely to be in the long-term interest of New Zealand consumers. On the one hand, it is not in the long-term interests of New Zealand consumers to be forced to pay prices that deliver a return for a business that is substantially in excess of the risk-adjusted cost of capital. On the other hand, it is not in the long-term interests of consumers for businesses to be deprived of a reasonable return on their investments, since any short-term welfare gain from lower prices may be more than offset through a diminution in quality of service; or worse, exit from the market.

Consequently, businesses would be afforded **20-days to lodge an application for merits review** by way of rehearing with the High Court following the Commission’s response.⁵⁰ Depending upon the number of businesses that seek review, there will likely be scope for the Court to adjudicate applications simultaneously. At the conclusion of any merits review proceedings, each business will either be subject to the default price path, or its own customised control terms, for the duration of the 5-year regulatory period.

Throughout the regulatory period, the Commission will be required to update its input methodology Guidelines in line with developing best regulatory practice and/or to reflect decisions made by the High Court in respect of those methodologies in a merits review. At

⁴⁹ The Commission may deem it appropriate to allow negotiate-arbitrate frameworks for certain services as is the case in Australia, eg, connection services provided to large customers with significant countervailing buyer power.

⁵⁰ See section 6 below for a comprehensive discussion of merits review.

the beginning of the *next* regulatory period all businesses would then revert to the revised default price path in the first instance, at which point they would again need to elect whether to propose their own customised terms.

Reverting to the default price path as a starting point at the beginning of each regulatory period minimises the risk that its relevancy as the default form of regulation will diminish over time as more and more firms move to the ‘customised control’ pathway. This addresses the concern expressed by the MED regarding the potential longevity of its default form of regulation under Option Two – comparative benchmarking – in the presence of a ‘propose-respond’ alternative.

5.5. Summary

Elements of MED’s Option Two have the potential to improve significantly upon the present Part 4A regime. However, this proposal has not presently been developed to a sufficient level of detail for there to be any confidence that it will address the identified priorities for change, or that it would not amount to a retrograde step. Consequently, we favour a regulatory framework that is *broadly consistent* with Option Two, but with significant modifications that we believe *would* substantially improve upon the existing regime. Specifically, during each 5-year regulatory period businesses would have the option of:

- § complying with a binding **default price path** of the lagged ‘CPI – X’ form for a 5-year regulatory period, in which the X-factor would be based on industry-wide total factor productivity (TFP) trends; or
- § submitting a **customised proposal** to the Commission within 90-days of the Commission announcing the default price path, that would be prepared consistently with key input methodologies specified by the Commission, to which the Commission would have 90-days to respond comprehensively.

Businesses would be afforded 20-days to seek merits review by way of rehearing in the High Court following the Commission’s ‘response’ to its proposal. Merits review can therefore be relied upon to ‘bed down’ the Commission’s input methodologies over time. At the conclusion of any merits review proceedings, each business will either be subject to the default price path, or its own customised control terms. At the beginning of the *next* regulatory period all businesses would then initially revert to a revised default price path.

To assist the transition between regimes, in the interim the Commission should maintain the existing thresholds for lines businesses. Twelve months from the date at which amending legislation takes effect, the Commission should be required to determine an industry-wide default price path to apply for the first five-year regulatory period and publish Guidelines on the input methodologies it expects businesses to employ if they opt to submit their own customised proposal. Such Guidelines would cover the appropriate forms of regulation, WACC, asset valuation and other key inputs. The procedures that the Commission must follow when making regulatory decisions generally should also be clarified and improved during this timeframe.

Recommendation: A binding price path should be implemented as the default form of regulation since it would be cost-effective and afford ELB's a degree of flexibility to conduct their operations as they see fit. However, as an alternative, lines companies should be afforded the option of submitting to the Commission within 90-days a customised proposal that complies with key input methodologies that it would set in advance. The Commission would then have 90-days to respond comprehensively. That response would be subject to merits review by way of rehearing in the High Court. To assist the transition between regimes, the Commission should maintain the existing thresholds for an interim period. Twelve months from the date at which amending legislation takes effect, the Commission should be required to determine the initial default price path to apply for the first 5-year regulatory period and publish Guidelines on the input methodologies it expects businesses to employ if they opt to submit their own customised proposal. The procedures that the Commission must follow when making regulatory decisions generally should also be clarified and improved during this timeframe.

6. Accountability Mechanisms

A significant shortcoming of Parts 4 and 4A of the Act is the absence of appropriate accountability mechanisms in the case of regulatory decisions made by the Commerce Commission.⁵¹ For the moment, such decisions of the Commission can only be challenged by way of (1) case stated on a question of law⁵² and (2) judicial review. Neither of these avenues of challenge provides a sufficient accountability mechanism because:

- § appeals by way of case stated on questions of law do not involve a merits review of the decision at issue; and
- § judicial review is concerned only with the correctness of the decision-making process, rather than the decision itself.⁵³

In contrast, there are standard rights of appeal under the Act in respect of all other determinations made by the Commission including, proposed merger transactions, restrictive trade practices clearances and authorisations.⁵⁴ In the case of such appeals, the decision of the Commission stands pending the appeal.⁵⁵ The Act contemplates two levels of appeal of Commission decisions. In addition to the right to appeal decisions to the High Court, there is also the prospect that, with leave, there may be an appeal to the Court of Appeal against the decision of the High Court.⁵⁶

There is no apparent reason for this anomaly between appeal rights being available for merger and restrictive trade practices decisions, but not for regulatory decisions. It is therefore appropriate that this matter is part of the current review of Parts 4 and 4A. MED addresses the issue of whether there should be merits review of Commission regulatory decisions in Chapter 12. This chapter sets out five core areas of inquiry which provide an appropriate framework for analysis of this issue, which we discuss below:

- § should regulatory decisions be subject to merits review?;
- § which regulatory decisions should be subject to merits review?;
- § what form of merits review should be followed?;
- § what should be the grounds for merits review?; and
- § what is the appropriate review body?

⁵¹ This section of our submission refers only to regulatory decisions made by the Commission and does not extend to recommendations made by the Commission to the Minister, or to the exercise of discretionary powers by the Minister on whether and how to regulate. Such matters are appropriately subject to judicial review, and adequate accountability in this context also comes from political and democratic processes.

⁵² Section 91(1)(b).

⁵³ See, for example, *Chief Constable of the North Wales Police v Evans* [1982] 3 All ER 141, 155; *R v Entry Clearance Officer, Ex parte Amin* [1983] 2 AC 818, 829.

⁵⁴ Section 91(1)(a).

⁵⁵ Section 95.

⁵⁶ Section 97(1).

6.1. Should Regulatory Decisions be Merits Reviewable?

The substance of merits review is akin to normal rights of appeal. The nature of merits review is usefully summarised by the Administrative Review Council as follows:⁵⁷

‘Merits review is the process whereby an administrative decision of the government is reviewed ‘on the merits’: that is, the facts, law and policy aspects of the original decision are all reconsidered afresh and a new decision - affirming, varying or setting aside the original decision - is made. Merits review is characterised by the capacity for substitution of the decision of the reviewing person for that of the original decision maker.’

It therefore follows that the Legislation Advisory Committee Guidelines (Guidelines) on appeals are relevant to the current discussion about merits review. These Guidelines:

- § articulate the circumstances in which it is generally desirable for there to be a right of appeal against decisions of tribunals, such as the Commission; and
- § set out countervailing factors which might count against conferring rights of appeal.⁵⁸

6.1.1. Reasons for appeal or merits review rights

Appeal rights are justified on the basis that they relate to decisions that affect “important rights, interests, or legitimate expectations of citizens”, and may correct errors and supervise and improve decision making. Appeal or merits review rights under Parts 4 and 4A satisfy both of these justifications.

Regulatory decisions clearly involve important rights and interests; indeed, such decisions go to the very heart of any regulated utility’s operations. Prices are set under such decisions and they impact directly on network investment decisions and the rates of return which may be achieved. Quality standards are also set against which the regulator will measure the performance of the regulated utility. Obviously, such issues of price and quality are of the most fundamental importance to utilities, and the members of the public that they serve.

These matters are no less important than decisions about whether a firm may merge with another entity, or engage in restrictive trade practices for which authorisation may be sought. As noted above, appeal rights already exist for these matters in relation to Commission adjudication into clearance and authorisation applications for mergers and restrictive trade practices. Plainly, it is inconsistent on these criteria of the magnitude of the rights and interests at stake to allow appeals for one matter but not the other.

The discipline of merits review will also serve to achieve both private and public purposes. The private purpose is to scrutinise and correct decisions of the Commission, where

⁵⁷ Administrative Review Council, Report to the Minister for Justice, “Better Decisions: Review of Commonwealth Merits Review Tribunals”, Report No 39, 14 September 1995, para 2.2.

⁵⁸ Legislation Advisory Committee Guidelines, “Guidelines on Process and Content of Legislation”, May 2001, paras 13.1.1 and 13.1.2.

necessary.⁵⁹ The public purpose arises through the discipline imposed by the prospect of merits review. Such prospect of scrutiny will encourage the primary decision-maker to produce rulings of the highest possible quality. For these reasons there is a strong and obvious case for merits review rights.

6.1.2. Countervailing factors

The Guidelines stipulate that the above considerations should be balanced against the following factors:

1. Cost;
2. Delay;⁶⁰
3. Significance of the subject matter;
4. The competence and expertise of the decision-maker at first instance; and
5. The need for finality.

The significance of the subject matter clearly points to the need for merits review, for the reasons outlined above. Decisions about the price for essential services, and the quality standards for the delivery of such services, are of fundamental importance to regulated utilities and the public.

Costs and delay are unlikely to count against merits review. Regulatory decisions of the Commission could stand pending merits review, in the same way that merger and restrictive trade practices decisions stand pending appeal by virtue of section 95. Further, the costs of merits review are unlikely to be disproportionate to the matters at stake, and such costs are unlikely to be greater than those currently applying to appeal rights under the Act.

The competence and expertise of the Commission, and the need for finality, are also relevant considerations, but neither counts against the introduction of merits review for the following reasons:

§ While due deference should be given by an appellate body to the expertise of specialist tribunals such as the Commission,⁶¹ appropriate appellate avenues can and do nonetheless exist for the assessment of errors in the competition law and regulatory context. The appointment of lay members with appropriate expertise is crucial in this context, and this topic will be discussed in more detail below.

§ Issues of finality do not count against the introduction of merits review because there is no reason to deny regulated utilities the standard appeal rights that apply to other matters of Commission adjudication under the Act. Such rights ought to exist as a matter of course, given the magnitude of the impact of regulatory decisions on utilities. Further the

⁵⁹ In this context the Guidelines note that this justification is met even if there are only occasional errors: see Guidelines, para 13.1.2.

⁶⁰ The Guidelines further say (para 13.1.1) that it will usually be appropriate to respond to concerns about costs and delay by limiting the scope of appeal, rather than denying it altogether.

⁶¹ See: *Air New Zealand/Qantas v Commerce Commission (No 6)* (2004) 11 TCLR 347, paras 9-13.

central concerns of finality, delay and frustration, will not arise where the original decision of the Commission stands pending the merits review.

In sum, there are no countervailing factors which should properly be regarded as counting against the strong case for the introduction of merits review for regulatory decisions.

6.2. Which Decisions?

It is difficult to anticipate the full range of decisions which should be subject to merits review. The risk is that not all subject areas may be apparent and, therefore, exhaustive lists cannot be compiled. To the extent that an indicative list may be foreshadowed, it would include each of the input decisions mentioned in the MED Discussion Document,⁶² the setting and approving of control terms and penalties, and so on.⁶³ Potentially each matter decided by the Commission in response to customised proposals, as anticipated in the discussion above, would be open to merits review. This matter is discussed further below in the discussion of the grounds for merits review (section 6.4).

6.3. What Form of Merits Review Should be Followed?

It is likely to be common ground that merits review should be by way of rehearing, as is the case for appeals under the Act.⁶⁴ This means that the appeal court will simply rehear the case presented to the Commission. Where questions of fact are involved, the evidence before the Commission will be brought before the court. In addition, the court has a discretionary power to rehear the whole or any part of the evidence or to receive further evidence. This approach to merits review will be the most efficient and appropriate way to approach the issue.

One related matter which is not raised by MED is whether there should be one or two levels of appeal.⁶⁵ In the ordinary course of events there should be a first right of appeal or merits review. The need for a second tier of appeal or merits review should be considered in the context of the character of the original decision-maker and the first appellate body. In the present context both these decision-making bodies will involve the input of experts over a range of disciplines. Such resource is unlikely to be utilised by the second tier of appeal, namely the Court of Appeal. While the Court of Appeal has the power to appoint technical advisers,⁶⁶ such assistance has not to our knowledge been invoked in the past. Accordingly, the second tier of appeal may be confined to the judges alone of the Court of Appeal.

Some consideration needs to be given to this issue. Our preliminary view is that there is no necessary need for a second tier of merits review. If it is established that there is a need for a

⁶² For example, the form of control, WACC, asset valuations, allocation of common costs, tax treatment and cost pass through. See Discussion Document, para 131. See also the discussion of input methodologies above in section 5.2.1.1.

⁶³ See Discussion Document, para 226.

⁶⁴ For discussion of principles relating to such cases, and the admissibility of updating evidence, see *Telecom v Commerce Commission* [1992] NZAR 193, 212.

⁶⁵ A useful discussion of this topic appears in the Guidelines, paras 13.2.1 and 13.2.2.

⁶⁶ See Section 99B-D of the Judicature Act 1908.

second level of merits review, then consideration should be given to whether this should be restricted to questions of law.

6.4. What Should be the Grounds for Merits Review?

MED correctly observes that the grounds for merits review will, in essence, be self-defining. In each case the applicant will be asserting error on the part of the Commission, and such articulation of error will form the basis of the grounds for merits review. Such error may involve questions of law and/or fact. The boundaries between these grounds is not always clear and, in such circumstances, it is unnecessary to contemplate legislative limitations on the grounds for merits review.

Accordingly, there should simply be a right to full merits review in respect of all aspects of the Commission's decision, in the way that there is such a right of appeal under section 91(1). Further, the relief provisions of sections 93 and 94 can also be adapted to apply to merits review, in the way that they apply to appeals.

It is informative to outline an illustrative example of how the merits review process may work (based on these suggested amendments to sections 91, 93 and 94), with reference to the modified Option Two which is set out in this paper.

Assume that an ELB puts forward a customised proposal in response to the Commission's default price path. This will involve the ELB putting forward building blocks analysis based upon the Commission's Guidelines. In many cases the customised proposal may reflect disagreement with some input methodology aspect of these Guidelines, eg, in relation to the asset valuation methodology or the indicative WACC. If the Commission rejects any aspect of the customised proposal, eg, the asset valuation or WACC in the above example, then it would be open to the ELB in question to seek merits review of *all* aspects of the Commission's decision in response.

The findings of fact, law and policy of the Commission's decision are all fully reviewable in this context. If the Court reaches a different view on (a) the formulation and application of any given input methodology, eg, as to the ELB's asset valuation or the applicable WACC in the above example; or (b) any other matter upon which the decision is based, then the Commission's decision may be reversed by the High Court.

6.5. What is the Appropriate Review Body?

Merits review of regulatory decisions will involve a complex range of questions relating to a number of discrete disciplines. Accordingly, a multi-disciplinary approach to decision-making is required. This is not new in the case of appeals under the Act. Economist lay members have sat with judges in the case of appeals of clearance and authorisation decisions of the Commission since the Act first came into force.

The Discussion Document anticipates two potential review bodies:

- § the High Court assisted by lay members; and
- § a new appellate tribunal, along the lines of the Australian Competition Tribunal.

6.5.1. Existing High Court structure

There is reason to believe that the current model under the Act for appeals would also work well for the merits review of regulatory decisions. The one qualification to this statement is that some care will need to be taken in relation to the composition of the lay member panel. The current lay members are largely industrial organisation economists, and not all of them may be well versed over the full spectrum of regulatory matters such as, for example, asset valuation and WACC.

Accordingly, the introduction of merits review under this model would require a reassessment of the lay member panel, and the addition of further suitable members with regulatory expertise. In this regard, the Discussion Document notes some concern about the size of the talent pool in New Zealand. However, if this matter is real, it can be overcome through the appointment of further Australian lay members. They have been a feature of the lay member panel for some time.

A further matter for consideration here is that, in any given case, there may be a need for expert assistance in more than one area. Accordingly, section 78 should be amended to permit more than one lay member to be appointed in the case merit reviews of regulatory decisions.

6.5.2. New appellate tribunal

The Discussion Document, and a related consultation document,⁶⁷ considers the need for a specialist tribunal to act as the appeal body. To the extent that these papers advance a justification for this approach, it appears to be that regulatory appeals will be more complex than other appeals under the Act.⁶⁸ The basis for this suggestion is not altogether clear and, in any event, if the concern is legitimate, then it can just as easily be answered by addressing more carefully the composition of the High Court lay member panel, as just discussed above.

In all likelihood, a new appellate tribunal along the lines contemplated by MED will not necessarily differ in its adjudicative capabilities materially to the current High Court appeal model. It is equally open for High Court judges with the most relevant experience to be assigned to regulatory merits review cases, together with lay members with the relevant experience, under the current model in the same way that it is proposed that specialist judges may be assigned to a new tribunal. Therefore the composition of the appellate decision-makers can be the same whether the current High Court model is retained, or a new specialist tribunal introduced.

Presumably the Australian Competition Tribunal model involves a greater allocation of resources, in particular support staff resources. This point is not fully addressed in the Discussion Document. For example, what would be the precise structure of a new tribunal, would additional costs be involved and, if so, would these be justified?

⁶⁷ Ministry of Economic Development, "Review of Clearance and Authorisation Provisions Under the Commerce Act 1986", May 2007.

⁶⁸ See above, para 176.

In sum, we consider that the existing High Court model can be adapted to meet the needs of merits review for regulatory decisions. The issue of the new appellate tribunal can be revisited at a later time if compelling reasons emerge for its introduction.

Recommendation: There is a strong case for the introduction of merits review by way of rehearing for a broad spectrum of regulatory decisions under the Act in the way that there is such a right to appeal under section 91(1). The existing High Court model can be adapted to meet the needs of merits review for regulatory decisions. The issue of the new appellate tribunal can be revisited at a later time if compelling reasons emerge for its introduction.

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