UNISON NETWORKS LIMITED

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

6 July 2007

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1. Executive Summary

Unison is of the view that the existing Part 4A thresholds regime is vulnerable to a number of significant failings, in particular:

(a) There is no clarity as to the circumstances in which a threshold breach should give rise to a control decision, this is heightened by the fact that there are many circumstances in which an ELB can breach a threshold without that indicating "out of control" behaviour;

(b) There is no clarity as to what the objective of regulatory control is in the event of a thresholds breach;

(c) The thresholds are backward looking and in effect deter investment;

(d) The purpose statement for guiding regulatory decisions is problematic;

(e) The purpose statement for Part 4A is clearly wider than the scope covered by the current thresholds, such as manner in which an ELB formulates it prices for different categories of customer; and

(f) There is no separation between the policy agency responsible for designing the thresholds and the agency that enforces the thresholds.

Unison generally endorses a modified version of Option Two for regulating firms including ELBs. The main features of Unison's proposed model for regulating is as follows:

(a) A business or sector is considered for "designation" in the first instance. If a business is designated it means that it will automatically be subjected to information disclosure requirements and can be considered for further regulation if the circumstances warrant it. As "designation" is in itself a low level of intervention the criteria for designating businesses should primarily be based on a firm meeting the competition criteria and satisfying some form of desirability test focused on efficiency;

(b) A "designated" business or sector that is found to be abusing its market power may then be considered for "notification", a simplified form of control in which incentive-based price (and quality) paths are imposed. There will be penalties for exceeding these. If a sector is notified then individual businesses may seek their own terms of control;

(c) Some businesses should be immune from notification, if their ownership and consumer base are closely aligned; and

(d) There should be provision for "designated" and "notified" businesses to negotiate aspects of price quality trade offs with consumer groups, but still operate within the parameters of the regulation that they are under.

Unison also has a number of additional points to make on the MED's proposals and on the ideal regulatory framework:

(a) Unison generally endorses the proposed purpose statement for the regulatory control Parts of the Act but considers that there should be a greater focus on efficiency and greater guidance given to the Commerce Commission for the purposes of interpreting the purpose statement;

(b) There should be a greater role for the MED in terms of regulatory design, setting key inputs and providing policy guidance:

(c) The Commission should focus on economic efficiency in its decision making;

(d) All regulatory Decisions should take into account the future investment needs of businesses;

(e) There should be an appeals body available to review certain key regulatory decisions;

(f) There should be simultaneous consideration of *whether* and *how* to control; and

(g) Unison supports consultation on key inputs as part of the regulatory process.

Finally, Unison believes that the timeframes to complete the review of the regulatory provisions under the Commerce Act are so tight as to seriously undermine the likelihood of sound outcomes being achieved. As the Discussion Document provides two options and recognises that other options or combinations of various elements may be proposed, at the very least a second round of consultation should undertaken. The Ministry would then receive useful and more focussed feedback on the specific set of arrangements the Ministry proposes to be adopted.

2. Introduction

Unison Networks Limited (Unison) is pleased to provide this submission to the Ministry of Economic Development (MED) in response to the MED's Discussion Document "Review of Regulatory Control Provisions under the Commerce Act 1986 (the Discussion Document).[1]

Unison is the fourth largest Electricity Lines Business (ELB) in New Zealand, providing electricity distribution services to over 105,000 consumers in the Rotorua, Taupo and Hawke's Bay regions.

As a large ELB, Unison is subject to the information disclosure and threshold regimes under Part 4A of the Commerce Act.

Unison's approach to developing its response to the Discussion Document has been to consider an appropriate regulatory regime at the conceptual level, unfettered by the existing legislative or institutional arrangements in the first instance.

Unison has then considered the current challenges thrown up by experience with the existing regulatory framework, with reference to the issues identified by MED in the Discussion Document and its own experiences.

As a result of engaging in this process, Unison has formulated from its perspective, what the key objectives of economic regulations should be.

With these considerations in mind, Unison's preferred set of regulatory arrangements has been developed and is described in this submission, including a description of the regulatory structures and mechanisms that Unison believes are likely to best deliver the regulatory objectives. Consideration is also given to the structure of the purpose statement, as the key touchstone for regulatory design and regulatory decisions under the regime.

The extent of change that should come about as a result of the review canvassed in the Discussion Document will be a point of contention. While there may be concerns with the current arrangements, moving to new arrangements may mean moving to new and untried mechanisms (in New Zealand, at least). Moving to new mechanisms introduces the risk that implementation may not result in the expected benefits. In any case, change is costly and the benefit of changing to different regulatory arrangements must be considered in the context of the costs and risk of making the change. Also businesses affected by reforms may be unlikely to invest while any new regime remains an unknown quantity.

For these reasons, Unison considers that there may be benefits from ensuring changes to the regulatory design are limited to those necessary to meet the challenges in the current arrangements.

Having concluded its consideration of appropriate solutions to the identified issues, Unison is largely supportive of Option Two as outlined in the MED Discussion Document, but proposes some modifications. The areas where Unison's proposed framework differs from the MED's Option Two are identified in this submission. In a

[1] "Review of regulatory Control provisions under the Commerce Act 1986" – Discussion Document; Ministry of Economic Development; April 2007

similar vein, Unison is supportive of and is a signatory to the ELB industry submission although again there are some areas where Unison's preference is for a slightly modified approach.[2] In several cases, the position put forward in the ELB industry submission is noted as being Unison's preferred second choice position.

[2] "Response to MED Review of the Regulatory Control Provisions under the Commerce Act; submission from the Electricity Lines Businesses in New Zealand; 6 July, 2007

3. Background

The electricity distribution sector is made up of 28 ELBs with vastly differing characteristics. There is a wide range of company size, as indicated by the following measures:[3]

Table 1: Indicators of ELB size range

Measure	Smallest	Largest
Customer Connections	4,211	660,347
System length	244 km	2,926 km
System ODV	$20.3m	$1,985m
Line charge revenue	$5.0m	$534.5m

ELBs also have significantly varying customer densities, proportions of underground assets, as well as topographical and environmental conditions. In addition, there is a variety of ownership structures in operation across the industry. This diversity makes comparison between ELBs difficult and the regulatory framework needs to have a degree of flexibility to cater for the range of firms and their specific circumstances.

ELBs provide an essential infrastructure to serve communities by delivering electric power from the national transmission grid to the end consumer. The major investments undertaken in the post war period are approaching the end of their economic life and will require significant investment to replace and expand capacity to provide ongoing service to consumers. This investment wave is known in the industry as the “wall of wire”.

Across the industry ELBs, with a combined book value of $6.2 billion, are forecasting capital expenditure to be in the region of $3.8 billion over the next ten years. This repeats the pattern in other jurisdictions, for example in the UK the distribution and transmission sectors (valued at £20 billion) are forecasting capital investment over the next four to six years of £10 billion and in Australia the distribution sector (valued at A$35 million) expects to spend A$16 billion on its networks over the next five years.[4] These comparative statistics show that the forecast capital expenditure in the New Zealand distribution industry is in line with overseas developments.

In Unison’s case the historical investment profile is shown in the Graph 1 below. This graph reflects the possible future investment pattern based on the age of assets assuming an average life of approximately 50 years.

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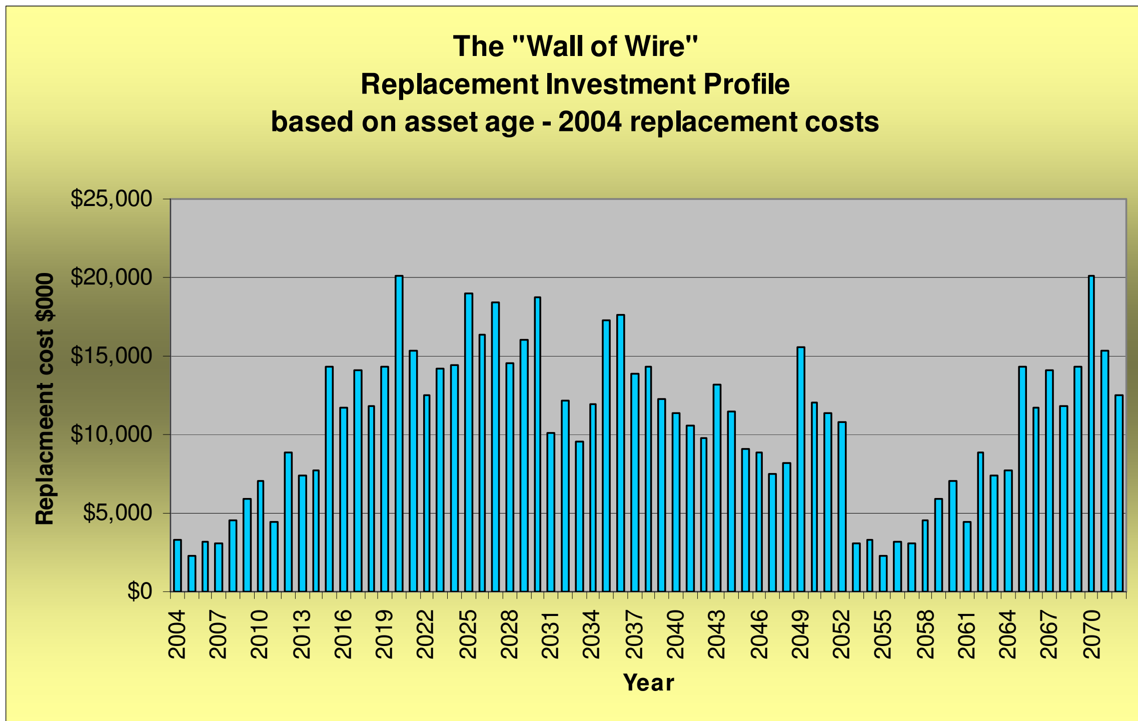
[3] Electricity Line Business and Gas Pipeline Business 2006 Information Disclosure Compendium; PricewaterhouseCoopers; February 2007

[4] Presentations to ENA CEO conference 14 June 2007; UK data from John Scott, Technical Director for Ofgem; Australian data from Andrew Blythe, Chief Executive of the Energy Networks Association in Australia

Graph 1: Unison's reinvestment requirements based on the historical investment pattern



The need for investment in infrastructure generally, not just electricity distribution, is becoming widely accepted.[5] It is important therefore that the regulatory regime provides sufficient support to investors to encourage and enable the necessary investment to take place for the betterment of the New Zealand economy as a whole.

[5] The Statements of Government Policy issued to the Electricity Commission and the Commerce Commission respectively in [August] 2006 indicate the importance placed on infrastructure investment by the Government.

4. Objectives of Regulatory Design

In the Discussion Document the MED sets out some possible desirable characteristics for a regulatory regime to possess and invites comment on these. Unison identifies below what, in its view, are the key characteristics or design objectives of an economic regulatory framework.

a) Commitment to the regulatory framework

While there is a strong degree of support for review of the regulatory regime, especially Part 4A in respect of ELBs but also Parts 4 and 5, Unison believes that the regime going forward, and in particular any changes, requires a high degree of commitment from the government, regulatory bodies and regulated entities to ensure an enduring regime is put in place.

b) Scope of regulation

The regulatory regime must consider application beyond ELBs, i.e. to other services provided in markets with limited or no competition in a manner that is consistent and coherent.

c) Focus on services

The focus of economic regulation should be on markets and/or services rather than on firms, i.e. contestable activities undertaken by firms also engaged in markets with limited or no competition should not be subject to, or influenced by, economic regulation.

d) Balance the interests of consumers and investors

While it is clear that a key role of economic regulation is to protect the interests of consumers, in particular against the exercise of monopoly power, it is also necessary for economic regulation to respect the needs of investors and to encourage investment in critical infrastructure. Accordingly, economic regulation should balance the interests of consumers and investors.

e) Promote price/quality trade-off

Economic regulation should foster the provision of services at levels demanded by consumers and for which consumers are prepared to pay. In particular, where possible, mechanisms by which consumers can make price/quality trade-offs should be promoted.

f) Promote innovation and efficiency

Innovation and improved efficiency benefits the economy. The economic regulatory regime should provide incentives to improve efficiency and innovation in goods or services provided in markets with limited or no competition.

g) Reduce uncertainty

In balancing flexibility and certainty, regulatory arrangements should be sufficiently certain to promote investment. In particular, to improve certainty and increase confidence in the shape and direction of economic regulation, key input methodologies should be established at the outset of an inquiry.

h) Ensure appropriate decision making structures

Decisions should be made at appropriate levels in order to match the significance of the decision, the need for technical and/or specialist knowledge, to provide for independence between conflicting roles and to ensure alignment with institutional objectives and roles.

i) Promote better decision making and appropriate accountability structures

Decision making arrangements should be exposed to review to incentivise better decision making in the first instance while also providing for review to address imperfect decisions and to build a sound body of precedent for future decisions.

j) Ensure regulatory mechanisms are forward looking

To support necessary investment, regulatory mechanisms should be capable of accommodating forward looking approaches, i.e. should be capable of providing for future investment needs relevant to the industry or firm. This may be provided, for example, through the firm being able to propose its own alternative regulatory arrangement, consistent with a forward looking workable building-blocks approach.

k) Regulatory decisions should be timely and effective

A particular point of concern is the impractical situation encountered where the decision "how to" regulate (pursuant to the current Part 5) cannot be considered at the same time as the decision "whether to" (pursuant to the current Parts 4 or 4A). Enabling these decisions to be made simultaneously would significantly enhance the transparency and predictability of regulatory decision making and improve the timeliness and effectiveness of the regime.

l) Strike a balance in regulatory mechanisms between low cost and efficacy

Regulatory options should be low cost (recognising that, in respect of the regulatory mandate under the current Part 4A, there are 28 lines companies). Consideration needs to be given to the potential work load that may be imposed on the regulatory body(/ies) while also recognising that many of the entities subject to the regulatory provisions are small, with limited resources to either manage or meet the costs of regulatory interventions.

5. Purpose Statement

The purpose statement is a critical part of the legislative framework for economic regulation as it provides the touchstone for regulatory design and for regulatory decision making.

Unison considers that the following key themes are important:

- The Government's focus for economic regulation is to "provide for the long-term benefit of consumers within New Zealand";[6]
- The Commerce Act is based on a presumption that competition is the most effective means of protecting the long-term interests of consumers (providing the market has workable competition);
- The focus of economic regulation should be markets or services, rather than regulating firms per se;
- It is generally accepted that the market for providing electricity distribution services to consumers does not have (nor the prospect of) workable competition;
- Economic regulation is unlikely to increase economic efficiency (the important focus from a policy perspective therefore being that regulatory intervention should be designed to reduce economic efficiency as little as practicable);[7]
- It is a widely accepted principle that economic regulation should seek to balance the interests of consumers and investors;[8]
- The benefits of economic regulation must significantly exceed the direct and indirect costs of economic regulation.

The Discussion Document proposes a purpose statement for economic regulation, i.e. covering the scope of Parts 4, 4A and 5, which is based on the current purpose statement for Part 4A. This reflects the current absence of a purpose statement for Part 4. The MED has proposed some amendments to the existing Part 4A purpose statement, largely to reflect the Government's emphasis on investment in the Section 26 Statement issued to the Commerce Commission on 7 August 2006. The MED's proposed purpose statement is:

> *"The purpose of this Part is, in markets where there is little or no competition or prospect of competition, to provide for economic regulation for the long term benefit of consumers of New Zealand. Any regulation under this Part should seek to ensure that suppliers:*
>
> *a) Are limited in their ability to earn excessive profits;*

[6] MED Discussion Document; para 2
[7] LECG analysis draws this conclusion by assessing the potential for economic regulation to enhance allocative, productive and dynamic efficiencies. In all cases the conclusion is that regulation is unlikely to improve economic efficiency.
[8] Eg World Bank Working Paper No 14; Regulation by Contract – A New Way to Privatize Electricity Distribution?; Bakovic, Tenebaum, Woolf; 2003; p2

b) Have incentives to improve efficiency and provide services at a quality that reflects consumer demands;

c) Share the benefits of efficiency gains with consumers, including through lower prices; and

d) Have incentives to innovate and to invest including in replacement, upgraded and new assets and in related businesses"[9]

Reviewing the MED proposal and considering the key themes identified above, together with the wider scope (i.e. economic regulation generally rather than for a specific industry that has been deemed appropriate for regulation), Unison believes an appropriate structure for the purpose statement is under the following headings:

- Objectives of regulation;
- When to regulate; and
- How to regulate.

Accordingly, the following key elements need to be covered in, or provided in support of, the purpose statement are:

- Objective of regulation:
  - provide for economic regulation of goods or services for the long-term benefit of consumers within New Zealand.
- When to regulate:
  - there is little or no competition and no prospect of competition;
  - the benefits of economic regulation substantially exceed the direct and indirect costs of regulation; and
  - alternative arrangements should be contemplated where these are as good as or better than regulation.
- How to regulate must balance the following trade-offs:
  - limiting suppliers ability to extract excessive profits;
  - providing incentives for suppliers to provide services at the quality and levels demanded by consumers and for which consumers are prepared to pay;
  - provide incentives for suppliers to improve the efficiency with which they deliver the services demanded and to share the benefits of efficiency gains with consumers; and
  - providing incentives for suppliers to innovate, to invest including in replacement, upgraded and new assets and in related businesses.

Unison has not sought to wordsmith a purpose statement and remains open for all of the above elements to be covered in the legislative purpose statement, legislative clauses, regulations or other interpretive tools as. However, the guidance provided by the above structure is the minimum that should be provided to the body charged with making regulatory decisions in relation to balancing the conflicting criteria.

[9] MED Discussion Document; page 28

6. Unison's Proposed Regulatory Framework

High quality regulatory design and implementation is of critical importance to achieve good market outcomes. It is not in anyone's interests – consumers, service providers or the economy as a whole - for regulation to deter investment. But that is the result of the current threshold regime under Part 4A, due to serious defects in the design of the thresholds. In particular:

- the regime creates unnecessary uncertainty because so many companies breach the thresholds for reasons unrelated to the need for control. For example, currently the almost inevitable result of making significant new investment, and increasing prices to pay for it, is a threshold breach. Similarly, the setting of quality thresholds as the simple average of five years of historical performance provides a random chance of threshold breach with the likelihood of once in every two years. Finally, if pass through costs, such as Transpower's charges, vary for some reason then it is likely that several ELB's will breach their price paths for the year; and
- There needs to be greater guidance in relation to the correct approach to recovery of investment costs and funding of new investment.

The issue underlying these concerns is that there is insufficient legislative and policy guidance underpinning the regime. Observing regulatory processes under Parts 4 and 5 indicates that similar issues exist with those processes also.

6.1 The Current Threshold Regime

Focussing specifically on the operation of Part 4A, Unison has identified two broad options: providing for universal control on a workable "building blocks" approach or improving the current targeted control regime.

6.1.1 Universal control

The Government and the industry may now consider, with the benefit of five years of experience of the Part 4A regime, whether the uncertainty and complexity of such a regime outweighs the savings from avoiding universal control. Across-the-board regulation (using a generic price path approach supplemented by a "building blocks"-propose/respond alternative to address company specific circumstances, designed in a way which maintains strong incentives to invest and which is based on real-world as opposed to hypothetical costs) could address the problems encountered to date.

6.1.2 Improved targeted control regime

An alternative, and second best, option would be to keep a targeted control regime.

Retaining the thresholds, albeit improved thresholds, leaves a number of questions to be resolved, such as:

- are thresholds aligned with the basis for control (i.e. the price glide path of the thresholds currently bears no obvious relationship to excess earnings as determined by a building blocks approach that is expected to underpin a control arrangement);
- what is the consequence for a firm that breaches the thresholds, i.e. is there a penalty for breaching a threshold;

- what breaches might be defensible and what breaches are likely to lead to control;
- what cost might a firm that has breached the thresholds face in defending that breach;
- if control is imposed following breach, to what extent should there be a punitive element to that control;
- should firms that exhibit similar "out of control" behaviour be treated similarly even if one has breached a threshold and the other has not.

Accordingly, Unison's preference is for a universal control approach as this is both simple and provides for certainty, although under such an approach merits review is a further desirable mechanism to ensure quality regulatory decision making.

6.2 Unison's Proposal

In summary, Unison's proposal provides for:

- separation of regulatory design from implementation;
- the specification of key input methodologies by an independent expert panel in advance of the implementation of control;
- the Commerce Commission to focus on economic efficiency, i.e. abuse of market power;
- a designation step to confirm coverage of the provision of specific goods or services by the regulatory provisions of the Commerce Act;
- an information disclosure regime to address information asymmetry between the firm(s) and the regulator and/or consumer;
- notification, imposition and monitoring of incentive-based regulatory arrangements;
- alternatives to regulation based on commercial arrangements or ownership structure;
- an option for firms to propose a firm-specific, building blocks-based alternative;
- a negotiate/arbitrate mechanism with an independent expert panel (in the case of ELB, the Electricity Commission) to arbitrate on issues of price/quality trade-off; and
- an appeals body to be available to review the merits of certain key regulatory decisions;.

6.2.1 Separation of regulatory design from implementation

From a design principle perspective, Unison considers it is sensible to clearly delineate the functions of regulatory framework design from implementation. Accordingly, Unison proposes that as a result of the review, the government separate out policy level questions of regulatory design from the administrative functions of the Commerce Commission. MED could be responsible for these policy questions. MED would be responsible for designing the thresholds, which would be set out in regulations, and the Commerce Commission would be responsible for implementing

the thresholds. This approach would maximise the policy expertise in the MED and the enforcement expertise in the Commerce Commission.

Separating the functions of regulatory design and enforcement would enable the regulatory designer to provide guidance to the Commerce Commission. The provision of detailed policy guidance would provide greater certainty to lines businesses in respect of the Commerce Commission's potential actions. It would also enable the Commerce Commission to be held accountable for its work because there would be standards against which the Commerce Commission's work could be measured. Unison supports making merits review available, where the Commerce Commission is considered not to have adhered to the guidelines, as it is available for clearance and authorisation decisions, otherwise there is no effective means to ensure the quality of decision-making.

6.2.2 Specification of input methodologies

Unison concurs with the position in the Discussion Document that input methodologies should be determined in advance. Unison considers key input methodologies start with key principles, such as defining the benchmark or standard as 'workable competition', and to include methodologies defining the basis of asset valuation, the determination of cost of capital, the allocation of shared costs and treatment of taxation. The key underpinning of the regulatory regime is undoubtedly a workable buildings blocks based analysis of performance. Clarity about the manner in which the building blocks analysis will be applied will greatly enhance certainty for firms subject to, or likely to be subject to, regulation.

Unison's experience of the regulatory regime so far leads it to suggest that a workable "building blocks" approach would have the following key features:

a) it would allow an acceptable level of return at a margin above mean WACC to reflect asymmetric risks of under investment;

b) it would provide a realistic expectation of the recovery of prudent investments thereby ensuring businesses an acceptable level of cash returns and the ability to attract further capital to fund renewals and new investment;

c) it would set a realistic starting point in terms of prices and investment levels.

The technical nature of the key inputs means they are best determined by an independent expert panel. Unison does not support the proposition that the input methodologies be approved by the Minister as this is likely to leave the input methodologies beyond the realm of merits review. Merits review is considered to be an important stricture to ensure good decisions in what are fundamental inputs into the regulatory framework, with enduring effect through precedent for future regulatory decisions.

6.2.3 Commerce Commission to focus on economic efficiency

The Commerce Commission has expertise in economic decision making and is the front line enforcement agency for fair trading and economic regulation in New Zealand. As such, the Commerce Commission is primarily focussed on issues of competition and efficiency.

Unison supports the continuation of the focus on competition and efficiency as the primary tests for capturing of the provision of goods or services within the regulatory provisions of the Commerce Act. Abuse of market power should then be the test for imposition of further incentive-based regulatory arrangements akin to control.

6.2.4 Designation of goods or services

Goods or services would be "designated" as being subject to the regulatory provisions under a revised Part of the Commerce Act (combining Parts 4, 4A and relevant parts of Part 5) based on the Commerce Commission's recommendation to the Minister. The Commerce Commission may undertake an investigation to develop this recommendation of its own accord or at the request of the Minister. "Designation" could be demonstrated by adding goods or services, on a sector or firm specific basis, to a schedule to regulations pursuant to the Commerce Act. Goods or services are designated when there is evidence that they are in a market with limited or no competition, and no prospect of competition. This does not subject firms providing these services to control per se but brings them under the auspices of the regulatory provisions of the regime.

6.2.5 Information disclosures

The designation of the provision of goods or services by a firm or firms leads to the automatic imposition of information disclosure requirements. The nature of these information disclosure requirements should be included in the recommendation from the Commerce Commission to the Minister that the goods or services should be "designated". The design of the information disclosure requirements should address the extent of the information asymmetry that invariably exists between the firm and the regulator and consumer. In this proposal the consumer focus is important as consumers should be sufficiently empowered to engage with the provider firms through the negotiate/arbitrate mechanism discussed below.

6.2.6 Notification of goods or services

The Commerce Commission may "notify" one, more than one, or all firms providing the "designated" goods or services that their provision of the specified goods or services will be subject to incentive-based regulatory arrangements. The basis for notification is abuse of monopoly power.

Process requirements would require the Commerce Commission to undertake an investigation that identifies the abuse of monopoly power and, if the decision is to impose control, to describe the proposed incentive-based regulatory arrangements. This effectively combines the "whether to" and the "how to" decisions that beset the current arrangements under Parts 4A and 5 of the Commerce Act. It also provides a clear notice to the target firm(s) of the nature of the incentive-based regulatory arrangements and facilitates analysis by the firm(s) of the practicality of those arrangements.

The Commerce Commission should only be able to proceed to a decision to "notify" firms in respect of the provision of certain goods or services following Ministerial consent that the goods or services have been "designated".

Notified firms will be subject to control by way of price cap and ongoing information disclosure requirements. Notification would last for a period of up to five years as can

the current control provision under Part 5 of the Commerce Act. Notification may be renewed for further periods of up to five years.

6.2.7 Alternative arrangements in place of regulation

As proposed by the MED, negotiation between consumers and providers of monopoly services may provide an alternative to regulation. Where the outcome of such negotiations is as good as or better than the outcome from regulation then regulation should be unnecessary. Arbitration, in the event a negotiated settlement cannot be reached, could provide a regulated back stop. Unison agrees with the MED that an industry such as electricity distribution is unlikely to be suited to negotiate/arbitrate as a basis for an alternative to regulation.

Firms may be safe harboured from the consequences of notification where they satisfy certain criteria in relation to ownership. In particular, trust or co-operatively owned ELBs with a very closely matching set of owners and consumers may present a low cost form of largely self-regulation with little economic harm arising from prices that are higher or lower than otherwise considered to be efficient. The ownership-based safe harbour proposal is discussed in more detail in Appendix I.

6.2.8 Propose/respond option

Within 90 days of notification any notified firm may propose an alternative arrangement reflecting firm specific circumstances. The Commerce Commission must accept a proposal that satisfies pre-determined criteria. If the Commerce Commission rejects the firm's proposal, it may impose an alternative solution that may be less favourable to the firm than the original control proposal. The criteria for a propose/respond mechanism should reflect a workable building block-based approach.

Given that the firm has a choice to select whether to accept the incentive-based regulatory arrangements or to pursue a more firm specific solution through the propose/respond approach, it is proposed that the regulatory arrangements applying to a firm should be mandatory, subject to a minimal, pre-defined range or "dead band" to allow for minor year to year variations and for estimation error.[10] In the event of a breach of the incentive-based regulatory arrangements or the agreed alternative regulatory arrangements, in excess of the dead band range, the Commerce Commission should be able to impose penalties and require conformance with the arrangements. The decision to impose penalties should be subject to merits review. In the event of unforseen circumstances or hardship, the regulator should have a discretion to agree to an amendment to the regulatory framework by way of a proposal, under the propose/respond mechanism, from the firm for the balance of the regulatory period.

6.2.9 Price/quality trade-off

To support price/quality trade-offs by consumers, where a firm has been designated, a negotiate/arbitrate mechanism should be available. Any of the Commerce

[10] For example, revenue and quality levels may have a "dead band" of +/- 5%, such that cumulative variations over the regulatory period would need to exceed the "dead band", relative to the current year's regulated values, before penalties would apply. The use of cumulative variances allows firms to correct an inadvertent overshoot or to recover a minor undershoot over the course of the regulatory period. The setting of the dead band range, taken together with the cumulative nature of the measure, should seek to avoid an incentive for any material "gaming" at the margin of this band.

Commission, any other body or one or a group of acquirers can negotiate with the provider on issues of quality and/or price (ie charge allocation).[11] Under this approach, it is considered preferable that pricing decisions remain within the firm, with a mechanism to encourage consumer engagement, rather than be determined by the regulator. In arbitrating a solution to a price/quality trade-off dispute, the arbitrator would need to consider an equitable basis for allocating costs reflective of the quality required and provided and in respect of interdependent assets and services.

A negotiated or arbitrated solution in this context would apply to all relevant consumers with like characteristics, eg in the same consumer class, on the same feeder, in the same geographical region or on the same network. If unable to successfully negotiate an acceptable outcome with the provider, then any of the Commerce Commission, any other body or two or more acquirers may apply to an arbitration panel with specialist capability in the relevant goods or services to have the matter arbitrated. In the case of ELBs the Electricity Commission is a logical body, independent of the regulator, to undertake such arbitrations.[12]

The Electricity Commission has been identified by the Government as responsible for developing "model" distribution pricing approaches and "model" contracts. The Electricity Commission is, therefore, expected to have the necessary and particular technical skill and expertise in price/quality trade-off debates within the context of complex network pricing environments. The Electricity Commission is able to reflect government policy more directly than, say, the Commerce Commission.

The negotiate/arbitrate mechanism should be available for consumers, firms or other parties once the firm's provision of the goods or services has been designated, including once the provision of the goods or services have been notified. This is because the ambit of the negotiate/arbitrate mechanism should be within the overall revenue/return arrangement imposed by the Commerce Commission under the incentive-based regulatory arrangements or the agreed alternative regulatory arrangements.

6.2.10 Merits review

The quality of key regulatory decisions should be enhanced through the introduction of merits review by way of a re-hearing. It is expected that merits review would not only provide for erroneous decisions to be corrected on appeal but also would improve the quality of decision making by regulatory bodies in the first instance. Unison's view on the merits review process is discussed further in Appendix II.

6.2.11 Summary of Unison's Proposal

The key steps, roles and application of merits review within Unison's proposal are summarised in the following table.

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[11] The term "any other body" may be, but is not limited to, bodies such as the Consumers' Institute, Grey Power, Federated Farmers, etc.

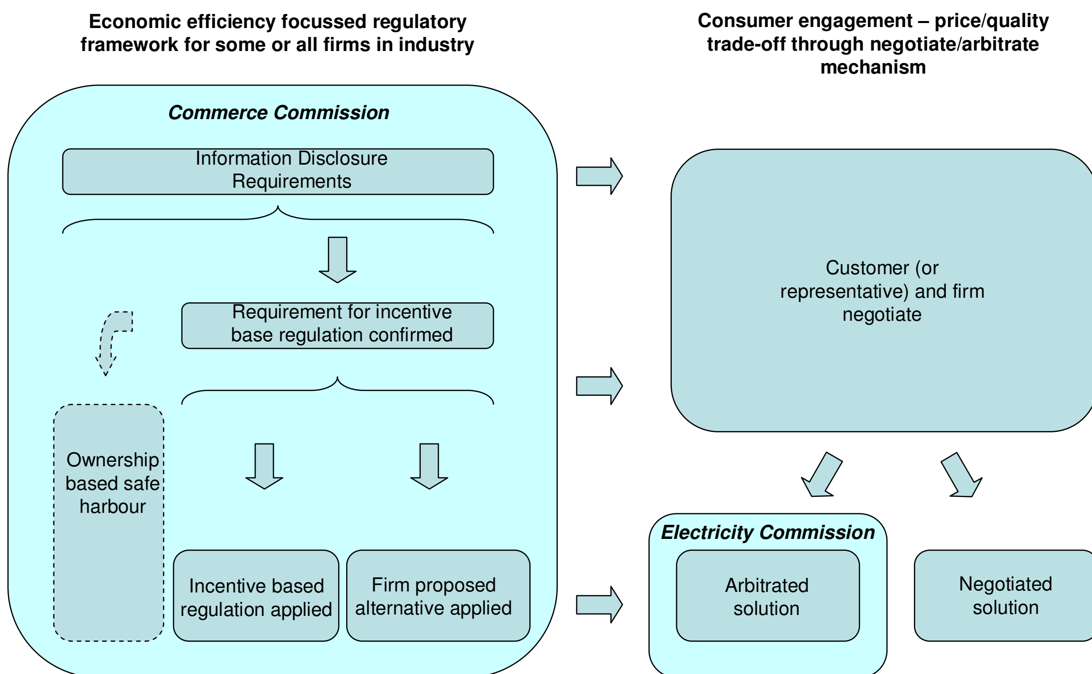
[12] It would be possible to expand the mandate of the Electricity Commission to the gas pipelines industry, perhaps re-branding it as the Energy Commission, to undertake the arbitration role across a broader range of industries with like characteristics. Other industries that might fall under the regulatory provision may have their own specialist arbitration panel for price/quality trade-off decisions.

Table 2: Summary of Unison's Proposed Regulatory Framework

Key step	Undertaken by	Subject to Merits Review
Decision to initiate investigation into whether market or goods or services should be covered by regulatory provisions, i.e. goods or services are provided in markets with limited or no competition and no prospect of competition	Minister on own initiative or on recommendation of Commerce Commission	No
Investigation into whether goods or services are provided in markets with limited or no competition and no prospect of competition; if so recommending what information disclosure regime will be imposed to provide information on performance in providing the goods or services	Commerce Commission	N/a
Decision that goods or services are provided in markets with limited or no competition and no prospect of competition, i.e. the goods or services are "designated"	Minister	No
Determination of key input methodologies in advance of their being used in any regulatory review or decision making	Panel of independent experts	Yes
Implementation and monitoring of information disclosure regime, consistent with the defined input methodologies	Commerce Commission	No
Initiate and undertake investigation as to whether provision of goods or services by a firm or firms should be "notified", i.e. subject to incentive-based regulatory arrangements. This requires that an abuse of market power is demonstrated. The proposed incentive-based regulatory arrangement should also be determined in this process	Commerce Commission	N/a
Decision that provision of goods or services by a firm or firms should be regulated, and proposed incentive-based regulatory arrangement.	Commerce Commission	No
Proposal for alternative regulatory arrangement	Firm	N/a
Decision to accept proposed alternative regulatory arrangement or to impose a regulatory arrangement of its choosing	Commerce Commission	Yes
Implementation and monitoring of incentive-based regulatory arrangements or alternative regulatory arrangements	Commerce Commission	N/a
Decision to impose penalties for breach of	Commerce	Yes

Key step	Undertaken by	Subject to Merits Review
regulatory arrangements	Commission	
Arbitrate in the event of an unsuccessful negotiation in respect of the provision of goods or services, i.e. price/quality trade-off issues including allocation of revenues between parties.	Specialist Arbitration Panel (Electricity Commission in case of ELBs)	Yes

Unison's proposed regulatory framework, as it applies to ELBs, is shown in the diagram below:



7. MED's Proposed Options

Unison's preference is that the regulatory framework promotes certainty of process and consequences, confidence in regulatory decisions and a more orthodox paradigm in which the regulator(s) and regulated firms operate. These key requirements are necessary to foster a positive environment for investment in critical infrastructure with an appropriate balance able to be struck between the interests of consumers and investors.

Unison also promotes the development of a regime that allows firms to manage key aspects of their business, in particular price-quality trade-offs, through direct engagement with consumers. This requires a mechanism to empower consumers to engage with monopoly service providers on a more equal footing than exists at present, with the support of a regulatory backstop. Unison believes that this opportunity should be available to all classes of consumer and should not just be restricted to large consumers and should not just be open to monopoly industries with a predominance of large consumers.

The MED's Option Two appears to satisfy Unison's requirements for a regulatory regime better than Option One, largely because Option Two contemplates a propose/respond mechanism that Unison regards as a vital opportunity for a forward looking solution. However, there are several areas where Unison proposes further modifications to Option Two to more closely align with Unison's perspective on a sound, effective and practical regulatory framework.

In particular, Unison proposes that:

7.1 Input Methodologies

Input methodologies should be established by a body that is independent of the regulatory body (i.e. the Commerce Commission). Input methodologies are of fundamental importance to the functioning of the regulatory regime. The MED Discussion Document recognises this point while also identifying that the decisions are "highly technical in nature".[13] As such, the decisions on the input methodologies are not well suited to decision by the Minister but should be subject to robust decision making processes and preferably should be made independent of the body that is implementing the methodologies.

Unison's preferred approach is that an independent body establish the input methodologies and that the decisions of this body are subject to merits review. The independent body could be an expert panel or, alternatively, the MED.

Unison's second preference is that the regulatory body (i.e. the Commerce Commission) develops the input methodologies but, as above, these decisions are subject to merits review. Unison regards this as a significantly inferior solution to an independent body to establish input methodologies as it clouds the distinction between regime design and implementation.

[13] Discussion Document, para 132

7.2 Appropriate test for determining whether to regulate

Unison agrees that the overall objectives of regulating goods or services provided in markets with limited competition need to address, in some balance, both economic efficiency and consumer surplus issues. However, the primary tests to be applied to determine if the provision of goods or services should be subject to the regulatory provisions of the Commerce Act are competition and economic efficiency tests. If these tests are satisfied then some level of information disclosure should be an automatic requirement to ensure a reduction in the asymmetry of information concomitant with monopoly positions.

One of the disadvantages with Option Two is that if competition tests are satisfied and a decision is made to impose control, a target firm may face uncertainty as to the type and extent of control to be applied. While this provides a wide degree of flexibility for the regulator, uncertainty will continue to prevail for industry. It is also unclear from the MED's proposal how the level of regulatory intervention or the choice of regulatory tool might be changed as circumstances changed and/or more or less regulatory intervention was considered necessary. Accordingly, Unison's variation on Option Two is much simpler in terms of the nature of control that can be imposed.

7.3 Incentive-based regulatory arrangements

The process outlined by the MED in their Option Two is consistent with Unison's proposal at this level of the overall regulatory framework. Consistent with Option Two, Unison accepts that ELBs should already be regarded as being at this step.

In most jurisdictions around the world, goods or services provided in markets with natural monopoly characteristics and limited competition are subject to formal regulation. This regulation is intended to provide incentives to promote favourable outcomes. It is important that business and the regulator share a sense of accountability for delivering positive outcomes which reflect a balance between the needs of consumers and investors while also giving the firms providing the goods or services certainty about the regulatory regime.

In Unison's view, this sense of shared accountability appears to be absent in the New Zealand environment, at least in respect of Part 4A, as a direct result of the ambiguities introduced by light handed, targeted regulation.

Accordingly, Unison believes that a more formal acceptance of regulation is appropriate. This should be through the application of a specific regulatory instrument such as price cap regulation, largely similar to the current price thresholds but with clear and enforceable compliance arrangements and without a subsequent 'control' step. An important aspect of this approach is that the price cap need not be significantly more sophisticated than the current thresholds and therefore is no more intensive from a regulatory workload perspective. The price cap would include incentives for operational efficiency over time.

Having a propose/respond option, that complies with pre-determined input methodologies, provides for firms to have a more suitable and company specific regulatory path agreed with the regulator where they feel the more generic price cap is not appropriate to their specific circumstances. A key aspect of the propose/respond approach is that it is based on input methodologies that have been defined in advance, as promoted by MED in the Discussion Document. The criteria for

the 'proposal' will therefore support an ex ante, forward looking, building blocks approach to setting an appropriate revenue path reflective of the specific circumstances of the firm.

7.4 Alternatives to regulation

In the discussion below on the purpose statement, Unison promotes the potential for regulation to be avoided where alternative arrangements are as good as, or better than, regulation. It is in this context that Unison contemplates mechanisms to enable an otherwise regulated good or service to be 'safe-harboured' from direct regulation. There is, therefore, a difference in interpretation of the role of mechanisms such as negotiate/arbitrate between the MED and Unison, although in effect these differences may be simply semantic.

7.4.1 Negotiated Solutions

Negotiated solutions represent the negotiate/arbitrate mechanism identified by the MED. Unison perhaps characterises this process slightly differently to the MED in that it is seen as a safe harbour, within an information disclosure regime, rather than a stand alone regulatory tool.

In essence, an outcome negotiated between willing parties may be regarded as being economically efficient. The potential for a regulatory backstop to kick-in strengthens the position of the consumer in the negotiation with the provider of the goods or services in such negotiations.

The MED notes that "negotiation/arbitration will likely only be suitable where an entity with market power is dealing with a small number of relatively large customers".[14] Unison acknowledges that this form of negotiate arbitrate is unlikely to be applicable to ELBs as, while they will have some relatively large consumers, they also have a large number of small consumers. Furthermore, the common and interdependent nature of the services and assets used to provide those services invariably result in a complex set of trade-offs being made in network pricing. This environment suggests that there would be significant difficulties in carving-out the provision of goods or services to some consumers from application of the regulatory regime.

Accordingly, Unison will not address the negotiate/arbitrate option further in this context (i.e. as the basis of a safe harbouring goods or services) as this is unlikely to be applicable to ELBs, but believes that there is a place for determining more specific price/quality trade-offs by way of negotiation in the first instance backed up by arbitration within the application of the wider regulatory regime.

7.4.2 Ownership

In the context of ELBs (and potentially some other industries), ownership structures such as trusts and co-operatives, where there is a high correlation between owners and consumers, should provide a basis for safe-harbouring the provision of the relevant goods or services from the incentive-based regulatory arrangements. In these situations the ownership structure in itself provides a low-cost and effective form of control. While the MED raises this, it does not feature in either of theirs options. Unison is supportive of an ownership-based safe-harbour.

[14] MED Discussion Document, para 120

7.5 Price/quality trade-off

Unison considers that the role of the Commerce Commission should be limited to competition issues and economic efficiency and should not extend to issues of specific price/quality trade-off.

Recognising that the Electricity Commission already has carriage of the following issues:

- Model approaches to distribution pricing;
- Model customer contracts;
- Model use of systems contracts;
- Benchmark transmission agreements;
- Transmission pricing methodology,

it is clear that the Electricity Commission has, or is expected to have, a degree of expertise in these areas. The complexity of network pricing and the trade-offs between price and quality for common services and shared assets has already been highlighted.

The link between consumer preferences and network design is also seen as critically important. By utilising negotiate/arbitrate in issues of price/quality trade-off, Unison believes that there is an opportunity to provide incentives on both the ELB and the consumer to engage constructively. Consumers, or representatives of classes of consumer, could initiate a negotiation with their ELB (or vice versa) which would better inform both sides of the negotiation on preferences, network capability and costs.

Consumers, who currently might not see the benefit of negotiating with a monopoly service provider, may be more prepared to negotiate when an arbitration backstop mechanism is available. Unison proposes that the arbitrator in the case of ELBs should be the Electricity Commission, building on its current accountabilities and knowledge.

In arbitrating a solution to a price/quality trade-off dispute, the arbitrator would need to consider an equitable basis for allocating costs reflective of the quality required and provided and in respect of interdependent assets and services.

As an alternative, albeit second best in Unison's view, the arbitrator could be the Commerce Commission but this would logically require the current accountabilities of the Electricity Commission (most notably model approaches to distribution pricing and model consumer contracts) to transfer to the Commerce Commission. Further, if the Commerce Commission were to take on the role of arbiter it would not be able to play a role advocating on behalf of consumer groups.

8. Other Issues

8.1 2009 reset

Unison has expressed concerns with the 2009 reset process in response to the request by the Commerce Commission for submissions on its "Reset of Thresholds – Process Paper".[15] It is a concern to Unison that work continues in respect of the 2009 threshold reset that might not be required because the Commerce Act review may do away with Part 4A. It is also a concern that significant effort is required to engage with the Commerce Commission in respect of its work plan on the 2009 threshold reset while significant demands are being put on the industry to engage with the Commerce Act review.

A significant element of the proposals included in the MED Discussion Document is the determination of input methodologies in advance. Unison is supportive of this approach, as discussed above, but on the basis that there is full consultation. It is concerning that presently there is work proceeding on matters such as cost allocation and cost of capital methodology which appears to be happening outside of any consultative process. There are also other matters on which consultation has been proposed, such as the treatment of tax, where no progress appears to have been made. Progress on other matters, such as information disclosure requirements, has fallen well behind schedule. These situations raise concerns that input methodologies may be prejudged and will be completed without consultation or within a timeframe that will not allow reasonable consultation.

It would be unfortunate if the perceived benefits of changes to the current regime were undermined due to hasty implementation or a sense of lack of due process.

The Commerce Commission is not limited to a regulatory period of five years for threshold setting by the Commerce Act. Section 57G of the Act is expressly open as to when thresholds can be set or reset it states:

> *Thresholds for declaration of control*
>
> *(1) The Commission must, as soon as practicable after the commencement of this subpart, and **may from time to time**—*
>
> *(a) consult with participants in the electricity distribution and transmission markets and with consumers as to possible thresholds for the declaration of control in relation to large electricity lines businesses; and*
>
> *(b) set thresholds for the declaration of control in relation to large electricity lines businesses; and*
>
> *(c) publish those thresholds in the Gazette, on the Internet, and in any other manner (if any) that the Commission considers appropriate.*
>
> *(2) Thresholds can be expressed in quantitative or qualitative terms.*

Accordingly there is no statutory basis for the 2009 reset date per se.

[15] Submission from Unison in respect of the Commerce Commission's Reset of Thresholds Process Paper; 13 June, 2007.

The Commerce Commission has established this limitation in the Commerce Act (Electricity Distribution Threshold) Notice 2004 (which would have status as regulations) through the definition of "Assessment Date". The definition implies that the thresholds set by the Commission will be in place until 2009 (and thus not to be interfered with until that date):

> ***Assessment date*** *means at date at which distribution businesses are to be assessed against a threshold, being 31 March 2005 to 2009 inclusive.*

Further the Explanatory Note to the Notice states:

> *The purpose of this Gazette Notice is to-*
>
> *(i) Set thresholds for the declaration of control in relation to lines businesses (other than Transpower New Zealand Limited) for the 5 years beginning 1 April 2004, pursuant to section 57G of the Commerce Act 1986….*

Crystallising a specified time period for the operation of thresholds within a *Gazette Notice* constitutes a very powerful commitment on the part of the Commerce Commission to abide by that time frame. Accordingly, the Commerce Commission probably would not be able to deviate from that path without compelling reasons.[16]

However, Unison supports the proposition that there is merit in establishing a sensible transition path from the current thresholds to any changed regime, be it a new regime arising from the Commerce Act review or a change to the role, form or level of thresholds. As a signatory to the ELB submission, Unison is aware that there is industry support for such transition arrangements. Given industry-wide consent to sensible changes to the thresholds program to accommodate the outcome of the Commerce Act review, it should be possible for the Commerce Commission to amend the Notice.

Alternatively, the MED could recommend making a small technical change to the Commerce Act, by way of the next Statutes Amendment Act, to allow the upcoming reset to be deferred or dealt with in some way.

8.2 Transfer of jurisdiction

Section 57DC of the Commerce Act provides for the transfer of jurisdiction under Part 4A relating to large ELBs from the Commerce Commission to the Electricity Commission at a date no earlier than 30 September 2007.

Unison supports the position in the ELB submission, that jurisdiction for economic regulation of ELBs should remain with the Commerce Commission. However, Unison also promotes a role for an expert panel (the Electricity Commission in the case of ELBs) to arbitrate on price/quality trade-off decisions.

8.3 Further Consultation

Unison believes that the timeframes to complete the review of the regulatory provisions under the Commerce Act are so tight as to seriously undermine the likelihood of sound outcomes being achieved. As the Discussion Document provides two options and recognises that other options or combinations of various elements may be proposed, at the very least a second round of consultation should undertaken. The Ministry would then receive useful and more focussed feedback on the specific set of arrangements the Ministry proposes to be adopted.

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[16] However, the case of *Northern Roller Milling Co Ltd v Commerce Commission (1994)* 5 TCLR is authority for the fact that where the Commission represents that it will regulate a business on particular terms and then it deviates from those terms then it will likely breach its public law obligations.

Appendix I Ownership-based Safe Harbour

Unison has developed its proposed regulatory framework having regard to its view on the necessary objectives of economic regulation, knowledge of the available regulatory institutions and perspective of the shortcomings and challenges revealed through experience with the current regime. A pragmatic review is required to ensure that the proposed solution is not over-engineered, makes best use of the existing infrastructure and experience and optimises the achievement of the objectives and the resources required to support the regime.

It is clear that Unison's preference is for universal regulation of the electricity distribution sector. This preference is driven by the desire to avoid the uncertainty inherent in the current threshold regime. However, as has been noted earlier in this submission, there are a number of small ELBs in the industry that do not have the resources to engage in a demanding regulatory environment. Similarly, the regulatory bodies, especially the Commerce Commission, have limited resources with which to undertake in depth analysis of these firms on a regular basis.

Unison has noted earlier in this submission that the purpose statement should be supported by guidance in terms of when to regulate and, in particular, that alternative arrangements should be contemplated where these are as good or better than regulation.

To accommodate these considerations, Unison considers that it may be practical to provide for a safe harbour for those ELBs that have a strong match between their ownership base and their consumer base. This match would generally be demonstrated through the trust or co-operative ownership structure of the ELBs.

Unison considers this safe harbour is appropriate because the commonality between owner and consumer means that little economic harm is done if prices vary from otherwise efficient levels as the benefit or cost of this inefficiency is offset by the increased or reduced returns to the consumers in their capacity as owners. Where this is the case, trust or co-operative ownership represents the lowest cost form of control on firm behaviour. Clearly this does not apply where owners and consumers are not largely the same.

Accordingly, Unison's regulatory proposal, taking account of pragmatic issues, is that a safe harbour is made available to ELBs on the basis of ownership structure and match of owners and consumers. This should reduce the number of firms that are covered by the Commerce Commission's generic regulatory path or that need to utilise the propose and respond mechanism. It is likely that at least the six largest ELBs, accounting for 74% of consumers, will not be subject to the safe harbour. These firms will be subject to the generic price path or, more likely, will make specific proposals to the Commerce Commission under the propose and respond mechanism.

Appendix II Merits Review

Unison supports the proposal for a merits review to be available in respect of key regulatory decisions. Both Australia and the UK have specialist bodies for considering competition issues. In the UK there is an opportunity to appeal any decision of the Competition Commission (which would include regulatory control decisions) to the Competition Appeal Tribunal. In Australia there is currently no right to merits review for price control decisions per se, although views strongly in favour of such a right have been expressed:

> *"Few regulatory processes are costless or error free. It is in society's interest to reduce the incidence of regulatory error. It is accepted internationally that regulators that possess large amounts of discretionary power should be held accountable for their decisions."*[17]

Australia's regulatory framework does provide for merits reviews of access decisions (which cover terms of access for essential services including price), the power to review access decisions actually covers a large proportion of the decisions made in respect of businesses with "natural monopoly characteristics".

As an enforcement agency the Commerce Commission will be perceived to have a particular natural bias in relation to its decision making, which can be summed up in the words of Terry Calvani, former FTC Commissioner:

> "*It strains credibility to believe that Commissioners, who have authorized the prosecution of a case that may cost the agency (and hence taxpayers) substantial sums, will at the end of the process conclude that a mistake was made and that the respondent committed no wrong*"

The same principle could be applied to a lengthy investigation into whether a business or sector should be subjected to some form of regulation, or to a public post breach inquiry in relation to an ELB that has breached a threshold. Therefore, there would be value in having final decisions in respect of these matters made by a person who is not the enforcement agency, or in the alternative for merits review to be available for these kinds of decision.

David Goddard QC argues that the two key reasons for having a merits review are:

a) Improving the quality of decision-making, and

b) Enhancing accountability of the regulator,

and that merits review achieves these objectives in three ways:

a) The potential for merits review strengthens incentives for the regulator to make high quality decisions, knowing that they may be subject to further scrutiny;

b) The review body can correct errors in particular cases – the "error correction" function that is such an important feature of first appeals in the Court system; and

[17] "The merits of merits reviews"; Professor David Round

c) The review body can provide guidance for the future, to the regulator and to those affected by the regulatory regime.[18]

For these mechanisms to effectively deliver the objectives of merits review identified by David Goddard QC, they must operate beyond the scope of decisions on customised control terms and action in the event of breach as proposed by MED.

Unison also believes that merits review is appropriate at other points in the regulatory decision making process, in order to improve the quality of decision making, including, if Unison's proposal is adopted:

- Decisions made in relation to key inputs/methodologies;
- Arbitrated decisions under a negotiate/arbitrate mechanism; and
- In the event of a proposal from a firm under a propose/respond mechanism, a control decision if it is other than to accept a firm's proposal.

A binding arbitration should be subject to merits review because it is anticipated that the decision maker will be operating in an environment that is governed by policy statements from government, within precedent established by previous decisions of the arbitration body and/or other regulators. The effects of the decision, if wrong, may have lasting effect on either the firm or consumers affected and may establish inappropriate precedents that will themselves have lasting effect.

In the context of a propose/respond mechanism the regulator would be expected to accept a firm's proposal if it met predefined criteria. If the regulator considers that the predefined criteria are not met then the regulator imposes a solution. The proposing firm (or affected consumers) may wish to challenge whether the regulator's judgement that the proposal has or has not met the predefined criteria is appropriate. Similarly, the exercise of judgement by the regulator in setting an alternative solution in place should also be subject to review.

If Unison's regulatory proposals are not adopted, Unison considers that merits review should be available on any key input or methodology decision and for any substantive part of the process on decisions whether to impose regulation or control.

The MED has sought submissions on whether the merits review body should be the Courts or a specialist body. As noted above, both the UK and Australia have specialist bodies to consider competition issues. Consideration of competition issues in general, and key inputs in particular, requires specialist expertise, which a specialist body would be more able to resource than the general Courts. In addition, a specialist body would be able to expedite hearings, whereas the ordinary Courts would be required to integrate merits review with its general caseload. However, it is recognised that the cost and limited resource pool may make establishing a specialist body impractical, notwithstanding that a specialist body could perform other competition functions, such as ratifying access arrangements, imposing penalties for breach of control requirements and ratifying resets of regulatory arrangements.

On balance, Unison favours a specialist body to deal with merits review. Utilising the Courts is regarded as a second best option as critical economic issues are often not well understood by the Courts.

[18] "Regulatory Error: Review and Appeal Rights"; David Goddard QC

The MED has also sought views on the scope of merits review, providing the options of:

a) *Pure appeals – no new evidence can be presented, starting from a presumption that the original decision was correct;*

b) *Appeals by way of re-hearing – further evidence can be submitted with the leave of the appeal body if it could not have been presented at the stage of the original decision-making. The appeals body has discretion to determine whether the whole or a part of the determination is to be re-heard, staring from a presumption that the original decision was correct;*

c) *Hearings de novo – the case is heard entirely from the beginning, new evidence can be introduced, and there is no presumption that the decision appealed from is correct;*

d) *Appeals by way of case stated – this is not a re-hearing of a dispute, rather a procedure whereby further clarification, usually on the point of law, is sought.*[19]

The Discussion Document proposes that merits appeal, if provided for, should be by way of re-hearing. Unison agrees with the MED in preferring option b) above.

[19] Discussion Document; para 236

Appendix III Summary of Responses to Questions Raised

Unison sets out below a summary of its responses to some of the specific questions raised in Chapter 13 of the Discussion Document.

Chapter	Question	Response
1 Introduction	1. Do you have any comments on the desirable characteristics of a regulatory regime as outlined in this Chapter?	Unison would add the following characteristics of regulatory design: • There should be commitment to the regulatory framework from the government, regulatory bodies and regulated entities; • The focus of regulation should be on goods and services not on firms per se; • Regulation should balance the interests of consumers and investors; • The regulatory framework should promote price/quality trade-offs by firms and consumers; • The regulatory framework should promote innovation and efficiency; • Regulatory mechanisms should allow for forward looking solutions.
3 Potential issues with the current regime	1. Does the list [of potential issues] capture the main issues with the current regulatory regime?	Unison agrees that: • The policy objectives are unclear, both in respect of Part 4 (eg net acquirers versus net benefits test) and Part 4A (eg absence of references to investment); • The separation of the *'whether'* and the *'how'* to control decisions is problematic. Combining the two decisions will require extra effort upfront but will avoid a two step process and mean that the likely benefits/impacts of

Chapter	Question	Response
		control will be known, providing for a more informed and productive decision-making process; • The current regime fosters uncertainty, which has a negative impact on incentives to invest; • There are insufficient accountability mechanisms for regulatory decision making, including insufficient delineation between the functions of regulatory design and implementation; • The Part 4A regime is not meeting is statutory objectives. Unison does not necessarily agree that there are constraints on the regulatory approaches available to the Commerce Commission due to the existence of the thresholds regime in Part 4A. Unison is concerned that the thresholds are not necessarily consistent with the outcomes that would arise from the use of a standard regulatory tool such as the building blocks methodology.
	2. Are these issues adequately identified and described?	Unison considers that there are a number of details that could be added to the discussion in Chapter 3 but is generally supportive of the description provided. For example, there is concern currently with input methodologies including the use of ODV and the treatment of asset revaluations in assessing firm performance.
	3. Are there any other issues with the current regime that are not listed … and should be considered as part of this review?	Unison considers the following issues also exist: • The design of the regulatory regime promotes an adversarial approach rather than a more enlightened approach where both the regulator and the firms take accountability for delivering sound outcomes; and • The current regulatory arrangements do not effectively

Chapter	Question	Response
		promote customer driven price/quality trade-offs.
4 Objectives of economic regulation	1. Do you agree that a regulatory regime needs to be available to address issues in markets with monopoly characteristics?	Unison does agree that a regulatory regime needs to be available to address issues in markets with monopoly characteristics. This regime should be largely generic across industries and the MED correctly focuses on markets (i.e. the provision of goods and services in markets) rather than on firms.
	2. Do you consider that the sole or primary objective of a regulatory regime should be economic efficiency or consumer protection (distribution), or do you consider that both should be taken into account?	Unison's preference is for a focus on economic efficiency, and considers that distributional issues should only play a secondary role.
5 Purpose statement	1. Is a regulatory-specific purpose statement desirable?	Unison agrees that a regulatory specific purpose statement is desirable.
	2. If so, do you agree with the proposed regulatory-specific purpose statement, or do you prefer an alternative formulation? If so, please suggest specific wording.	Unison is generally comfortable with the elements of the purpose statement proposed by the MED but there should be greater legislative guidance as to its meaning, including a clarification that greater emphasis should be given to efficiency.
6 The decision on whether to impose regulation	1. Do you agree with the proposed criteria for deciding on whether regulation *may* be imposed?	Unison considers that the issue of *whether* to regulate should be focussed on efficiency considerations rather than distributional outcomes.
	2. If you agree that one of the tests for whether control may be imposed should be where long term benefits to acquirers *exceed* direct and indirect costs, do you consider that such benefits should (a) *'substantially'* or (b) *'clearly'* exceed costs, or should there be some other guidance on weighting?	Unison supports the ELB industry submission which proposes that the long term benefits should *'substantially'* exceed direct and indirect costs before control is imposed.
	3. If you agree that one of the tests for whether control may be imposed should be where long term benefits to acquirers exceed direct and indirect costs, should those	Unison believes that where end users acquire goods or services indirectly then it should be necessary to establish that benefits *will* be passed on to end users before control is

Chapter	Question	Response
	benefits be considered regardless of whether acquirers acquire the goods or services *directly* or *indirectly*, or should it be necessary to establish that benefits *will* be passed on to end users (or consumers or end-acquirers)?	imposed.
	4. Should the current provisions in the Act allowing control to be imposed in the interests of *suppliers* (to a monopsonist) be retained?	In principle control should be able to be imposed in an environment where there is only one buyer of the goods or services. That such markets are likely to be rare should not preclude their inclusion within the regulatory framework, however they may require specific and separate consideration in the drafting of legislation. Accordingly, Unison has not given consideration to this situation in developing its proposed regulatory framework.
	5. Do you agree that there should not be a legislative test for when regulation *should* by imposed?	Unison agrees that there should not be a legislative test for when regulation *should* be imposed. Rather, there should be clear process and criteria where, if satisfied, control *should* be imposed.
	6. Do you agree that the Minister should remain the decision-maker on whether control should be imposed under Part 4, but that the Minister must receive a report and recommendation from the Commerce Commission before making the decision?	Unison agrees that the Minister should remain the decision maker in respect of if the provision of goods or services should be specifically covered by the regulatory provisions of the Commerce Act. Unison promotes a two stage process where: i) a decision by the Minister that the regulatory provisions of the Commerce Act should apply puts those goods or services generally or as provided by specific firms on a schedule in regulations and imposes information disclosure in respect of those goods or services; and ii) a decision by the Commerce Commission may decide to subject firms to control against price path and quality criteria or an alternative regulatory arrangement proposed by the firm, or firms may have

Chapter	Question	Response
		commercial or ownership arrangements in place that mitigate the need for specific regulatory arrangements (i.e. safe harbour)
	7. Do you agree that the decisions on *whether* and, if so, *how*, to regulate should be undertaken simultaneously?	Unison agrees with the proposal for simultaneous consideration of '*whether*' and '*how*' to regulate.
7 Types of economic regulation	1. Dou you agree that it is desirable to widen the scope of the Commerce Act by providing for regulatory options other than control, specifically: • Negotiation/arbitration and • Price monitoring/information disclosure?	Unison has set out its own proposal in relation to how businesses should be regulated and the relevant criteria for regulating which acknowledges a role for negotiate/arbitrate, but not as a stand alone regulatory tool.
	2. Dou you consider that specific, easier tests should be provided to determine whether lighter-handed types of regulation, such as information disclosure, may be imposed, such as: • Meeting the competition criteria only • Requiring qualitative (rather than quantitative) cost-benefit analysis?	Unison promotes a two stage process where: i) a decision by the Minister that the regulatory provisions of the Commerce Act should apply puts those goods or services generally or as provided by specific firms on a schedule in regulations and imposes information disclosure in respect of those goods or services. The test for this step is competition and efficiency; and ii) a decision by the Commerce Commission may decide to subject firms to control against price path and quality criteria or an alternative regulatory arrangement proposed by the firm, or firms may have commercial or ownership arrangements in place that mitigate the need for specific regulatory arrangements (i.e. safe harbour). The test for this step is abuse of market power which should be subject to criteria consistent with those that would guide acceptance of an alternative regulatory arrangement proposed by the firm.
8	1. Do you see value in having key input decisions set as a	Unison agrees that having key inputs set as a stand alone

Chapter	Question	Response
Key input decisions	stand-alone process in advance of an inquiry and recommendation to regulate? If so, should they be set for a specific sector once an inquiry has been initiated, or set generically irrespective of whether or not an inquiry has been initiated?	process would be an improvement on the existing regime. Unison agrees that generic regulation could be set to apply to all businesses within a sector.
	2. Is it practical, or possible, to set generic methodologies that could apply to all potentially regulated sectors?	Unison believes that it is practical to set generic methodologies, although different parameters may be applied to some of these methodologies (eg WACC) depending on the industry. In other cases, the methodological decisions should be consistent (eg the principles for the treatment of taxation).
	3. Do you consider input methodologies should be set: • As guidelines by the Commerce Commission; • As Rules by the Minister following a recommendation from the [Commerce] Commission; or • Another option (please specify)?	Unison believes that the decisions establishing the input methodologies should be subject to merits review as these are fundamental decisions that will have wide and lasting impacts. Unison also believes that the key input methodologies should be set by an independent expert panel. Unison is not well placed to advise on how decisions of an expert panel would be implemented with the necessary binding force on the Commerce Commission. As noted in this submission, Unison recognises that an alternative, albeit second best solution, is for the Commerce Commission to produce binding guidelines which would be subject to merits review.
9 Regulatory control design issues	1. Should specific provision be made (eg in Part 5) to allow the Commerce Commission to use comparative benchmarking as a methodology for setting control terms?	Unison is not supportive of comparative benchmarking, especially in the context of the electricity distribution industry. As this submission points out, ELBs are vastly different and are subject to unique operating environments. However, where there is the possibility for firms to propose alternative regulatory arrangements, comparative benchmarking may provide a cost-effective means of

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<tr><th>Chapter</th><th>Question</th><th>Response</th></tr>
<tr><td></td><td></td><td>establishing broad price and or quality paths.</td></tr>
<tr><td></td><td>2. Should specific provision be made to allow the Minister to request the [Commerce] Commission to consider whether economic regulation may be imposed on a sector as a whole (rather than each individual firm within a sector) and if so, should provision be made for cost benefit analysis on this matter to be undertaken in qualitative (rather than quantitative) terms?</td><td>Unison promotes a two stage process where:
i) a decision by the Minister that the regulatory provisions of the Commerce Act should apply puts those goods or services generally or as provided by specific firms on a schedule in regulations and imposes information disclosure in respect of those goods or services; and
ii) a decision by the Commerce Commission may decide to subject firms to control against price path and quality criteria or an alternative regulatory arrangement proposed by the firm, or firms may have commercial or ownership arrangements in place that mitigate the need for specific regulatory arrangements (i.e. safe harbour).
Unison believes that a quantitative test is appropriate as the test should be based on competition and efficiency.</td></tr>
<tr><td></td><td>3. Is there value in allowing firms to propose their own control terms for the [Commerce] Commission's consideration ('propose/respond' model)?</td><td>Unison is supportive of businesses being able to propose their own control terms where appropriate.</td></tr>
<tr><td></td><td>4. If firms are able to propose their own control terms, should the [Commerce] Commission be required to accept proposals that meet pre-set criteria? Do you have any comment on the proposed 'reasonableness criteria'?</td><td>Unison is supportive of criteria for accepting a firm's proposal for alternative regulatory arrangements to be pre-determined. Such criteria should be consistent with a building blocks approach and satisfy the input methodologies that have also been predetermined.</td></tr>
<tr><td></td><td>5. If firms have the ability to propose their own control terms, should this proposal take place before or after declaration of control by the Minister (note that on section 9.3 the paper proposes different sequences for control of individual firms compared to sector control)?</td><td>Under Unison's proposal, the Commerce Commission would establish its proposed regulatory arrangements and the firm would then have 90 days to propose an alternative regulatory arrangement.</td></tr>
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Chapter	Question	Response
10 Possible packages of 'how to regulate'	1. With regard to the Part 4A thresholds regime do you favour: • Retaining the threshold regime and making it more generic (that is, applicable to sectors other than electricity lines businesses), or • Repealing Part 4A and amending Part 5 to allow the Commerce Commission to use comparative benchmarking to set terms and conditions for control while allowing firms to seek customised control terms.	Unison has proposed a variation of Option Two as the best model for regulating. Part 4A is considered to not be achieving its statutory purpose. Unison promotes a two stage process where: i) a decision by the Minister that the regulatory provisions of the Commerce Act should apply puts those goods or services generally or as provided by specific firms on a schedule in regulations and imposes information disclosure in respect of those goods or services; and ii) a decision by the Commerce Commission may decide to subject firms to control against price path and quality criteria or an alternative regulatory arrangement proposed by the firm, or firms may have commercial or ownership arrangements in place that mitigate the need for specific regulatory arrangements (i.e. safe harbour).
	2. Are there other options for addressing the issues with the Part 4A threshold regime?	Not practically. Unison considers Part 4A to be fundamentally flawed as it promotes an adversarial environment, generates uncertainty, does not incentivise investment or innovation and does not provide for forward looking solutions. Any effective solution to these problems requires a fundamental rethink starting with reviewing the premise that regulation of ELBs should be targeted.
	3. Are small businesses within a sector likely to be disproportionately affected by the requirements of the regulatory regimes proposed in the [Discussion Document]? What are the likely *incremental* costs of complying with the current Part 4A and proposed alternative regimes? How could these costs be minimised?	Unison does not believe that small firms will be any more proportionately disadvantaged by its proposed regulatory framework than they are by the current regime. Where firms can take advantage of the ownership safe harbour arrangements their compliance costs are likely to be lessened. Firms subject to the (price and quality) incentive-based regulatory arrangements should face similar demands to the current threshold setting process. It is unlikely that

Chapter	Question	Response
		small firms would opt for the propose/respond mechanism, although with clear and predetermined criteria, this may not be a particularly costly process either.
	4. Should local community owned trusts be subject to a different regulatory regime than larger non-trust electricity lines businesses?	Unison also agrees with there being a specific regulatory carve out for consumer trust firms where there is a strong alignment between the customer base and the consumer owners (Unison would exclude itself from such a category).
11 Processes for amending and enforcing control terms	1. Do you agree that control terms should not be re-opened within a specified control period, other than under exceptional circumstances? If so, do you agree with the exceptional circumstances suggested in [Chapter 11 of the Discussion Document]?	Unison agrees that the (price and quality) incentive-based regulatory arrangements or the firm proposed alternative regulatory arrangements should not be able to be re-opened unless there are unforeseen circumstances or hardship. Unison is supportive of the exceptional circumstances proposed in the Discussion Document.
	2. Are the current provisions relating to penalties in the Act for breaches of control terms (s70C) satisfactory or should additional guidance be provided?	The penalty provisions currently in the Commerce Act lack the latitude that would be available in a more co-operative environment. Under Unison's proposed regulatory framework a degree of latitude would be appropriate. Given that the firm has a choice to select whether to accept the incentive-based regulatory arrangements or to pursue a more firm specific solution through the propose/respond approach, it is proposed that the regulatory arrangements applying to a firm should be mandatory, subject to a minimal, pre-defined range or "dead band" to allow for minor year to year variations and for estimation error.[20] In the event of a breach of the incentive-based regulatory arrangements or the agreed alternative regulatory

[20] For example, revenue and quality levels may have a "dead band" of +/- 5%, such that cumulative variations over the regulatory period would need to exceed the "dead band", relative to the current year's regulated values, before penalties would apply. The use of cumulative variances allows firms to correct an inadvertent overshoot or to recover a minor undershoot over the course of the regulatory period. The setting of the dead band range, taken together with the cumulative nature of the measure, should seek to avoid an incentive for any material "gaming" at the margin of this band.

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		arrangements, in excess of the dead band range, the Commerce Commission should be able to impose penalties and require conformance with the arrangements.
12 Accountability mechanisms	1. Do you consider that it is desirable to provide for merits review of regulatory decisions or does judicial review provide sufficient constraints on regulatory decisions?	Unison considers that merits review is vital for decisions on key inputs and all substantive decisions on whether and how to regulate.
	2. Do you agree with the document's conclusions that, if merits review is provided for, it should only apply to control decisions made by the [Commerce] Commission and be limited to the form of 'appeals by way of re-hearing' where new evidence can be introduced only if it is fresh and it could not have been submitted at the original decision-making stage?	Unison does not agree that merits review should only apply to control decisions made by the Commerce Commission. Under Unison's proposed regulatory framework the following decisions should be subject to merits review: • Determination of key inputs/methodologies; • Decisions to accept/reject alternative regulatory arrangements proposed by a firm; • Decisions to impose penalties for breach of regulatory arrangements; • Arbitrated decision on price/quality trade-off dispute. Unison agrees that, if merits review is provided for, it should be limited to the form of 'appeals by way of re-hearing' where new evidence can be introduced only if it is fresh and it could not have been submitted at the original decision-making stage.
	3. What is your preferred composition of any merits review body, taking into account New Zealand's small size and limited resources?	Unison's preference is for a specialist body to carry out the merits review.