

**Key input decisions, a merits review and the role of the firm in proposing  
regulatory control terms:  
A contribution to the MED Review of Regulatory Control Provisions**

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**1. Introduction**

The Ministry of Economic Development (MED) is conducting a Review of Regulatory Control Provisions under the Commerce Act 1986 (per terms of reference announced 13 September 1986). In April 2007 it published a Discussion Document, which refers to “some uncertainty around the policy intent of regulatory control, some inefficiency of regulatory processes, potentially insufficient accountability for regulatory decisions”. (p. 6)

The Document outlines some possible approaches to regulation. These include discussions of

- a) key input decisions, such as the nature of a price control, and whether the methodology to be used should be specified in advance, and if so by whom (chapter 8);
- b) the role of regulated firms in the process of setting control terms, and the extent to which firms should be able to propose such terms (chapter 9); and
- c) whether the regulator (in this case the Commerce Commission) should be subject to merits review (in addition to judicial review), and if so to which decisions the review should apply, what form it should take and what body should carry out the review (chapter 12).

Vector Limited has asked me to look at experience in the UK and elsewhere that pertains to these three issues. Specifically, it has asked me to describe

- a) the evolution of the methodology used in price control regulation of electricity distribution (and transmission) utilities;
- b) the alternative approaches to setting price controls by means of negotiated settlements between utilities and users of these services, as used in the US and Canada and now beginning to be considered in the UK; and
- c) the nature of the merits review process that has existed in the UK since the beginning of utility regulation, the experience of that process, and how this has impacted on regulation in the UK, including the evolution of the price control process.

## 2. Outline and conclusions of paper

New Zealand initially envisaged reform of the utility sectors as involving relatively little direct regulation, relying instead on general competition policy. At that time there were concerns that sector-specific regulation would be costly and uncertain, and would discourage firms from improving efficiency.

In the UK, there were similar concerns at the time of reforming the utility sectors. However, the general conclusion was that some form of sector-specific regulation was appropriate, provided it was 'light-handed' and designed to encourage greater efficiency. In general the sector regulators have developed a satisfactory price control methodology. A greater role for firms and customers in proposing control terms may well be appropriate, however. Provision for a merits review has been very important.

### SECTION I

The UK considered that sector regulation was necessary in order to provide reassurance for investors as well as customers. This was implemented by means of licence conditions including a price cap, set initially by the Minister at the time of privatisation, and set for (typically) five years ahead. This approach was intended to minimise the costs and uncertainty of regulation, and to encourage firms to improve efficiency. In general it has been very successful in these respects.

To allow for flexibility over time, the sector regulator was empowered to propose changes to the licence, including to the price control. Typically this has involved revising the control at the end of each specified period of years. There has been a continual process of evolution in the precise nature of the price cap. In general the price caps have become more complex over time as they seek to provide more refined incentives to encourage a wider range of desirable activities, and to discourage any undesirable activities.

**Section I** of this paper outlines the evolution of price control methodology in the UK, especially in the electricity distribution sector. This experience suggests that, under appropriate conditions, there is advantage in allowing a regulatory body in New Zealand to develop an appropriate price control methodology in discussion with the parties involved, and to modify this over time as circumstances evolve. A merits review is important in this process. There may be considerable uncertainty and lack of confidence in regulatory decisions in New Zealand at present. However, there could be disadvantages in trying to speed up the process of securing an appropriate and agreed methodology by requiring the Commerce Commission to specify key input decisions in advance for approval by the Minister. Greater weight should therefore be placed on developing an appropriate merits review framework. There would also be advantage in requiring the Commerce Commission to comply with general principles of better regulation. The MED or the Commerce Commission should not rule out the appointment of an Expert Panel (as found helpful in Guernsey) to consider particular issues facing the Commerce Commission.

## SECTION II

The conditions under which the regulator develops the price control methodology are important. Bearing in mind the difficulty of predicting what changes might be appropriate, the UK reform Acts did not seek to constrain the nature of the changes that the regulator could propose. Instead, they specified that any changes to the licence (including to the price controls) could only be implemented by agreement with the regulated company. In the absence of such agreement, the regulator was empowered to refer the matter to the Competition Commission, which would hear both sides and decide whether the proposed modification, or some other modification, was in the public interest. The Commission's decision empowered the sector regulator to make appropriate modifications to the licence.

In effect, the ability to appeal to the Competition Commission is a form of merits review. This has been extremely important in reassuring companies. Where a company feels that a regulator's decision is questionable, it can "get a second opinion" and the regulator cannot impose that decision unless the Commission endorses it as reasonable.

The impact of this appeal process goes beyond simply reassuring companies. Because sector regulators have not had the power to impose licence modifications, they have needed to have regard to the interests of the regulated companies and their investors, as well as to the interests of customers. They have needed to ensure that their processes and also the substance of their proposals are reasonable. They have typically done this by means of increasingly extensive and detailed consultation processes, and by developing methodologies that build upon regulatory precedent. The approaches to be adopted and the parameters to be assumed tend to start from the assumptions made in the previous review. They are discussed and debated with companies, consumer representatives and other interested parties before the regulator makes a set of proposals for licence modifications. In practice this has tended to iron out most difficulties with the price control process.

The appeals process, which applies to all the regulated utility sectors, provides two main advantages. First, it has enabled an acceptable set of methodologies to be developed. The Competition Commission has in practice tended to confirm the methodologies adopted by the regulators, but not without some modifications and qualifications, and it has sometimes taken a different view on particular parameters. Second, because the Competition Commission hears appeals from all the utility regulators, it tends to bring about a greater degree of consistency between them. It is difficult for the regulators to justify approaches significantly different from what the Commission has previously endorsed. This brings increased certainty and stability to the regulatory process.

**Section II** of this paper describes the nature and experience of this appeals process in the UK. It has been helpful and has not been abused by the companies. It suggests that providing for a merits review in New Zealand is very important indeed, both for its own sake (in terms of fairness) and in facilitating the evolution of a mutually acceptable form of price control regulation. Experience in Guernsey suggests that it is

possible for a small and resource-constrained country to provide a review process without undue cost.

### SECTION III

Price controls proposed by regulators nonetheless have some limitations. Ultimately, they reflect the regulator's own judgements rather than the preferences of customers themselves. And in the UK, at least, they need to be set on a consistent basis as between all the different firms in each sector. This constrains innovation. They have also become increasingly complex over time. Uncertainty about the likely and desirable future development of the electricity sector (for example, in face of global warming) has been a particular and increasing challenge in recent price control reviews, often drawing the regulator into difficult areas of detail.

For these reasons, there would be merit in a regulatory process that allows the firm to discuss with its customers or users what kinds of services they most want, at what prices and under what conditions. Then, where they are able to reach agreement, it would allow them to make proposals to the regulator for approval, instead of requiring the regulator to initiate and propose everything. This kind of process – so-called negotiated settlements, has been actively practiced in parts of the US and Canada with considerable success. Although experience is perhaps greatest with oil and gas pipelines and their shippers, in Florida the Office of Public Counsel and other consumer representatives have actively negotiated settlements with electric and other utilities. A version of this practice known as constructive engagement is presently being applied by the Civil Aviation Authority in its price control process for certain UK airports, again with some success.

**Section III** of this paper sets out some of the international experience with such negotiated settlements. It suggests that there should be scope for such an approach in New Zealand legislation – indeed, that legislation should encourage it. Precisely how it might be implemented, and how far it might relate to the propose/respond model identified in the Discussion Document, are matters for further consideration.

## **SECTION I THE EVOLUTION OF UK PRICE CONTROL METHODOLOGY**

### **3. The decision to adopt price caps**

The utility regulatory regimes in the UK have been intimately tied up with privatisation of the utility companies. They have reflected a need not only to protect customers, but also to ensure that the sectors are sufficiently acceptable to investors to attract the capital that will continue to be required.

It was considered that a licence setting out the rights and obligations of each utility company, that would be monitored and enforced by a sector regulator, would give greater reassurance to investors and to customers than would simply leaving the matter to a competition authority responding to complaints.

In particular, for the activities where competition was not expected and the companies would have significant market power, it was decided to put an ex ante price or profit control in the licence. This would indicate to investors and customers what would or would not be acceptable. This would be more helpful than leaving this issue to ex post investigation by a regulator, which would render uncertain the subsequent conclusions and regulatory action.

I was asked to advise the UK government in 1983, just before the very first utility privatisation, of British Telecoms, as to what form this control should take. I recommended an RPI-X price cap rather than US-style rate of return regulation. This was for the kinds of reasons that I understand have also been important in New Zealand. That is, it would be simpler, less intrusive and less costly to impose and enforce than the traditional rate of return approach then used in the US. It would give greater certainty to the company and to customers as to what prices they could expect for the period of the control. And it would give greater incentive to the company to increase efficiency during that period.

The government accepted my recommendation and adopted RPI-X for British Telecom. The method proved acceptable to investors, customers and regulators. In one form or another it was used for every utility privatisation thereafter. It has also been adopted widely in other countries, not least in Australia and parts of the US.

### **4. Setting and modifying price controls**

The government set the initial values of X at flotation of each utility company. But typically it did not explain how it reached its decisions on these values. Neither the government nor the Acts of Parliament that established the regulatory frameworks specified whether or how the price or other controls should be continued or modified at the end of the initially specified period, typically four or five years. Nor, for that matter, did these Acts or the Government specify any other parameters of a potential future price control, such as the value of an initial Regulatory Asset Base.

Regulators thus had a free hand to propose new forms or levels of price caps, or indeed to discontinue the controls or replace the price caps by other types of controls,

such as on profit or earnings. But they could only propose modifications, they could not impose them. It was considered necessary to give sector regulators the power to initiate a modification process in order that the regulatory regime should be able to respond to changing conditions in the market and in society generally. But giving them power to simply to impose changes on privatised companies would deter investment.

The solution was to provide that modifications proposed by a sector regulator could be incorporated into the licence if the licensee accepted them as reasonable. If the licensee did not accept them then the regulator could put the matter to the Monopolies and Mergers Commission (later the Competition Commission), and was empowered to make changes in the licence in accordance with the Commission's recommendation. (More detail on this process in section 4 below.)

## **5. Consultation processes**

Towards the end of a price control period, regulators typically now set in motion a consultation process with the companies and all other interested parties as to whether and how to replace the price control. This lasts about a year. The companies are asked to provide information and views, the non-confidential information and responses are published, there are both public and private discussions. The regulator indicates its preliminary views, typically narrowing down over time the range of likely outcomes, until the regulator makes a final proposal that the companies either accept or reject. In the event that a company rejects the proposal, the matter is referred to the Commission. All parties including the regulator give evidence (typically the material they have been discussing with each other for the previous year or so) and engage in discussions with the Commission. The Commission gives its conclusion within six months.

## **6. Setting the level of X**

What if any changes have been made to the initial price controls? Typically the regulators have considered and rejected alternatives to an RPI-X type of control. But they have made numerous changes to the form of that control as well as to the levels of X. Importantly, they have also needed to establish methods for actually setting the levels of X.

As noted, the Acts did not prescribe how regulators should set price controls. Initially, the telecoms and gas regulators were at that time each dealing with a single company,. They may have adopted an approach based mainly on financial considerations. They may have asked themselves 'in order to best protect the interests of customers, what is the toughest X value that I can set?' But they were not obliged to set out their thinking in any detail, and the explanations of their proposals do not extend beyond a few paragraphs.

When the water and electricity regulators came to reset the initial price controls, they were faced with several comparable companies (14 in the case of electricity, over 40 in the case of water). They needed a method that could be set out more explicitly, to show that no individual company had been favoured or disfavoured relative to its

peers. There was also increasing pressure to explain publicly how proposed price controls had been calculated.

As the electricity regulator, I was concerned to find and adopt a method that would properly balance the interests of customers and investors, and that could be explained and justified to companies, customers and the general public. To that end we explored numerous approaches, focusing mainly on two. Both involved assessing the efficient level of operating costs and capital expenditure and cost of capital for the forthcoming period (and beyond), and projecting cash flows. One then involved projecting the dividend streams necessary to finance the sustained operation of the company and any needed borrowing. The other involved what has subsequently become known as a building-block approach, with a regulatory asset base and a return on this capital. In the event I decided that on balance the second approach would be easier to explain, implement and defend.

The water regulator took a similar view with respect to a building block approach. The two approaches differed in some respects, however. For example, following the practice of the telecoms regulator, the water regulator calculated the level of price that would be appropriate in the final year of the forthcoming price control period, and set  $X$  as the value necessary to reduce the present price to that level over the five year period. This became known as a glide-path. In electricity, where very high profits were being made, I took the view that this would not adjust prices downwards fast enough. I therefore set  $X$  so as to provide a reasonable return on capital across the period as a whole. If the price control had started from the level of price obtaining at the end of the previous period, this would have meant a value of  $X$  so great that price would have been unsustainably low at the end of the next period. I therefore introduced the concept of an initial reduction in price – the so-called  $P_0$  reduction – followed by a correspondingly lower value of  $X$ .

These concepts of a building block approach, a glide-path and a  $P_0$  reduction, have in general been maintained in the UK and increasingly adopted worldwide.

## **7. Price caps and revenue caps**

What changes have been made to the format of the price controls? An early example was the issue of whether to set a price cap or a revenue cap. The initial control set a cap on the price per unit. This meant that if the total electricity usage increased or decreased, the revenue of the transmission and distribution companies would increase accordingly. This increased the risk to the companies, which in turn increased the cost of capital, which ultimately would have to be paid for by customers. It was also argued to increase the incentive on the company to promote the use of electricity rather than encourage energy efficiency. A subsequent price control on the transmission company replaced the per unit price cap by a total revenue cap. However, this had the adverse effect of increasing the risk to customers of fluctuating prices if throughput fluctuated unexpectedly, which it did in the case of a Scottish interconnector whose availability did not meet expectations. The next price control on the distribution companies embodied a 50-50 weighting of actual and expected output, thereby sharing the output risk between company and customers and providing some acknowledgement of energy efficiency considerations. This is an example of

regulatory control reflecting learning from experience and responding to changing priorities of public policy.

## **8. Capital expenditure predictions and outcomes**

Another example of modification of price controls over time would be the treatment of actual capital expenditure in relation to earlier projections. At the time of the first price control reviews, it was not clear what levels of capital expenditure had been assumed in setting the controls, so it was not possible to compare actual against projected expenditure. At the time of the second price control reviews it was possible to make such comparisons. Typically the companies had invested a little less than assumed. The water regulator argued initially that this was to be expected, and consistent with the efficiency aims of the regulation. In electricity, there was more concern as to the fairness of rewarding companies for investment that they had asserted was necessary but had not in fact carried out. Over time, this issue was dealt with in various ways, including by adjusting the Regulatory Asset Base to reflect actual rather than assumed expenditure, by seeking greater agreement on future capital expenditure plans, by providing incentives to forecast accurately (and penalties for failing to do so), and by making allowed capital expenditure more conditional on (e.g.) the growth of demand and the actual emergence of new generation.

## **9. Quality of supply and other incentives**

Practice has also evolved with respect to quality of supply. There were always obligations on companies to meet specified standards of performance. The question arose whether it would be desirable to strengthen the incentives to meet and beat such standards by incorporating additional financial rewards and penalties in the price control. Initially I took the view that this was unnecessary and could be problematic insofar as the accurate measurement of quality standards was sometimes difficult, the abilities of companies to respond and the preferences of customers were largely unknown, and companies differed in their particular circumstances. However, my successors decided to move along this path, and in recent controls there have been quite extensive incentives and penalties of this kind, albeit limited in the impact they can have on total revenue.

Other new incentives have related to loss factors in distribution companies. Reportedly the introduction of these incentives has reduced distribution losses considerably.

## **10. Degree of regulatory involvement**

Originally, the regulatory thinking was that price controls would be set for, say, five years, then the regulator would let the companies get on with things provided they continued to meet these controls. The situation would be comprehensively reviewed five years later in setting a new control. Increasingly, however, the controls have required feedback, monitoring, discussion and sometimes action in each year within the control period. For example, one aim has been to avoid the burden of agreeing five years worth of operating and investment data at one time, and to agree this on an ongoing basis. Another consideration has been the smoothing of operating and investment appraisal and incentives from one price control to another to minimise the

incentive to game the system by loading expenditure in the last year or two of a price control period. Yet another consideration has been the need to respond to uncertain and ever-changing data more rapidly than once every five years. The consequence of this is that the regulatory body is increasingly involved with price controls on a continuous basis rather than at five yearly intervals.

## **11. Complexities and ongoing evolution**

A final consideration that is increasingly of concern is how price controls should respond to environmental, technological and market considerations that are presently difficult to forecast. For example, it is not clear what kinds and mixes of generation technologies will be appropriate to deal with global warming concerns – what combination of gasfired, clean coal technology, nuclear, offshore and onshore wind, solar, biofuel and other generation technologies will emerge? Where will such generation be located? How far will it be distributed throughout the network or at demand sites rather than located in places far from demand? How far will demand reduce because of energy efficiency? What size and kind of transmission and distribution network will be required, and should new and different control technologies be built into the local distribution networks? How far should such networks respond to the actual emergence of generation or be constructed in advance so as to facilitate or influence or direct the emergence of such generation? Who should assess and take the risks involved, and who should pay for them?

As yet, regulators do not have all the answers to such questions. However, they are certainly looking at further modified versions of price controls, or complements to them, as means of responding to these changing circumstances. For example, they are looking at the possibilities of bilateral contracts between generators and networks as means of sharing the risks of new investments, and increasing the incentives to efficient coordination of such activities.

## **12. Summary of UK experience**

To summarise, UK experience has shown that a price control methodology does not have to be imposed by statute or government. Under appropriate circumstances it can be developed by the regulatory bodies as part of an interactive process with those affected by it. There seems to be no single answer to the question of what price control methodology is correct. The most appropriate methodology seems to have varied in detail by sector although there have been significant common features. Finally, and importantly, the methodologies have evolved – and have needed to evolve - over time in the light of experience and to meet different and changing circumstances.

## **13. Implications for New Zealand**

What are the implications for New Zealand? The Discussion Document asks (chapter 8) whether there is value in setting key input decisions in advance of an enquiry, whether it is possible to set generic input methodologies that could apply to all potentially regulated sectors, and whether such input methodologies should be set by the Commerce Commission or by the Minister or by a separate independent body.

The Document considers that, “on balance ... it is likely that certainty, transparency, predictability and quality of regulatory outcomes will improve if input methodologies are set in advance of the inquiry and following a transparent consultation process”. (para 138) It notes that “any Ministerial involvement may be perceived as simply lengthening the process, reducing the Commission’s levels of independence, and increasing the scope for politicising the process”. (para 141) It says that the Commerce Commission has the appropriate technical expertise to make the relevant judgements, but this would lack ‘checks and balances’. These could be provided by a merits review, but this might be costly and time-consuming. An independent body would also be costly. The Document suggests that “It is likely that such ‘checks and balances’ can be provided at relatively low risk if the Minister’s powers are limited to accepting, rejecting or referring back recommendation[s] from the Commission.” (para 141)

UK experience has not involved any such specifications beforehand. A satisfactory outcome has resulted from the relevant sector regulator considering and deciding upon the appropriate methodology in each particular case. This has been on a case-by-case basis, but regulators have built on precedent and modified it in the light of experience. There has been no suggestion that a policy move towards pre-specification would be necessary or desirable. Nor has there been any suggestion that it would be helpful for ministers to be involved: on the contrary, an important aim of privatisation and regulation was to reduce the scope for government involvement, which was considered an integral part of the problem.

It is important to stress, however, that this approach has been grounded in a process of decision-making that obliges the regulator to have full regard to the concerns and circumstances of the companies as well as the customers. Ultimately the regulator’s proposed approach has to be acceptable to the companies themselves, or otherwise has to be justifiable to an independent appeal body, as discussed in Section II below.

An attempt to pre-specify generic input methodologies or key input decisions in the abstract, regardless of whether these are developed by the Commerce Commission or an expert body, could cause difficulties in the treatment of specific actual cases. It is also important for there to be a degree of flexibility in the way in which a regulator approaches new issues over time. The involvement of Ministers is problematic in both respects. The Discussion Document correctly observes that appropriate checks and balances on the Commerce Commission’s actions could be provided by merits review. In my view, the Document understates the advantages of such a merits review and overstates its disadvantages. Greater weight should therefore be placed on developing an appropriate merits review framework to ensure confidence in the regime as it evolves over time.

It might be argued that the degree of uncertainty and lack of confidence in regulatory procedures is very great in New Zealand at the moment, and that this is a major concern for the utility companies that have significant investment programmes at risk. In these circumstances, some further augmentation of the Commerce Commission’s duties might be helpful. In the UK there has been an attempt to identify the ‘Principles of Better Regulation’ and increasingly to incorporate these in the statutory obligations on utility regulators (and others). There would seem to be advantage in a similar approach in New Zealand. For example, the Commerce Act might prescribe that the

Commerce Commission should discharge its functions in a way that is proportionate, accountable, consistent, transparent and targeted only at cases in which regulatory action is needed. In the present context, it might be helpful to require that the Commerce Commission should seek to secure a reasonable consistency between its decisions in setting thresholds and its decisions with respect to intentions to declare control and subsequent authorisations (actually setting price controls). I suggest in section III below that the Commerce Commission might be required to recognize or establish rules, practices and procedures that facilitate negotiated settlement. If the 'propose/respond' model is to be taken further, then the Commerce Commission might be required to indicate the kinds of proposals that it would be likely to find acceptable.

These recommendations are not to rule out the possibility of the MED or the Commerce Commission inviting an Expert Panel to consider particular issues of relevance to the Commerce Commission's approach, with a view to the Commerce Commission taking the Expert Panel's views into account in its future statements and determinations. As explained in Section II below, this has been found helpful in Guernsey.

## **SECTION II THE UK MERITS REVIEW PROCESS**

### **14. The Discussion Document**

It will be helpful to relate the discussion of experience in the UK to the summary of these issues in the Discussion Document (chapter 12). This explains that a merits review is a review of the substance of a regulatory decision rather than of its process. It typically complements rather than substitutes for judicial review.

The Document sees four potential benefits

- better incentives for high quality analysis and decisions by regulator
- correcting poor quality decisions in individual cases
- providing principles and guidance for future cases
- reducing the incentive or need for political processes and lobbying.

The Document sees four potential problems

- costs of litigation for regulator and businesses, plus extra funding for regulator to get it right first time
- delays to regulatory process
- potential for simply different rather than better outcomes
- incentives for regulated businesses to game the system by seeking the preferred decision-maker.

The Document then discusses further aspects of the design of a merits review system:

- which regulatory decisions should be open to merits review?
- what form of merits review (is new evidence allowed and what is the presumption about the correctness of the original decision)? and
- what is the appropriate review body (judges? Assisted by a lay member? Specialist Tribunal? Same body as for judicial review?).

### **15. The UK approach**

When UK utility regulation was established, Parliament was conscious that it was not possible to specify in advance what kind of regulation was appropriate, and that the regulator needed flexibility to adapt to experience and changing circumstances. At the same time Parliament recognised that giving excessive power to the regulator, or the unreasonable exercise of this power, would discourage the significant levels of investment that were needed in the newly privatised industries.

Legislation therefore provided that utilities would be given a licence specifying their obligations (such as a price control). The regulator could propose changes to this licence (such as a revised price control). If the licensee agreed, the changes would take effect and could be enforced. If the licensee did not agree the regulator could not impose the changes. But the regulator could refer the matter to the Monopolies and Mergers Commission. (This was an existing body for hearing competition cases brought by the Office of Fair Trading, later renamed the Competition Commission, henceforth the Commission). The Commission had to judge whether the initial situation without the change was against the public interest, and if so what change in

licence conditions would be appropriate to remedy the situation. In the latter case the regulator was empowered to make such changes to the licence as seemed appropriate to remedy the adverse effects identified by the Commission. In determining the public interest, the Commission was required to have regard to the statutory objectives of the utility regulator.

In simple terms, if a utility objects to a regulator's proposal to change a licence condition, the regulator can withdraw or reconsider the proposal but in practice generally refers the issue to the Commission. The Commission hears what both sides have to say, asks various questions and often asks for further evidence. It invites the views of all interested parties, not just the regulator and the utility. It then explains in some detail (in at least as much detail as the regulator gives and often more) what its conclusion is. Typically it does not simply agree with the regulator or the company, but comes up with a proposal that differs in some ways from the earlier one. Almost invariably the regulator then implements that decision. (In one case the regulator decided that a different decision, more like his original one, best remedied the detriments identified by the Commission, but this was exceptional.)

There are certain differences between the different utility sectors, and the provisions have evolved slightly over time. Nonetheless, what I describe below applies broadly to the electricity, gas, telecommunications and water sectors (and with some modifications to post and railways too).

## **16. Potential benefits**

What does UK experience say about the benefits identified by the Document?

- a) Better incentives for higher quality analysis and decisions by the regulator

I believe that this is the case. I can say from practical experience as electricity regulator that I was always conscious that I might have to justify both my analysis and my decision to the Commission. I would constantly ask myself: would this evidence or this argument convince the Commission? (I had sat as a member of the Commission for the previous six years so I had some insight as to how Commission members might feel.) I suspect that this awareness of the potential need to convince the Commission carried some weight with the utilities too.

- b) Correcting poor quality decisions in individual cases

I would not want to suggest that individual regulatory decisions in the UK were or are or otherwise would generally be of poor quality. However, the process does allow a fresh set of eyes to look at some aspect of a regulatory decision away from the heat of the immediate regulatory process, and arguably thereby improves the outcome. Let me give two examples.

- (i) As the culmination of a price control review in 1994 I made proposals for all 14 electricity distribution utilities. 13 accepted, one did not. I referred that one (in the North of Scotland) to the Commission. As with all the utilities, I had set the price control on the basis of lower future capital expenditure (capex) and operating expenditure (opex) than the utility had

argued for, and tried to take a uniform approach across all the utilities. The Consumer Committee in the North of Scotland sided with the utility on the issue of capex, arguing for greater capex in order to bring about higher quality of supply, since that was hitherto lower in that area than in the rest of the UK. The Commission heard what all parties had to say, then decided on higher capex than I had allowed, but also lower opex, with the outcome a price control slightly tougher than the one that I had proposed. Although I had argued that such additional capex would be uneconomic given the relatively high cost per customer affected compared to the other utility areas, in retrospect it is hard to argue against responding to the wishes of the local consumer representatives in this way.

- (ii) My successor at Ofgem at one point took the view that all generating companies should agree to follow certain practices and to cede certain powers to the regulator, in order to deal with potential anti-competitive practices. Some generators agreed, others did not. The regulator took the issue to the Commission. It concluded that the case had not been made, and that the regulator was already taking other steps to deal with the situation. In retrospect, the lack of the restrictions and powers sought does not seem to have been a problem for Ofgem.

c) Providing principles and guidance for future cases

The UK process does seem to have led to this benefit. A good example would be with respect to cost of capital. The Commission has set out its methodology and its reasoning for particular components of the cost of capital. Regulators and utilities have recognised that they cannot depart significantly from this approach otherwise they will be challenged and likely defeated at the Commission.

In addition, electricity, gas, water, telecoms and airport cases can be and have all been referred to the Commission. This means that the process of review by the Commission has brought about a greater degree of consistency between regulators on cost of capital than would otherwise have been the case.

Principles and guidance go beyond this one cost of capital issue. For example, in my first price control reviews, I followed the practice hitherto adopted by other regulators. I did some financial modelling that was shared with each individual company on a confidential basis, but the final proposals and the specific assumptions that they were based upon were not set out in detail. In contrast, the Commission set out its assumptions and calculations line by line. This has been the practice adopted by regulators ever since.

d) Reducing the incentive or need for political processes and lobbying

I think this must be the case. A utility has less need to lobby the regulator, politicians, the government or the media because it has a further opportunity to argue its case if the regulator's decision goes against it. For their part, politicians and ministers can point to this opportunity rather than feel under an obligation to take sides in the matter or put pressure on the regulator. If the Commission decision goes for the utility, the utility is satisfied. If not, these parties can ask

whether the utility's case is all that strong if not only the regulator but also the Commission have found against it.

The process thereby provides some reassurance for the regulator, too. If he or she is worried about being unduly harsh on the licensee, the comfort is that an appeal process is available if the utility feels aggrieved.

## **17. Potential problems**

- a) Costs of litigation for regulator and businesses, plus extra funding for regulator to get it right first time

I mentioned that as regulator I was conscious that I might have to justify my analysis and decisions to the Commission, and that this tended to improve the quality of regulation. However, I did not feel that this took a great deal of extra cost, it was rather a matter of using judiciously what information one had. It does seem to be the case that regulators and utilities incur more and more costs on price controls and certain other regulatory issues than they used to do, but this seems to be inherent in the UK regulatory process (and elsewhere). I have not heard it attributed to the Commission appeal process, and the infrequency of the appeal process in recent years (see below) suggests that this has not been a significant determinant of regulatory funding.

An appeal to the Commission does indeed cost something, in terms of the management time and consultancy on both sides. However, the bulk of the work has already been done as part of the discussions with the regulator leading up to the proposal at issue. That material typically is presented to the Commission, along with each side's confidential advice from its consultants. So the additional cost is mainly a matter of explaining to the Commission what the issue is all about, answering the Commission's questions and appearing before it to argue the case.

The costs and other disadvantages would be higher if reference to the Commission were a regular occurrence. In practice it is not, for at least two reasons.

The first reason is that, since a reference to the Commission is costly to the utility, the utility is loathe to employ that approach. It takes up further valuable management time, typically after a long and intensive price control review process that has already taken up a lot of management time and has thoroughly debated all the issues. There are strong pressures on the board to get back to business, and to implement the increased efficiency measures that are typically required. One utility Board chairman indicated to me that a complaint about a regulatory proposal had to be quite significant in order to justify appealing it to the Commission. (He suggested that the revised decision would have to result in at least £25m in additional revenues, if I remember correctly.)

The second reason is that the utility can end up no better off, or even worse off, if it fails to convince the Commission of its case. In the second example I mentioned above, the generators won their case and the regulator abandoned its plans to impose the additional licence condition. In the first example mentioned, the utility

ended up with additional capex obligations, the expectation of greater improvements in operating efficiency and slightly lower allowed revenue. In another case, the mobile telephone operators appealed against the reductions in termination charges set by the regulator, and the Commission concluded that the reductions should be even more severe. In general, I don't think one could say that the expectation would be that a utility appealing against a regulatory decision would be likely to be better off as a result – the range of outcomes is too mixed to predict either way.

As a result of these two considerations (and, I hope, the reasonableness of the UK regulatory process before that stage), the number of licence modification appeal cases going to the Commission has been rather small. In the nearly ten years that I was electricity regulator, there was only the one case mentioned. I doubt if there have been more than about half a dozen in electricity, gas, telecommunications and water sectors combined over a period of about 20 years, even though there are about a hundred major licensees. In fact, the present chairman of the Commission has recently pointed out that there has not been a licence modification reference for over five years. (There have been other references to the Commission in connection with mergers and takeovers, but this is a separate process driven by the competition authorities rather than by the utility regulators.)

#### b) Delays to regulatory process

Since there have been relatively few appeals to the Commission, the extent of delay has been minimal in the aggregate.

There is of course an impact in the particular case where a reference is made to the Commission. However, provision for this is made in the process. The Commission is required to report within six months. A price control review (for example) is therefore scheduled to take about a year, concluding with recommendations about six months before the new prices are due to be implemented. If all licensees agree, the six months are in any case taken up with working out the detailed wording of the licence changes to embody the proposed revised price control, any necessary organisational or reporting arrangements, and notifying customers and other users.

Where a licensee objects and the matter is referred to the Commission, the above work still takes place and it may still be possible to implement the new price control on schedule (if the Commission finds for the regulator or recommends only a small change). Often the regulator and utility agree to implement all or part of the regulator's original proposal on schedule, and to implement the final outcome of the Commission's review up to a year later (with appropriate adjustment for the deferred revenue). So regulatory delay has not been a significant concern in practice.

#### c) Potential for simply different rather than better outcomes

There has been one case (noted earlier) where the Commission was effectively presented with a Yes/No decision (namely, is this licence change needed or not?) and decided against the regulator. But in most cases the question has been whether the proposed price cap is at a reasonable level, or too severe. What is noticeable

here is that, even where it differs on some element of that calculation, the Commission has confirmed that the original regulatory approach was a reasonable one. This has been valuable in reinforcing confidence in the regulatory regime even in those cases where references are not made to the Commission.

In respects where the Commission's recommendation is different from that of the regulator, I think (though this is a subjective matter) that the general impression is that the Commission's decision is a more defensible one. I don't sense that anyone challenges the UK appeal process on the grounds that it just substitutes one judgement for another, without any basis for doing so. Nor, given the relatively small number of cases going to the Commission, has there been a danger of the regulator being undermined by this process.

- d) Incentives for regulated businesses to game the system by seeking the preferred decision-maker

If the Commission had systematically favoured utilities appealing to it, and if the regulators had not responded over time to what the Commission was saying, then the utilities could have had an incentive and opportunity to game the system. But the Commission did not do that, and for the reasons given above utilities have not made frequent use of the appeal process. In the one case where some might have argued that the companies (mobile operators) were gaming by spinning out the process, they were hit with tougher price controls than the regulator originally proposed. So UK experience does not suggest that the utilities use the appeals process as a means of gaming.

## **18. Other issues**

The Document discusses three further aspects of the design of a merits review system. I take these in turn.

- a) Which regulatory decisions should be open to merits review?

Much of this discussion is specific to conditions in New Zealand, so I shall not get into that here. Suffice it to say that in the UK, a proposed change to a license condition is subject to a reference to the Commission if a licensee declines to accept it. So whatever is proposed to be changed in a licence effectively determines the set of decisions that are subject to appeal.

A couple of additional points may be noted. First, there is power for the Secretary of State to veto any licence amendment proposed by a regulator, or to veto a reference to the Commission. (Though if the Secretary of State allows the reference he may not prevent the regulator from implementing the Commission's recommendations.) I am not aware that this power has actually been exercised. Knowledge that the Secretary of State has this power and might exercise it may conceivably have discouraged some regulators from proposing changes that would be problematic for the government, but I am not aware that any regulator has felt discouraged from making a licence amendment reference to the Commission.

Second, there are increasingly cases where it is convenient to embody in licenses certain uniform rules of procedure or Codes (eg with respect to the operation of markets or dealing with customers) that typically refer to large numbers of licensees. It might be appropriate at some point to modify some of these Codes. Having to get the approval of every licensee to a proposed licence modification could present difficulties. Recently, provisions have been introduced for approving such Code modifications on a majority basis, still with an appeal procedure to a subset of Commission members.

- b) What form of merits review should be envisaged? Is new evidence to be allowed or should the review use only the previous evidence? Should the original decision be presumed correct or not?

In the UK, in principle any arguments and evidence can be adduced. In a sense the Commission can also identify new problems, as well as new solutions to the previously identified problems – or at least, new aspects to the public interest issues identified by the regulator. In practice, however, the regulator and the utility start by submitting (and explaining) the same material as discussed between them previously, including the material published by the regulator in the form of consultation documents and the final proposal. There is no objection to either side (or third parties such as the Consumer Committee) providing new evidence if it helps to shed light on the specific items at issue. The six month time limit effectively constrains the extent to which new evidence is presented, although if such evidence had been available it would probably have been brought forward earlier. Typically, I suspect, the review process is not primarily a matter of providing new evidence, but of teasing out more carefully some arguments that may have been glossed over a little in the earlier exchanges between the regulator and this particular licensee.

- c) What is the appropriate review body? Should it be one or more judges? Should they be assisted by a lay member? Or should there be a Specialist Tribunal? Should it be the same body as responsible for a judicial review?

The Commission in the UK is not comprised of judges. It presently has about fifty part-time members, being a mixture of businessmen, economists, former civil servants or local government officials, consultants, lawyers, trade unionists, people from the voluntary sector, and others. (Nowadays they are reimbursed only when actually engaged in references.) Some members of the Commission were appointed primarily for the purpose of assisting with utility licence amendment references, and these may have qualifications and experience more closely related to the utility sector.

The purpose of the reference to the Commission is not to ask the same kind of questions as a judicial review would ask, such as whether the regulatory decision followed due process and was consistent with the evidence available. Rather, it is to ask whether the regulatory decision was a fair and sensible one, a decision that balanced the interests of the parties in a way that the Commission found acceptable. For this purpose, specialist legal training has not been found necessary on the part of the Commissioners.

Of course, the Commissioners are backed up by staff that include lawyers as well as economists, accountants and others. The Commission may well appoint its own technical consultants on some price control issues. (As indeed they did when assessing the arguments of the utility versus the regulator in the case of capital expenditure in the North of Scotland.)

The suggestion that the relevant body should be the same as for a judicial review is surprising. The two sets of issues would seem to require a quite different expertise and approach.

### 19. Experience in Guernsey

Clearly it will be relevant to consider what kind of expertise is available on these matters in New Zealand. This might include access to international advice, e.g. from Australia. The following experience in Guernsey suggests that it is possible for a small country to provide the substance of a merits review in a relatively short time using relative few resources.

Guernsey is a small self-governing part of the UK. Its electricity sector is about one tenth of one percent of the UK sector. In 2002 certain of the States-owned utility departments were reconstituted as commercial companies, including Guernsey Electricity Ltd (GEL). A new Office of Utility Regulation (OUR) was also established. Differences of view soon emerged on regulatory issues, which mainly focused on the value of the initial assets in the Regulatory Asset Base and the appropriate return on capital. Legislation made no formal provision for a merits review in the conventional sense.

In December 2005 the regulator proposed a transitional one-year interim price control for GEL and at the same time proposed to appoint an Expert Panel to advise him on certain matters at the heart of the dispute. Over the next few months there were some discussions about the scope of the Panel. In May 2006 the regulator set out the terms of reference and named the three members of the Panel. These were Chris Bolt (UK Rail regulator), Sir Ian Byatt (Scottish water regulator and former England and Wales water regulator) and Professor David Newbery (Professor of Applied Economics at Cambridge and expert on utility regulation internationally). The regulator would make available to the Panel his draft proposal of December 2005, the government's Financial Framework document, and GEL's submissions to the price control review. In June the company made further submissions (including a paper by me). On 9 and 10 July the Panel visited Guernsey and met with interested parties including the regulator, government and GEL. On 27 July the Panel issued a draft report. Interested parties including GEL responded on 9 August, prior to a second hearing on 11 August. The Panel issued its final report on 21 August. This was a significant revision of its draft report in several respects, and notably included a novel proposal that the return on pre-reform assets be set at the level obtaining before 2002 and the return on subsequent assets be set at a commercial level. The regulator and GEL both accepted this proposal. The regulator implemented it in the next draft price control document of December 2006.

It was thus possible for a small country to use an expert panel to secure the substance of a merits review on the key price control inputs in some eight months from

announcement of the idea to receipt of the Panel's final report. The bulk of the work was actually accomplished in four months from the naming of the Panel and specification of terms of reference, and was not unduly onerous in terms of preparation and participation. It is not known how the three Panel members were chosen, and it is possible that the regulator discussed this issue with the government. But there was no disputing the expertise of the proposed Panel members, and this was generally accepted as a sensible way of resolving a difficult dispute. The precise nature of the ultimate solution could not have been expected beforehand, and incidentally might not have been consistent with any guidelines that might have been laid down beforehand.

## **20. Conclusions on merits review**

The UK has arrangements whereby a licensee can appeal to the Competition Commission against the substance of a regulator's proposal to change its licence, in addition to an ability to seek judicial review on the process. This equivalent of the merits review process was instituted to reassure and protect investors at the time of privatisation. It has worked well, been accepted by all parties and is now taken for granted. Indeed, it is difficult to see how the absence of such a facility could be tolerated in the UK.

The arrangements in the UK have indeed delivered the various benefits of merits review identified by the CC's discussion paper, and have not been associated with the potential detriments identified there. Of course conditions in the New Zealand utility sector differ in certain respects from those in the UK, and allowance needs to be made for this. Nevertheless, the experience of merits review as in the UK is such that I would strongly recommend it for consideration in New Zealand.

## **SECTION III**

### **ROLE OF FIRMS IN PROPOSING REGULATORY CONTROL TERMS**

#### **21. The Discussion Document**

Chapter 9 of the Discussion Document suggests (inter alia) that the Commerce Commission should be allowed to use a “customised approach” rather than comparative benchmarking, if this provides a more cost-effective and efficient outcome. This customised approach would take into account firm-specific investment plans, cost structures, demand growth and so forth.

The Document then explores whether the controlled firm should have a role in proposing its own regulatory control terms, with the Commerce Commission having some degree of discretion in accepting or rejecting the proposal. It suggests the possibility that the Commission should be required to accept proposals that meet specified criteria of reasonability, and examines possible criteria of reasonability.

#### **22. UK experience**

Experience in the UK suggests that there is advantage in allowing firms to propose approaches to regulation. Firms will in general be more familiar than the regulator with the circumstances of their own business and the wishes of their customers. This can also provide a source of new ideas and approaches.

However, where a number of firms has to be assessed on the same issue, such as a periodic price control, it is very difficult for a regulator to adopt different approaches for different companies. Partly this is a matter of the time and effort involved in customising the regulatory approach. But more fundamentally it is the difficulty of justifying - to other companies and to each set of customers and to the general public – that each company has been treated comparably with the others. I recall several such proposals from firms during the time I was regulating, that seemed interesting, but that had to be set aside because it did not seem possible or desirable to adopt the proposed approaches for the set of regulated firms as a whole.

A consequence of this is that there is less variety, less innovation and probably less suitable regulation for any particular firm, than there would be if a differentiated approach were able to be taken. In addition, it means that the regulator has to impose his or her own views on the firms and their customers – for example, in terms of the quality of supply to be provided by investment plans - rather than allowing the views of the customers themselves to determine the outcomes.

#### **23. Actively involving firms and customers**

I have therefore been considering the possibility of involving firms and customers more directly in the regulatory process. If firms and customer representatives could propose, discuss and agree proposals for regulatory control, then it would be more defensible for the regulator to accept such proposals. The regulator might need to specify or check that they met any other conditions that were deemed appropriate. But it would be easier for the regulator to say that it was prepared to accept a different approach if “both sides” had accepted it, than it would be otherwise.

The nature of such active customer involvement is important. To varying extents there is at present some opportunity for customers to express their views about transmission investment plans. There may be some concern that customers have insufficient information for this purpose. No doubt there is scope to improve this information.

However, customers need more than simply the opportunity to express an informed view. They need to be able to exercise a degree of control over (e.g.) whether a proposed investment goes ahead or not. This in turn means that firms will need to take into account - more explicitly than at present - whether the investments that they are proposing fully meet the needs of customers. This is not to say that every customer needs to be represented, or that unanimity is required. But some mechanism for representing customers' interests in negotiations with firms, and for indicating agreement or otherwise with proposals by firms, seems an important component of this approach.

It turns out that in many countries, utility regulation does indeed make provision for discussions and agreements of this kind, which regulators can then consider whether to accept. The remainder of this section examines some of the experience with such approaches, which are generally known under the heading of "negotiated settlements".

#### **24. The concept and practice of negotiated settlements<sup>1</sup>**

In many jurisdictions around the world, utilities are regulated by a traditional form of litigation process along the lines of US regulation. But in many of these jurisdictions including in North America itself, utilities and other market participants effectively propose regulatory control terms on a wide range of matters that are conventionally thought to be the province of regulation by means of litigation. They do so by means of negotiated settlements.

Traditionally, the regulated utility would provide information and give testimony. This would be challenged in court by the regulatory body and by intervenors. Then the regulatory body would decide the case. The settlement approach typically begins with the same initial process during which the company is required to provide relevant information. Then, in contrast to the litigated or regulated approach, interested parties including user and consumer groups negotiate a settlement or 'stipulation' with the regulated company. They put this proposal to the regulatory authority, and it is typically (though not always) confirmed.

This practice is apparently widespread. Settlements have been used in a wide variety of regulatory contexts.<sup>2</sup> At least one US state has actively demanded that a utility seek to achieve a settlement. I am told that settlements are widely used and supported in

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<sup>1</sup> This section draws heavily on J Doucet and S C Littlechild, "Negotiated settlements: the development of legal and economic thinking", *Utilities Policy*, 14, December 2006, 266-277.

<sup>2</sup> One study instances water, electric and telephone rate cases; sale of an electric plant and various ratemaking and accounting aspects of nuclear plant; and competition in telecommunications and new telecommunications offerings of private line service and customer-owned coin-operated telephones. Petruilis, R C. "NRRI Report: Commissions Use Negotiated Settlements to Expedite Regulatory Process", *NRRI Quarterly Bulletin*, 1985, 6: 379-390, at p. 381.

Australia, particularly in ports, freight rail infrastructure, gas pipelines and airports. However, there has been little economic analysis of the practice until recently. It may therefore be helpful to indicate how thinking and practice have developed, even though these settlements may not have focused on electricity transmission systems.

Settlements have traditionally been seen primarily as a way of economising on time and cost, or reducing uncertainty, compared to traditional regulation which proceeds by litigation. The implication is that the outcome is unlikely to be significantly different from the outcome of litigated regulation.

More recently, however, it has been suggested that settlements better serve the needs of the parties. This is not a new claim, but it is an aspect that seems to be increasingly appreciated. The reason is that regulators do not know the precise situations and preferences of the parties involved. They have to make judgements according to their own perceptions and preferences rather than those of the parties. Their choice is not necessarily what the parties themselves would choose, and therefore not necessarily as acceptable. Some consumer advocate practitioners put it this way.

[W]hen the regulator makes the decisions, everyone loses something, and parties have no control over what they lose. In the negotiation process, each party chooses which among the many points it is willing to lose in order to gain something else. Although this may sound like a distinction without a difference, in fact, the trade-offs arrived at voluntarily are much more stable and effective. Negotiated settlements are actually more democratic because all parties participate in the decision. As a result the terms are more likely to be implemented with enthusiasm and effectiveness than if they had been imposed from above by a regulator. Furthermore, in an atmosphere of trust and negotiation, more information is freely shared, with the result that more comprehensive solutions can be developed.<sup>3</sup>

The greater involvement of parties themselves means that a wide range of issues is susceptible to settlement, and “some kinds of utility cases can be better resolved through negotiation than litigation.”<sup>4</sup> This is because “negotiation allows the parties themselves to make the trade-offs, instead of leaving it to the regulator to split the difference.”

Negotiated settlements also allow greater flexibility and innovation, and can achieve results that lie beyond the traditional litigated approach. It has been argued that the flexibility inherent in the settlement process may be by far the most telling ground for its encouragement, particularly in the evolving competitive context.

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<sup>3</sup> G J Palast, J Oppenheim and T MacGregor. *Democracy and Regulation: How the public can govern essential services*, London and Virginia: Pluto Press, 2003, p. 96.

<sup>4</sup> Palast et al. “These include energy conservation or efficiency programs, and payment and other assistance to the poorest citizens of society.” (p. 88) “Besides energy conservation cases, other types of cases have been successfully negotiated and settled, including the guiding principles of electricity industry restructuring in Rhode Island and Massachusetts, price-setting cases in New York and elsewhere, and cases in which the regulator was reviewing the operating performance of generating plants owned by an electric utility.” (pp. 96-7)

Flexibility is especially important now, as the utility marketplace moves from integrated monopolies to multi-party and/or unbridled competition. Since full and effective competition will take years to accomplish, parties to utility proceedings must effectively function in this largely undefined transitional period. The creation of the new competitive environment will be far more successful if stakeholders are able to talk openly, share ideas, and challenge the traditional approaches that once suited the monopoly marketplace. ... By exploring new approaches, parties will be able to fashion solutions beyond the regulatory authority of a commission when they do not violate any important regulatory principle or practice.<sup>5</sup>

## **25. Evidence from US: negotiated settlements for gas pipelines at FERC**

In the US, negotiated settlements appear to have been initiated or at least strongly encouraged by the Federal Power Commission (FPC) during the early 1960s as a way of working off a large backlog of regulatory applications. The view that settlements should become an objective of regulatory policy seems to have been accepted at the Federal Energy Regulatory Commission (FERC), which superseded the FPC in 1977. By 1980 settlements were reached in approximately two-thirds of all electric utility rate cases there, and in 1986 in over 70 per cent of gas pipeline rate cases. It was once claimed that FERC “resolves approximately 80 per cent of its caseload through negotiated settlements.”

Settlements evidently developed in various State commissions as well as federal ones. It would not be surprising if the majority of US States have now recognised settlements of some kind.

Recent research on FERC practice confirms the claims about the extent of settlements and the benefits of this approach. One study set out to determine how the settlement process at FERC differed from the formal adjudicatory process, how the outcome differed, and why the players settled a case.<sup>6</sup> The author examined 41 natural gas pipeline rate cases from 1994 to 2000, of which 34 were settled in whole, 5 were settled in part, and two were fully litigated. He noted that a typical case involved many issues.<sup>7</sup> He found that “the informal settlement process differs fundamentally from the litigation process, thus leading to significantly different outcomes.”<sup>8</sup> The most significant outcome was one that FERC could not impose in a litigated case.

Perhaps the most innovative settlement outcome is the rate moratorium provision in 21 of the 39 settlements in the sample. It is remarkable that the

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<sup>5</sup> A P Buchmann and R S Tongren, “Nonunanimous Settlement of Public Utility Rate Cases: A Response.” *Yale Journal of Regulation*, 1996, 13: 337-345.

<sup>6</sup> Zhongmin Wang, “Settling Utility Rate Cases: An Alternative Ratemaking Procedure”, *Journal of Regulatory Economics*, Vol. 26, No. 2, September 2004, pp. 141-164.

<sup>7</sup> These include “the quality and variety of the services, the level and structure of the service prices, the inputs, and many other contractual issues such as the contract length and the timing of the following rate case”. (p. 142)

<sup>8</sup> “In order to reach the ‘just and reasonable’ end result for a litigated case, FERC follows an issue-by-issue merits determination procedure. That is, FERC makes a separate decision on each of the issues, based on the findings of fact and its rules, policy and precedents. During the settlement process, however, the players could focus directly on the end result by bargaining over all the issues together as a package, so that they can make tradeoffs among the issues.” (p. 142)

rate moratorium, a simple form of price cap regulation, arises endogenously from the settlement process of the traditional rate of return cases. FERC is prohibited by the governing statute from imposing a rate moratorium on the pipeline in a litigated case, but is free and willing to approve settlements with rate moratoria. (p. 142)

There is perhaps a question as to how far these rate moratoria were intended as a simple form of price cap in the sense of incentive regulation, as opposed to a way of providing a time at which the terms would be reviewed. However, the conclusion is not in doubt, that the main purpose of settlement was not to reduce uncertainty about regulatory decisions, but to achieve an outcome that could not be achieved under litigation.<sup>9</sup>

For present purposes, the main point is not so much to emphasise the innovative nature of negotiated settlements approved by FERC, though this is important. Rather, the purpose is to show that pipelines have been able to propose regulatory control terms that have proved acceptable to their users or customers, and that these parties are indeed able to come to agreement on rate cases. Moreover, this approach has improved relationships between the parties. That is surely conducive to better coordination and more efficient investment.

## **26. Further evidence from US: negotiated settlements (stipulations) in Florida**

The evidence and conclusions at FERC are mirrored by those in Florida.<sup>10</sup> The Office of Public Counsel (OPC) has negotiated many settlements (stipulations) of rate cases before the Florida Public Services Commission (PSC). The OPC was set up to represent the citizens of Florida in utility matters. It often worked in tandem with representatives of consumers, particularly (but not only) larger ones.

For gas, electricity and telephones sectors in total, stipulations were agreed in 31 per cent of earnings reviews. These stipulations brought tangible benefits. From 1976 to 2002 stipulations accounted for 77 per cent of rate reductions, but only 0.7 per cent of allowed rate increases.

There is evidence that these settlements secured a much better deal for customers than regulation would have done. Across these three sectors, the average value of a rate reduction was \$49.6m with a stipulation and \$6.7m without. In the electricity sector,

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<sup>9</sup> “The empirical findings suggest that the players settle a pipeline rate case mainly to make the tradeoffs that cannot be made during the litigation process. Avoiding the uncertainty in the formal adjudicatory process is of secondary importance because the litigation outcome is apt to be fairly predictable, and for some cases is known.” (p. 143) “The settlement approach to ratemaking substantially expedites the regulatory process and leads to creative solutions that cannot be achieved through ratemaking.” (p. 162)

<sup>10</sup> Stephen Littlechild, “Consumer Participation in Regulation: stipulated settlements, the consumer advocate and utility regulation in Florida”, Market Design 2003 Conference, Stockholm, 17 June 2003, Slide presentation and conference paper (called Report) in *Proceedings* at [http://www.elforsk-marketdesign.net/archives/2003/conference/conferencemain\\_en.htm](http://www.elforsk-marketdesign.net/archives/2003/conference/conferencemain_en.htm). Also Stephen Littlechild, “Stipulations, the consumer advocate and utility regulation in Florida”, Electricity Policy Research Group Working Paper No. EPRG 06/15, February 2006, and “The bird in hand: stipulated settlements in Florida electricity regulation”, EPRG Working Paper 0705, February 2007, University of Cambridge, at <http://www.electricitypolicy.org.uk/pubs/index.html>.

nine stipulations accounted for \$3.8bn worth of rate reductions. Detailed examination suggested that most of these reductions were attributable to the stipulations. They would not otherwise have been achieved. At the very least they were achieved earlier than they otherwise might have been.

What did the utilities gain from settlements in return for these very significant rate reductions? They saved some costs, but these savings were relatively small, estimated at under 0.5% of the amounts involved in the settlements. Perhaps companies avoided some uncertainty or embarrassment of public hearings. But mainly they achieved innovative modifications to the traditional Public Service Commission procedures, sometimes in the face of advice by Commission staff.

One example of such a modification was more flexible accounting procedures (including deferring accounting provisions, and either not increasing depreciation or even reversing it). More importantly, however, companies and users were often able to agree the adoption of revenue-sharing incentive arrangements lasting several years instead of traditional rate of return regulation or earnings-sharing schemes. That is, they were able to remove a limit on profits in return for accepting a limit on prices or revenues. In effect, they managed to achieve an incentive price-cap approach to regulation, which the traditional US framework of regulation via litigation was unable to deliver.

It remains to be seen whether Florida's experience is unique, associated with the person appointed as Public Counsel during this whole 25 year period, and also whether negotiated settlements will continue to be agreed during a period of potential rate increases rather than rate reductions. Whether it would generally be helpful to introduce or increase the role of consumer advocates in New Zealand is beyond the scope of this paper. But the idea of negotiated settlements between utilities and customer representatives deserves further consideration.

## **27. Evidence from Canada: negotiated settlements for oil and gas pipelines<sup>11</sup>**

Negotiated settlements have been encouraged by the National Energy Board (NEB) in Canada since the late 1980s and widely adopted since the mid-1990s. In contrast to the FPC in the US, the NEB was not driven by a desire to reduce a backlog of cases, although there was certainly an aim to reduce the frequency and duration of regulatory proceedings. Government deregulation policy was also an influence.

Importantly, oil and gas pipelines and shippers realised they could achieve their ends more effectively and more surely with settlements than they could by conventional litigation. Multi-year incentive agreements developed particularly rapidly among all the pipelines. Settlements have also been used to specify and improve service quality, revise information and publication requirements, and agree investments and risk-sharing arrangements for new facilities. One particularly innovative settlement provided for the transition of one pipeline's gas gathering and processing services from one type of regulation (conventional litigation) to another (a specially designed scheme of light-handed regulation). This latter scheme provided for negotiated

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<sup>11</sup> This section draws heavily on J Doucet and S C Littlechild. "Negotiated settlements and the National Energy Board in Canada", Electricity Policy Research Group Working Papers, No. EPRG 06/29, November 2006, University of Cambridge, at <http://www.electricitypolicy.org.uk/pubs/wp.html>.

settlements with individual shippers, information provision to facilitate price discovery, interconnection terms to reduce barriers to entry, and a complaint-handling procedure that envisaged the NEB as the last resort rather than the first.<sup>12</sup>

With the exception of one gas pipeline during the four-year period 2001-4, negotiated settlements have superseded the litigation of oil and gas pipeline toll and tariff cases for at least the last decade. They have also streamlined the regulatory process. For example, settlements last between 50 per cent and 150 per cent longer than previous litigated outcomes, and NEB processing times have been cut by between a quarter and two-thirds. Settlements have also provided a new forum for collaboration and increased value creation between pipelines and their customers. Observers and participants are in no doubt that this could not have occurred under the traditional litigated approach to utility regulation.

The key contributions of the NEB seem to have been twofold. One was to modify the settlement guidelines in 1994 to say, in effect, that if the process of settlement was acceptable (i.e. was open to all interested parties and reached general agreement) then the Board would deem the outcome just and reasonable and would not 'cherry-pick' the settlement. This assured the parties that their negotiations were not in vain. The other contribution was the 'generic cost of capital' decision that provided an explicit and uniform basis for annually updating the cost of capital of each pipeline in the absence of a settlement. This removed a main source of dispute and of market power, and thereby facilitated negotiation and agreement on the provision of services of increased value to customers.

In parallel with the development of negotiated settlements, NEB has put increased reliance on contracts instead of traditional regulatory procedures as a means of approving gas pipeline expansions.<sup>13</sup> Before granting approvals, the NEB must be satisfied that the pipeline expansion is necessary and that the associated tolls are just and reasonable. Traditionally, the NEB prescribed the provision of detailed information concerning supply, demand, purpose, justification and economic evaluation. It also required detailed information about project-specific gas markets and calculation of tolls based on a cost of service methodology with rate base, rate of return, rates of depreciation and operating costs prescribed by the NEB.

Since 1995, however, the NEB has approved a number of pipeline expansions based on risk-sharing agreements between the pipelines and shippers under which the shippers contract for capacity and agree to pay specified tolls. The existence of the contracts has sufficed to determine that the pipeline is needed and that the tolls are just and reasonable. With one exception these tolls were established by contract and not subject to cost of service methodology.

Ongoing research on the use of settlements at the Energy and Utilities Board (EUB) in Alberta suggests that the EUB takes a more 'hands on' approach than the NEB, and

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<sup>12</sup> On this settlement that provided for light-handed regulation, see also N J Schultz. "Light-handed regulation", *Alberta Law Review*, 37(2) 1999: 387-418.

<sup>13</sup> Keith F Miller, "Energy regulation and the role of the market", *Alberta Law Review*, 37(2) 1999: 419-436.

places more emphasis on generating information for the record.<sup>14</sup> Nonetheless, settlements have been increasingly adopted in Alberta, and take roughly half as long to complete as litigated cases. There, too, settlements have also been innovative. For example, one settlement introduced performance based rate making in the gas sector; another settlement was the means of implementing the Regulated Rate Option (RRO) in the electricity sector. The latter is an innovative form of retail price control based on a risk-sharing approach to energy procurement contracts, which is unlikely to have been possible under traditional litigation.

## **28. Evidence from UK: Constructive engagement and airport regulation**

An interesting recent development is the encouragement by the UK airport regulator (the Civil Aviation Authority or CAA) of so-called “constructive engagement” between British Airports Authority (BAA) airports and their airline users.<sup>15</sup> The aim of this arrangement is that the airports and their users should agree the main elements of a business plan for the foreseeable future. This includes traffic forecasts, investment requirements and other parameters relevant to the CAA’s price control review for the forthcoming quinquennial period 2008 - 2013. The CAA will need to satisfy itself that the interests of any parties not represented around the table are adequately protected. Subject to that, the intention is that the CAA will then accept those plans agreed by constructive negotiation rather than make its own determinations on these matters.

Previously, there had been numerous tensions between airlines and BAA. However, good progress is reported at BAA’s two largest airports (London Heathrow and London Gatwick). There has been substantial agreement on almost all the above matters. Moreover, the parties have reported improved relationships and a desire to continue the process beyond this price control period.

In contrast, agreement has not yet been reached at BAA’s Stansted airport. There is a difference of view as to the case for an expansion here, with the (predominantly low-cost) airlines disputing the need for an extension of the size and expense and timing proposed by the airport. There are also political issues involved, since the government previously gave priority to an extension at Stansted in preference to the expansion plan at Heathrow favoured by many airlines.

While this constructive engagement process is not yet complete, UK experience to date suggests that users and airports are indeed capable of negotiating mutually agreed and acceptable airport investment plans. Failure to agree an investment is itself instructive, and may be a salutary constraint on excessive or untimely investment.

## **29. Summary and implications of international experience**

The examples given above differ in various respects. They cover actual experience in a variety of different sectors and countries: gas pipelines at FERC in the US and utilities generally in Florida, oil and gas pipelines in Canada and electricity utilities in Alberta, and airports in the UK.

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<sup>14</sup> J Doucet and S C Littlechild. “Negotiated settlements and the Alberta Energy and Utilities Board” (research in process 2006).

<sup>15</sup> *Airports Review: Policy Update*, Civil Aviation Authority, 15 May 2006, chapter 8.

However, the experiences all have certain important lessons in common. In all cases, important aspects of the operation of these sectors are determined on the basis of proposals agreed between utilities themselves and customers of their networks. In some cases (eg UK airports), users agree demand forecasts and investments but not charges for usage. In other cases (eg FERC and Florida) users typically agree charges but not investments. In yet other cases (eg pipelines in Canada) users often agree both.

In all these cases, and often in face of initial scepticism, it has generally proved possible to obtain substantial agreement between the utilities and their customers, and between customers themselves. There has been no significant regulatory challenge to the ensuing pricing or investment proposals. All parties prefer this process to conventional regulation. There has been substantial improvement in relations between the parties. There is also a wish to continue and extend this means of operation.

When utilities and customers are allowed a significant role in decision-making, the role of regulation is altered but not eliminated. Conventionally, the decision to regulate a utility or other sector means that the information, judgements, preferences and decisions of the market participants are replaced by the information, judgements, preferences and decisions of the regulatory agency. Even if the agency wishes to replicate the effects of a competitive market, it still makes all the key decisions. This has well-known limitations, associated with the information available to the regulatory bodies and the influences that might be brought to bear on them. The active involvement of utilities and customers changes that. Subject to a satisfactory settlement process, the regulatory agency allows market participants to make the key decisions themselves, using their own information, judgements and preferences.

In some circumstances the purpose of regulation might be precisely to prevent market participants from taking their own decisions, and to substitute regulatory decisions reflecting a different view of the public interest. If so, it may not be appropriate to give a greater role to customers. But much regulation is not of this kind. It is often justified by some perceived 'market failure' such as market power or externalities or a free rider problem. In such cases there is no presumption that the judgements of market participants are inadequate. In this case, an active role for customers can be encouraged. In doing so, the regulatory agency may need to take steps to address any specific market failure. But it does not have to substitute its own judgements on the main investment decisions.

In all the cases studied above there is a more limited but nonetheless still critical role for regulation. Essentially, it is enabling the market to work. To use the words of an early proponent, "agencies should be viewed not primarily as decision makers ... but as a means of helping the parties ... work out a result that is both mutually acceptable and in the public

### 30. Adapting these ideas for regulatory control in New Zealand

The success of utility and customer involvement in these various countries suggests that it is worth considering its use in New Zealand. There are no doubt different ways of doing that.

It would be possible to encourage this approach within the present regulatory frameworks. One could design or modify statutory duties to encourage the role of utilities and customers without removing an ultimate role for regulation. For example, the Alberta Energy and Utilities Board Act 1995 (s132) provides that “the Board must recognize or establish rules, practices and procedures that facilitate negotiated settlement”. A UK utility regulator is presently obliged to ‘protect the interests of consumers, wherever appropriate by promoting effective competition’. It would be possible to add the clause ‘and by promoting negotiated settlements or other arrangements agreed between licensees and consumers’.

There will naturally be questions about who would represent end-user customers. However, in each particular context it should be possible to identify organisations that could fill this role. The very largest industrial and commercial consumers can represent themselves. In most countries there are generally groups representing medium-sized energy users. Smaller businesses might be represented by local chambers of commerce or trade associations. There are often government-appointed consumer bodies with responsibilities to protect and advise domestic/residential users. A variety of non-government organisations represent subsets of interested parties.<sup>16</sup>

There would need to be provisions for customers to obtain relevant information from the companies, perhaps via the regulator. Customer groups could commission expert advice as required. In some jurisdictions there is provision for the settlements to cover the legitimate costs of such intervenors. In Alberta the EUB can decide to reimburse such costs. The EUB is taking steps to ensure that such reimbursement does not stimulate inefficient duplication of evidence and argument.

A regulatory body might be able to take certain actions to diffuse issues where agreement is unlikely to be reached in order to facilitate agreement on other issues. For example, the NEB in Canada specifies the allowed return on capital in the event that customers and the utility fail to agree a rate. The CAA does not ask airports and airlines actually to agree on this rate of return but hopes that parties will nonetheless agree on an investment programme, presumably in light of the return on capital that the CAA is expected to allow. A regulator might therefore price the capital expenditure items ‘on the menu’ of a possible investment programme, but leave it to

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<sup>16</sup> To illustrate, in Florida intervenor parties participating in electricity settlements have often included (in addition to the Office of Public Counsel) the Florida Industrial Power Users Group and various of the Office of Attorney General, Florida Retail Federation, Commercial Group, Federal Executive Agencies, American Association of Retired People, Sugarmill Woods Civic Association, Lake Dora Harbour Homeowners Association, Coalition of Local Governments, Lee County local government, Florida Consumer Action Network, South Florida Hospital and Healthcare Association, Coalition for Equitable Rates, Florida Alliance for Lower Electric Rates Today, a variety of individual large users such as Occidental Chemical Corporation, White Springs Agricultural Chemicals, Tropicana Products, Georgia Pacific Corporation, Publix Supermarkets Inc, Dynegy Midstream Services LP, and even interested individuals such as Thomas and Genevieve Twomey.

utilities and consumer groups to decide the items that should appear on the menu and to choose which items to incorporate in a forward programme.

Working out all the details of an approach for fully involving utilities and customers in New Zealand is beyond the scope of the present paper. However, experience elsewhere suggests that a suitable approach can be found to provide results that are acceptable to all the parties and preferable to conventional regulation.