

The Chair
CABINET ECONOMIC DEVELOPMENT COMMITTEE

REVIEW OF PARTS 4 AND 4A OF THE COMMERCE ACT

PROPOSAL

- 1 This paper makes recommendations on amending Parts 4, 4A and sections 70-73 of Part 5 of the Commerce Act, which provide powers to price control sectors which have natural monopoly characteristics.

EXECUTIVE SUMMARY

- 2 Part 4 of the Act has generic provisions enabling price control to be imposed where competition is limited and control would be in the interests of acquirers. Part 4A empowers the Commerce Commission to impose control on electricity lines businesses where they breach thresholds set by the Commission. Sections 70-73 of Part 5 set out process requirements.
- 3 In 2006 Cabinet agreed to review Parts 4, 4A and 5. In April 2007 Cabinet approved release of a discussion paper [EDC Min (07) 7/13].
- 4 The discussion paper and submissions identified a number of issues with the current legislation, including the absence of a specific purpose statement for Part 4, absence of powers to implement alternative forms of regulation, lack of certainty for electricity lines businesses under Part 4A, and a limited accountability regime for the Commerce Commission as regulator. In addition, the view was expressed that the “control” provisions tended to be punitive rather than to have a forward-looking focus on long-term incentive regulation.
- 5 Following consideration of submissions, the following key amendments are proposed:
 - a Specifying a purpose statement for Part 4
 - b Provision for alternative forms of regulation in addition to conventional price control, namely:
 - i information disclosure
 - ii a negotiate/arbitrate regime (potentially suitable for sectors with a few large customers), and

- iii a 'default/customised price-quality path' regime for sectors like electricity lines to replace Part 4A. This would allow the Commission to set a default price-quality path (like Part 4A) while providing an ex-ante, time-bound opportunity for a firm to seek a customised path (eg where it needs to make a step-change in investment to maintain quality standards required by consumers)
 - c A more conventional, qualitative test (with quantification where possible) for when regulation may be imposed. Decision-making powers on whether to regulate would remain with the Minister of Commerce, in consultation with sector ministers
 - d A requirement that "input methodologies" (how to determine the cost of capital, value assets, allocate common costs etc) should be set as soon as possible by the Commission with the aim of improving certainty and predictability for businesses. Commission decisions on input methodologies would be subject to merits appeal to the High Court.
- 6 It is also proposed that trust-owned electricity lines businesses (17 out of 28 ELBs) be subject only to information disclosure, while the 'default/customised price-quality path' approach would be applied to other ELBs and to gas pipelines.
 - 7 The amendments are expected to be generally welcomed by affected businesses. They aim to improve certainty and apply more internationally conventional forward-looking approaches to regulation than the Act currently allows. The changes are expected to improve business confidence and, as a consequence, improve the climate for investment in infrastructure.
 - 8 It is proposed that the Act be amended in 2008. We also recommend a brief and informal period of consultation with interested parties on design details in parallel with commencement of drafting.

BACKGROUND

- 9 The Commerce Act 1986 is a generic competition law which is a key part of the business law framework in New Zealand. The over-arching presumption in the Act is that competition is the most effective means to achieve long-term consumer welfare where competition is possible. The overall purpose statement of the Act is "to promote competition in markets for the long-term benefit of consumers within New Zealand". To this end, Part 2 prohibits or restricts anti-competitive conduct, while Part 3 restrains business acquisitions (mergers and takeovers) which substantially lessen competition unless there are net public benefits.

- 10 Parts 4 and 4A however, relate to markets where competition is not possible. Specifically, Part 4 allows goods or services to be placed under price/revenue and/or quality control (economic regulation) where there is limited or lessened competition and control would be in the interests of acquirers¹. Control may be imposed by Order-in-Council on the recommendation of the Minister of Commerce or the Minister of Energy (for energy sectors). Two inquiries have been undertaken by the Commerce Commission under these provisions, into airports (1999-2003) and gas pipelines (2003-2005)².
- 11 Part 4A applies a 'thresholds' regime for electricity lines businesses, which enables price and quality control to be imposed if businesses breach thresholds set by the Commission. Part 4A was passed in 2001.
- 12 Sections 70-73 of Part 5 set out the processes for operating price control.
- 13 On 22 May 2006 the Minister of Commerce announced that Parts 4 and 5 would be reviewed, and on 13 September the Ministers of Commerce and Energy announced the inclusion of Part 4A in the review. On 4 April 2007 Cabinet agreed to release of a discussion paper "Review of the Regulatory Control Provisions of the Commerce Act 1986" [EDC Min (07) 7/13].
- 14 Submissions were received from 45 parties. A list of submitters is attached as Appendix A. Submissions are posted on MED's website. A summary of submissions is available from the Minister's office.

COMMENT

Reasons for economic regulation (price-quality control)

- 15 The key reason for economic regulation is to counter the ability of firms which are not faced with competition or the threat of competition to charge excessive prices and/or cut back on quality. Potentially, such firms may also have weak incentives to improve efficiency and to make investments in a timely manner.
- 16 There are relatively few sectors which are not faced with competition or the threat of competition and where there is substantial scope for the exercise of market power. These sectors tend to be basic infrastructure such as electricity lines, gas pipelines, water, some airport services, telecommunications lines (last mile), and, in some countries, rail and ports. All OECD countries regulate such sectors where they are privately owned.

¹ The Act also allows for control where that would be in the interests of suppliers (eg to a monopsonist buyer).

² In the case of airports, the Commerce Commission recommended control of Auckland airport (and Wellington airport if it increased its prices). The Minister decided not to impose control because net public benefits (overall efficiency) were negative and benefits to consumers were low. In the case of gas pipelines, the Commission recommended control of the gas pipelines of Vector and Powerco. It also recommended that other gas pipelines (except those of Nova Gas and the Taranaki pipelines) be subject to a Part 4A regime. The Acting Minister of Energy (and Cabinet) agreed to these recommendations.

Issues identified with Parts 4 and 4A

- 17 The review of Parts 4 and 4A was prompted by a number of perceived problems. Submitters generally (but not unanimously) agreed that the issues include:
- Absence of a specific purpose statement for Part 4. This has led to dispute and uncertainty³
 - The test for whether to regulate is controversial⁴, and the practice of the Commission is to undertake a comprehensive quantitative cost-benefit analysis when undertaking inquiries⁵
 - Separate inquiries are required on ‘whether to regulate’ and ‘how to regulate’
 - There are no powers to implement alternative forms of regulation
 - The Part 4A thresholds regime is generally regarded (except by the Commission and two other submitters) as unsatisfactory, in terms of certainty for businesses and incentives to invest (covered more fully later)
 - The accountability regime for the Commission is limited (only judicial review is available).
- 18 Additionally, several submitters argued that the current Act had a negative backward-looking focus on control as punishment for bad behaviour and “breaches”, rather than a forward-looking incentive-based approach where the regulator and the firm seek to mimic the outcomes of competitive markets.

Overall objectives of the review

- 19 The objectives of the review have been to seek ways of addressing these issues, and in particular to:
- Provide an efficient and credible regime to address the potential to exercise market power in markets where competition is not possible
 - Improve clarity, certainty, timeliness and predictability for businesses
 - Tailor the regime to New Zealand’s small size (with small firms and limited resources)

³ In the absence of a specific purpose statement the overall purpose statement of the Commerce Act applies, which is “to promote competition in markets for the long term benefit of consumers in New Zealand”. The purpose statement clearly doesn’t work well for markets where there is little or no scope for competition.

⁴ The current test is interpreted by the Commission as a “net acquirers benefit” test (that is, that regulation may, and should, be imposed when doing so results in a net benefit to acquirers after taking into account any efficiency effects). Many argue however, that a better test would be “net public benefits” which considers society as a whole.

⁵ No other OECD country appears to undertake formal, published quantitative cost-benefit analysis on the issue of whether to regulate (price control).

- Provide specifically for incentives to invest in infrastructure. Certainty is considered a pre-requisite for this.

Purpose statement

- 20 As noted, there is currently no purpose statement for Part 4. Part 4A does have a purpose statement however.⁶
- 21 All submitters agreed that a purpose statement was required for Part 4, but there was no consensus on suitable wording. A key point of contention was whether the purpose should be about improving overall efficiency in the economy or should also explicitly provide for protection of consumers from excessive prices (although these two objectives are not necessarily in conflict).
- 22 We consider that both issues need to be explicitly provided for, and propose wording along the following lines (subject to PCO drafting) which builds on existing wording in Part 4A:

“The purpose of this Part is to provide for regulation of prices and quality of goods and services to promote the long term benefit of consumers in markets where there is little or no competition and prospect of competition. Any regulation provided for under this Part should promote outcomes such that suppliers:

- (a) have incentives to innovate and to invest, including in replacement, upgraded and new assets and in related businesses;
- (b) face strong 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;
- (d) are limited in their ability to extract excessive profits.”

Forms of regulation

- 23 At present, the Act only provides powers to implement full price control where an inquiry concludes that economic regulation is justified. Submitters generally agreed with the proposals in the discussion paper that a wider range of regulatory instruments should be available. (There were differences in views on the design detail of some of these forms: these are discussed later in this paper).

⁶ “The purpose of this subpart is to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers:

- (a) are limited in their ability to extract excessive profits; and
- (b) face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) share the benefits of efficiency gains with consumers, including through lower prices.”

- 24 The following forms of regulation are proposed:
- Information disclosure
 - A negotiate/arbitrate regime
 - A 'default / customised price-quality path' regime for sectors to replace Part 4A
 - Price-quality control for individual firms.
- 25 These models are specified later in the paper and in more detail in Appendix B.

Tests and processes for imposing regulation

- 26 The current test for whether control may be imposed on goods and services is that competition is limited and control is necessary or desirable in the interests of acquirers. There is no test for whether control should be imposed. Separate inquiries are required on whether to control and, if so, how to control.
- 27 Decisions on whether to regulate are currently made by the Minister of Commerce, or, in the case of energy sectors, the Minister of Energy. The Commission may initiate inquiries or it may be requested to undertake an inquiry by the Minister.
- 28 As noted, the Commission's practice, when undertaking inquiries, is to undertake full quantitative cost-benefit analysis on "net acquirers benefit" in assessing whether regulation may be imposed. For the gas pipelines inquiry, the Minister also asked the Commission to assess "net public benefits" to assist in the judgement about whether regulation should be imposed. These inquiries are very time and resource intensive, and open up wide scope for dispute.
- 29 Following consideration of submissions, the following revised criteria and processes are recommended:
- a Goods or services in a market *may* be subject to regulation where:
 - i There is little or no competition and prospect of competition and there is substantial scope for the exercise of market power, taking into account the effectiveness of existing regulation or arrangements (including ownership arrangements), and
 - ii The benefits of regulation in meeting the objectives of the purpose statement clearly exceed the costs and risks of regulation.
 - b In providing recommendations to the Minister, the Commission should undertake a *qualitative* analysis of all material long-term efficiency and distributional considerations. As part of this analysis, the Commission should, as far as possible and practicable:
 - i quantify material effects on market efficiency
 - ii quantify material distributional and welfare consequences on suppliers and consumers

- iii assess the direct and indirect costs and risks of the forms of regulation considered, including administrative and compliance costs, transaction costs, and spill-over effects
 - c Any regulation should be the least intrusive necessary to meet the objectives of the purpose statement
 - d Where competition develops in a market so that the test for whether regulation may be imposed is no longer met, regulation should be removed
 - e 'Whether to regulate' and 'how to regulate' should, to the extent practicable, be determined at the same time.
- 30 Most submitters favoured retaining current decision-making processes, whereby decisions on whether to regulate are made by the Minister, given the need to weigh up a range of factors including efficiency and distributional considerations. It is proposed however that:
- The current powers for Ministers to make decisions without an inquiry by the Commerce Commission be repealed
 - That decisions be taken by the Minister of Commerce in consultation with the sector Minister (such as the Minister of Energy or the Minister of Transport)
 - An inquiry be required both on whether regulation should be introduced (and the form of regulation) and on proposals to change the form of regulation.

Input methodologies

- 31 "Input methodologies" refers to the methodologies for how to calculate the weighted average cost of capital (WACC), value assets, allocate common costs, prepare regulatory accounts and so forth⁷. They are a critical input for any inquiry and for implementing all forms of regulation, including information disclosure, negotiate/arbitrate and setting price paths.
- 32 The discussion document proposed that "input methodologies" be set in an up-front stand-alone process at the start of inquiries and any set or re-set of price/quality paths. The purpose is to give greater certainty, transparency and predictability to businesses (including businesses not subject to regulation) and their customers. Virtually all submitters, including the Commission, endorsed the proposal.
- 33 The Commission has already developed (and continues to develop) high-level principles, guidelines and specifications on many of the input methodologies as part of its current duties (including administering Part 4A, developing information disclosure for electricity lines, setting price control terms for the gas pipelines of Vector and Powerco and undertaking inquiries on airports and gas pipelines). However, the Commission advises that finalising the methodologies and frameworks at an early date constitutes a major additional workload.

⁷ A more detailed list is provided in section E of Appendix B.

- 34 Most submitters were strongly of the view that the methodologies should be subject to some form of merits review given the importance of the issues, the need to correct any errors and to provide confidence to businesses about the integrity of the regulatory regime.
- 35 There are two main options for review, one is an independent expert panel appointed by the Minister and the other is appeal to the High Court (with specialist lay members). The pros and cons are noted below:

High Court	Independent panel
<ul style="list-style-type: none"> ○ With up to two lay members (specialist expertise) 	<ul style="list-style-type: none"> ○ Chaired by former judge (or equivalent) ○ Standing panel appointed by Minister: specific panel members for cases selected by Chair ○ Levy funded ○ Minister could set timeframes for decisions in consultation with the Chair
<p><i>Pros</i></p> <ul style="list-style-type: none"> ○ Established processes and procedures ○ Low risk of further appeals (process or proper interpretation of law) ○ No suggestion of ‘political’ involvement <p><i>Cons</i></p> <ul style="list-style-type: none"> ○ Timeliness issues given other court workloads ○ Courts may prefer to deal with case-specific applications rather than methodologies in the ‘abstract’ ○ May be difficult to assign judge with specialist expertise 	<p><i>Pros</i></p> <ul style="list-style-type: none"> ○ Faster decisions than High Court ○ May allow for more tailored expertise ○ Costs met by affected parties (levy) <p><i>Cons</i></p> <ul style="list-style-type: none"> ○ Higher risk of further appeals ○ Perception of political involvement ○ More difficult to manage conflict of interest issues ○ Need to develop rules for processes and procedures ○ Levy design may be difficult (‘fairness’ issues) ○ Costs of members may be high

- 36 On balance, we prefer, and recommend, consideration of appeals by the High Court. In particular we think this is a more conventional approach, minimises the risk of further appeals and reviews (because processes are likely to be better) and minimises the difficulties of managing conflict of interest problems.
- 37 The Commission estimates its costs for preparing input methodologies (at a high generic level, and for electricity lines, gas pipelines and airports) at \$1m in 2007/08, \$2m in 2008/09 and \$1m in 2009/10. These costs would be funded by levy. The costs exclude defending any appeals (estimated at [withheld due to confidentiality] in 2009/10 and [withheld due to confidentiality] in 2010/11).

Ministry of Justice's views

- 38 The Ministry of Justice agrees that the input methodologies should be subject to independent review, however, it disagrees with the proposal that appeals be to the High Court. The Ministry considers that review decisions about input methodologies are not suited for judicial decision-making since they relate to fact, rather than interpretation and application of the law. There may also be difficulties in assigning judges with specialist knowledge in this area. While many judges have particular areas of interest and particular specialist knowledge, their role is to interpret and apply the law to a particular factual situation, rather than be the principal decision-maker in matters which require highly specialised knowledge about input methodologies.
- 39 Although the proposal allows for the High Court to appoint lay members with specialist knowledge, the Ministry considers that an independent body made up of specialists is more appropriate. An independent panel will enable the appointment of people with the appropriate technical knowledge and skills. Furthermore, an appeal to the High Court is likely to take more time than an independent panel which could dedicate resource to such reviews. This could impact on the timeliness of inquiries under the Commerce Act as well as implementing regulation.

Criteria for appeals

- 40 It is proposed that the criteria for appeals be based on the draft Australian National Gas Law, as follows:
- a The original decision maker made an error of fact in its findings of facts, and that error of fact was material to the making of the decision;
 - b The original decision maker made more than one error fact in its findings of facts, and those errors of fact, in combination, were material to the making of the decisions;
 - c The exercise of the original decision maker's discretion was incorrect, having regard to all the circumstances.
 - d The original decision maker's decision was unreasonable, having regard to all the circumstances.⁸
- 41 It is also proposed that:
- The Commission may adopt, with modifications where required, methodologies used by regulatory bodies in similar overseas jurisdictions
 - Appeal processes should be limited to a re-consideration of material submitted to the Commission⁹.

⁸ National Gas Law Second Exposure Draft, section 225

⁹ This is an important provision to limit the risk of gaming and "forum shopping". Further specifications on appeal processes are provided in Section E of Appendix B.

Information disclosure

- 42 We propose that powers to recommend and implement information disclosure be provided in the Act. Information disclosure is a relatively light-handed form of regulation, although it can be quite powerful in setting standards on what is acceptable and for early identification of trends which may raise concerns.
- 43 It is recommended that the power includes the ability to require forward-looking information (such as asset management plans, investment intentions, regulatory accounts, prices and quality standards) and that the Commission be empowered to monitor compliance and outcomes. Clear and explicit “input methodologies”, including pricing principles, are a key component of effective information disclosure.

Negotiate/arbitrate regime

- 44 The discussion paper proposed that the Commerce Act include powers to put in place a ‘negotiate/arbitrate’ regime, as follows:
- a Parties (suppliers and their customers) would be encouraged to negotiate a settlement on matters such as investments, quality of service and prices
 - b If they fail to agree within a specified timeframe, they may agree on an arbitrator, or the Commission may appoint an arbitrator (including itself as arbitrator)
 - c The Commission would have powers to set processes and timeframes for negotiation, and specify the scope of negotiation, the form of arbitration (including final offer arbitration) and the input methodologies to be used.
- 45 The Australian Trade Practices Act Part III provides for a negotiate/arbitrate regime for terms and conditions for access to essential facilities and negotiate/arbitrate-determine also underpins New Zealand’s Telecommunications Act. A number of overseas jurisdictions (including Canada and Florida on electricity and the UK with some airports) are said to have experienced success with ‘negotiated settlements’, with suppliers and customers able to customise a settlement to meet their own requirements.

Arguments in favour	Arguments against
<ul style="list-style-type: none"> • Less costly and intrusive than conventional price control • Arbitrator/regulator only involved if parties fail to agree • Provides incentive for parties to negotiate a settlement • Less costly for regulator • Parties able to customise settlement to meet own circumstances • May improve relationships between suppliers and customers (some evidence from overseas) 	<ul style="list-style-type: none"> • Parties look to the end-game (i.e. arbitration/regulation) and position themselves to get the best outcome from arbitration/regulation, partly reducing the incentive to negotiate • Some submitters say that it would stall and frustrate investment [<i>though</i> it should not do so if timeframes are set] • Arbitration can be complicated where there are multiple services and parties <ul style="list-style-type: none"> – Very difficult to get agreement of all parties, so arbitration/regulation is inevitable • May be less efficient than price control

- 46 Submitters were divided on whether negotiate/arbitrate was a useful option¹⁰. The option was strongly supported by airlines (which want it applied to airports), and was strongly opposed by airports (which see it as not much different to full regulation).
- 47 On balance, we propose to include this form of regulation as an option, recognising that it will only be likely to be used in fairly specialised circumstances.

Default/customised price-quality path

- 48 This approach is designed to build on and replace the Part 4A thresholds regime for electricity lines businesses (except trust-owned businesses: see later). It is also proposed for gas pipelines (see later comment) and to be available as a potential form of regulation for other sectors.
- 49 The design details are specified in Appendix B. Its key features are as follows:
- a The Commission should set a default price-quality path for a regulatory period (normally 5 years) for all businesses in a regulated sector based on factors such as productivity trends and comparative benchmarking. In this respect it would be very similar to the current Part 4A thresholds regime
 - b A firm would have a choice of either accepting this default path or making a (public) proposal to the Commission for a customised path. The Commission would specify the scope and quality of information required from the firm for a proposal, including use of specified input methodologies (for WACC etc)¹¹, consultation requirements with customers, independent audit and so forth.
 - c The Commission would make a determination on the firm's proposal within 9 months (plus two months if additional information is required from the firm for a complete proposal, plus a further 6 weeks if the firm and the Commission agree). Timeframes are shown in Appendix C. The Commission may set a tougher price-quality path than the default.
 - d Conventional penalties and remedies would apply to any breaches of default or customised price-quality paths.
 - e Other design specifications:

¹⁰ Air New Zealand, BARNZ, IATA, Virgin Blue, NZ Shipping Federation, the Commerce Commission, Electricity Networks Association, MEUG, Mighty River, NZCID, and Unison supported negotiate/arbitrate. The Ak Elect. Consumer Trust, Babcock & Brown and Transpower were either equivocal or gave qualified support. Aurora, Case Associates and Powerco, Wellington and Christchurch airports, port companies (joint submission), and the Wellington Chamber of Commerce opposed, submitting that it might be costlier and more "heavy-handed" than imagined.

¹¹ The requirement to comply with input methodologies (ie a prohibition on re-litigating input methodologies) should significantly reduce the scope of proposals and for argument, and should help limit the number of proposals and the time required for consideration. Proposals are therefore most likely to be focused on the need for a step change in investments (compared to historic levels) in order to meet customer requirements and quality standards.

- i The firm may submit a proposal in any year of the regulatory period, but may only submit a proposal once during the regulatory period
- ii The Commission would only be obliged to make determinations on four proposals per sector a year, and to prioritise its work as it saw fit. Other proposals would be deferred until the following year
- iii The default path would apply from the start of the regulatory period. Provision would be available for reasonable revenue-recovery where the Commission subsequently set a higher price path
- iv Any customised path would apply for 3 to 5 years and firms coming off a customised path would revert to the then applicable default path
- v If the Commission does not make a determination on a proposal for a customised price-quality path within the specified timeframe:
 - (a) The default path would apply if, in the Commission's view, the firm had not adequately met the Commission's (reasonable) requests for additional information within specified timeframes
 - (b) The firm's proposed path would apply if the firm had met such requests.

50 This regime is designed to build on the strengths of the Part 4A thresholds (namely setting sector-wide price paths based on comparative information) while addressing its main weaknesses. These weaknesses include:

- Lack of certainty for businesses. (There is uncertainty for firms over what happens in the event of a breach and the outcomes of administrative settlement processes. Over 100 breaches dating back to 2003 remain outstanding, and 27 of 28 lines businesses have breached. One effect of uncertainty is that the incentives built into CPI-X thresholds do not work properly¹²).
- Absence of a mechanism for ex-ante approval of abnormal investment. (A firm must breach thresholds in order to engage with the Commission on future investment. This tends to be an adversarial and time-consuming process)
- Lack of timeliness in decision-making
- Potentially disproportionate penalties for breaches. (Breaches may be minor, technical and historic, while the consequences can relate to any aspect of a firm's activities).

¹² CPI-X (the thresholds are based on CPI-X price paths) is designed to require a firm to make efficiency gains but also incentivise it to do better as it gets to keep any additional profit for the regulatory period. (At the end of the regulatory period a re-set of the price path aims to share these efficiency gains with customers). Critically, the effectiveness of the CPI-X regime depends on certainty for the firm that the price path is fixed for the regulatory period and cannot be re-opened by the regulator except under pre-defined and exceptional circumstances. The CPI-X incentives are muted under the current Part 4A regime because firms which breach the thresholds – as all firms have bar one – are potentially open to Commission action. If firms know they may be subject to detailed scrutiny at any time they have an incentive to ensure their rates of return remain modest.

- 51 The proposed regime overcomes these deficiencies by providing an ex-ante, time-bound opportunity for firms to seek Commission approval of a customised path. Any breaches of a price-quality path would be subject to a conventional 'reasonable' penalty/remedy regime (already provided for in the Act).
- 52 Virtually all submitters¹³ favoured some sort of replacement to the Part 4A regime. The Electricity Networks Association (ENA) favoured a "propose-respond" regime whereby firms which breach thresholds could make proposals at any time to which the Commission would respond. (ENA proposed that arbitration or merits review would be available where the firm and the Commission could not agree).
- 53 The Commerce Commission favours retaining the Part 4A regime. It considers it is working well, that criticisms are over-stated, that future thresholds could have an ex-ante element, that administrative settlements are effective, and that as precedents are set firms would be provided with more certainty. The Commission notes that regulation is a learned process, is developed over time with experience, and that the thresholds regime is still relatively new and has not yet completed its first cycle. It also argued that the regime provides it with flexibility to address problems and issues which arise and that it is premature to replace it.
- 54 Careful consideration has been given to the views of submitters and the Commission, and the proposed regime reflects detailed discussion with the Commission on practicalities. On balance, we consider that the proposed regime retains the most useful aspect of the Part 4A regime (setting price-quality paths based on sectoral information) while improving certainty and incentives for investment.

Merits review

- 55 The discussion paper raised the possibility of limited merits review of Commission decisions relating to specific matters (as well as input methodologies), for example on customised price-quality paths¹⁴. It suggested that merits review might be by way of appeal to the High Court for a re-hearing¹⁵.

¹³ Exceptions were the Commerce Commission, Aurora (though it also favoured a "propose-respond" regime) and Mighty River Power (on the grounds that more time was required to allow the regime to settle).

¹⁴ The discussion paper concluded that merits review should not apply to Commission recommendations and decisions by Ministers on those recommendations given the accountability mechanisms applying to ministerial decisions.

¹⁵ Re-hearing allows for updated evidence to be presented with the leave of the court, but only if it could not have been presented to the Commission. Rehearing does not allow parties to present substantive new evidence or arguments.

56 The main arguments for and against merits review can be summarised as follows:

For	Against
<p>a. Improves accountability for the regulator</p> <ul style="list-style-type: none"> • Likely better quality decisions over time <p>b. Allows for correction of errors of fact or judgement</p> <p>c. Improves business confidence in the regulatory regime</p> <p>d. Consistency with the rest of the Commerce Act</p> <ul style="list-style-type: none"> • Merits review is available on clearances and authorisations 	<p>a. Gaming risk</p> <ul style="list-style-type: none"> • Though can be mitigated by providing for full implementation of decisions pending conclusion of appeals <p>b. Cost (most likely recovered by way of a levy on regulated parties)</p> <p>c. Ties the Commission up (time, resource and management focus) in the courts</p> <p>d. Courts lack the specialist expertise of the regulator (notwithstanding lay members)</p> <ul style="list-style-type: none"> • Decisions may be different as opposed to better <p>e. Results in delays and uncertainty</p> <p>f. Likely pressure to extend to other sectors, such as telecommunications and electricity</p> <p>g. Judicial review provides an effective discipline on Commission processes and ensures that decisions are not unreasonable.</p>

- 57 Businesses submitters generally supported the introduction of merits review, noting the importance and far-reaching effects of regulatory decisions. They argued that merits review is desirable to minimise the risk of regulatory error and improve the quality of regulatory decisions over time. Experience in overseas jurisdictions was cited (such as the UK) where relatively few decisions have gone to appeal.
- 58 The Commission argued that the case for introducing merits review had not been made. It questioned whether, given the highly technical nature of arguments, courts are well placed to make better judgements than the Commission.
- 59 Officials recommend that merits review be provided for. However, on balance, we (Ministers) consider that the arguments against introducing merits review of Commission decisions (other than on input methodologies) outweigh the benefits. Accordingly, we consider that appeals should be permitted only on points of law. Commission decisions would also be subject to judicial review.

Electricity lines businesses

Consumer trust-owned electricity lines businesses

- 60 The discussion paper raised the possibility that 100 percent consumer trust-owned electricity lines businesses should be subject to lighter-handed regulation (such as information disclosure) on the grounds that (a) their consumers were also their owners and (b) their relatively small size may mean that the costs of heavier regulation outweigh the benefits.
- 61 The arguments in submissions covered the following:

Arguments in favour of disclosure only	Arguments against
<ul style="list-style-type: none"> • Consumers have redress against over-charging or inefficiency (can vote in new trustees) • Information disclosure (including forward-looking information) provides sufficient pressure on prices and efficiency <ul style="list-style-type: none"> – Provides comparative information on efficiency/prices – Pricing and cost allocation principles minimise risk of cross subsidies – Costs of ‘default price path/propose-respond’ regime outweigh benefits for smaller businesses • Any disadvantaged consumers can petition for a stronger regime • Alleged “under-pricing” and “under investment” may reflect rational (local) consumer trade-offs 	<ul style="list-style-type: none"> • Sets up a ‘two tier’ regulatory regime • Risk of cross-subsidies: voters may vote for trustees favouring lower prices for residential consumers (subsidised by businesses) • Voters/consumers may be myopic (favour lower price and put long-term security of supply at risk: inter-generational concerns), or may be apathetic or poorly informed • Discourages efficiency-improving amalgamations <ul style="list-style-type: none"> – [Though little incentive to do so anyway, and alternative regime is not a major barrier] • Increased risk of cross subsidies to other activities/investments (low returns on capital)

- 62 The Electricity Networks Association (ENA) and trust-owned companies in particular supported a lighter-handed regime where there is a high overlap (over 90 percent) between customers and beneficial (voting) owners of the business. The Commerce Commission, some generators and some non-trust ELBs recommended against a special regime for trust-owned ELBs for the reasons noted above.¹⁶
- 63 On balance, we recommend that 100 percent consumer trust-owned ELBs be subject to information disclosure only. Qualifying criteria are:
- There is an overlap of at least 90 percent between consumer owners and customers of the ELB
 - All of the ELB's consumers (including, for example, businesses) benefit from any distribution of profits made by the ELB or the trust, and
 - The ELB is "small" (under 100,000 consumers).
- 64 Information disclosure would cover both historic and forward looking information, including prices, investments, asset management plans, and quality. It is also proposed that input methodologies specify principles for pricing and cost allocation, to ensure that prices to particular classes of customer are cost-reflective and do not involve cross-subsidies. Information disclosure will reveal compliance with these principles.
- 65 To manage risks, it is proposed that the Commission may make a recommendation to the Minister that the 'default / customised price-quality path' regime be imposed on a trust-owned ELBs where:
- it no longer qualifies for the lighter regime, or
 - where a substantial proportion of its consumers have petitioned the Commission and the Commission concludes that a change in the form of regulation would better meet the purpose statement¹⁷.
- 66 The main reason for the lighter-handed approach is that the case for economic regulation is relatively weak where the customers are also the owners of a firm. The incentive of trusts to charge excessive prices is relatively low where excess profits are returned to the customers. With regard to quality, the power of consumers to replace trustees and the right to petition the Commission constitute sufficient safeguards against quality which is unacceptable to the affected community. In addition, we propose that the Commission be empowered to require trust-owned ELBs to disclose their performance against quality and price standards set for other ELBs, and to analyse and comment on that performance.

¹⁶ The Commission in particular noted that some trusts were poor performers in terms of quality and advocated that any exemptions (for any companies) should be on the basis of past performance. It also recommended that if Ministers decided to exempt trust-owned ELBs, the Commission be empowered to set a quality threshold, which, if breached would result in stronger regulation being imposed.

¹⁷ The following thresholds are proposed for a petition: 15 percent of residential consumers; 20 percent of non-voting residential consumers or 25 percent (by numbers or consumption) of non-residential consumers. The Commission recommended a 10 percent threshold in line with local government thresholds.

67 This approach would cover 17 of 28 ELBs. A list of affected ELBs is provided in Appendix D.

Transitional arrangements for other ELBs

68 As noted earlier, it is proposed that the 'default/customised price-quality path' be applied to other electricity lines businesses.

69 The existing thresholds under Part 4A expire on 31 March 2009. The Commission is currently working on a re-set for 2009 to 2014. ELBs have argued for a roll-over of thresholds at the rate of CPI-0% until a replacement regime (including input methodologies) is in place. However, it is not evident that CPI-0% (or roll-over of existing thresholds) is appropriate, and the proposal raises legislative and timing issues. Accordingly the following transitional arrangement is proposed:

- The Commission should continue its current work programme to re-set thresholds from 1 April 2009 (this includes updating its non-statutory Guidelines, which can be regarded as a pre-cursor to statutory 'input methodologies')
- the 'default/customised price-quality path' regime should apply from 1 April 2009 with the thresholds becoming the default path
- Until the input methodologies are ready, any proposals by firms for a customised path should be based on the Commission's Guidelines. Conventional penalties/remedies apply to breaches.
- Any administrative settlements in place at 31 March 2009 would continue for their term
- Breaches older than six months should expire when the legislation comes into force (except where the Commission has notified the company of its intention to undertake an inquiry or has given notice of an intention to declare control).

Transpower

70 Transpower is currently subject to the Part 4A regime administered by the Commerce Commission. Transpower breached its thresholds in 2003 and every subsequent year. The Commission and Transpower are currently finalising an administrative settlement to apply until 2010/11.

71 The Commerce Act currently provides for transferring responsibility for administering Part 4A for Transpower (and other lines businesses) from the Commerce Commission to the Electricity Commission by Order in Council. The Minister of Energy consulted on whether to transfer responsibility for Part 4A to the Electricity Commission in 2006. At that time, the Minister decided not to make the transfer because of concerns about the capability of the Electricity Commission to undertake the additional workload. Both Commissions also recommended against the transfer at that time.

- 72 Transpower's submission favoured transferring responsibility for the Part 4/4A regime to the Electricity Commission as part of the amendments to the Commerce Act. It considered this would improve certainty, reduce administration and compliance costs, and ensure integrated decision-making¹⁸.
- 73 However, the Electricity Commission considers the case for transferring responsibility at this stage is not strong. It considers that the tasks of the two Commissions are different, and that an updated Memorandum of Understanding between them ensures that decisions are taken in an integrated manner. It also notes that it would need to replicate expertise currently held by the Commerce Commission and that a decision to transfer can be made in future, if necessary, under the current provisions of the Act.
- 74 After considering the various views, we propose to retain the status quo.

Energy efficiency

- 75 The way price/revenue paths are set has an important influence on incentives for electricity lines businesses to invest in energy efficiency and demand-side management. Arguably, the way thresholds are currently set (based on price irrespective of volume) incentivises firms to encourage consumption (or at least not discourage consumption) because this improves their rates of return¹⁹. (An exception to this occurs where lines/facilities are near capacity and where investing in demand reduction would be cheaper than constructing new lines/facilities).
- 76 In order to avoid this effect, we recommended that the Commission be required to provide for incentives to improve energy efficiency/demand-side management and to reduce energy losses when administering the regime for electricity lines businesses.

Gas pipelines

- 77 In 2005 the Government accepted the recommendations of the Commission, following an inquiry, that price control (under Part 5) be imposed on the gas pipelines of Vector and Powerco. The Commission is expected to set a 5 year price path early next year.
- 78 The Commission also recommended that the Government legislate for a Part 4A regime for all gas pipelines (except Nova Gas and the Taranaki pipelines). The Government also accepted this recommendation.

¹⁸ Under the Electricity Act, the Electricity Commission is responsible for approving new investments by Transpower, its pricing methodology (who pays for new investments and sunk costs of the grid), quality and security of supply, contracts with grid users and the wholesale market and system operator rules. Given the interrelationship between these issues and Transpower's overall revenue requirements (and the trade-offs between operational and capital expenditure) Transpower considers it would be efficient for all regulatory issues to be managed in an integrated manner by one regulator, in line with overseas jurisdictions.

¹⁹ Alternative ways of setting price-quality paths, such as using revenues or volume-weighted prices, do not have the same effect. Other creative ways of incentivising investment in energy efficiency are also likely to be available, although considerable care in design would be essential.

- 79 On the basis of these decisions, it is recommended that all gas pipelines (except Nova Gas and the Taranaki pipelines) be subject to the 'default / customised price-quality path' regime and that Powerco and Vector transfer to this regime at end of their current regulatory period.

Other sectors

- 80 A companion paper makes recommendations concerning the regulatory regime for airports. No changes are proposed for other sectors. The amended Commerce Act would be available for application if an apparent need arise.

CONSULTATION

- 81 A discussion paper was released in April with a 3 month consultation period. Submissions were received from 45 parties. Consultations have been held with submitters on request. Detailed consultations on design issues have been held with the Commerce Commission.
- 82 This paper has been prepared by the Ministry of Economic Development in consultation with Treasury, Ministry of Transport, the Ministry of Justice and the SSC. DPMC has been advised of the paper.
- 83 In the light of the complexity of some of the design issues, we propose to allow for a brief and informal period of consultation on design detail, based on the specifications in Appendix B.

FISCAL IMPLICATIONS

- 84 The main additional costs arising from this paper are to develop and set input methodologies. The commission estimates its costs at \$4.000 million comprising \$1.000 million in 2007/08, \$2.000 million in 2008/09 and \$1.000 million in 2009/10. This excludes the costs of defending any appeals and judicial reviews but includes the costs of developing input methodologies for airports (subject to decisions regarding airports). Costs would be funded by levy.
- 85 The costs of merits reviews undertaken by the High Court on input methodologies will be a fiscal cost to the Government. It is difficult to estimate these costs, which will depend on the nature and extent of appeals. It is proposed that merits review costs be funded from the existing Commerce Commission Litigation Fund appropriation, reviewed from time to time as required.
- 86 The Commission will also incur costs for implementing the proposed new regime for gas pipelines. The Commission estimates its incremental costs as follows:
- Preparation of a default price-quality path for gas pipelines businesses not currently under price control: \$1.200 million in 2009/10
 - Preparation of gas pipeline information disclosure: \$1.000 million in 2009/10 and \$0.400 million in 2010/11
 - Consideration of any proposals for customised price-quality paths: about \$0.700 million per proposal.

- 87 These costs would be levy funded, except that about 35-40% of the cost of considering any proposals for a customised path could be recovered by fees.
- 88 Officials consider that the estimated costs for preparing the default price-quality path and considering any customised proposals are too high and are based on a level of information-gathering that is not in line with the proposed approach. Officials recommend that further discussions be undertaken with the Commission on its costings in 2008 in the light of proposed legislative specifications for formulating default paths.
- 89 The Commission considers that the costs of implementing the default / customised price-quality path regime for electricity lines can be met from within current baselines. Costs relating to airports are contingent on decisions and are covered in that paper.
- 90 Officials recommend that further discussions be undertaken with the Commission concerning some of its costing as the specifications for the amendments to the Act are fine-tuned, and that recommendations for appropriations for 2008/09 should be made as part of the Budget 2008 process. Any resulting budget bid will have no impact on the operating balance or debt.
- 91 In the meantime, an appropriation of \$1.000 million in 2007/08 is recommended to cover costs to make an early start on the input methodologies. This would be recovered by levy funding on the electricity lines and gas pipelines businesses and will therefore have no impact on the operating balance or debt. In the light of its current work programmes, the Commission recommends a 75:25 division between the two sectors.

HUMAN RIGHTS

- 92 There are no human rights implications from this paper.

LEGISLATIVE IMPLICATIONS

- 93 The recommendations in this paper require a comprehensive revision of Parts 4, 4A and s70-73 of the Commerce Act. A legislative bid will be made in the New Year for a place on the 2008 legislative programme.

REGULATORY IMPACT ANALYSIS

- 94 A RIS was prepared and the Regulatory Impact Analysis Unit considers the analysis and the RIS to be adequate.

PUBLICITY

- 95 Announcements on the decisions taken pursuant to this paper will be made by the Ministers of Commerce and Energy.

RECOMMENDATIONS

96 It is recommended that the Committee:

- 1 Note that on 4 April 2007 Cabinet approved release of a discussion paper on reviewing Parts 4 and 4A and s70-73 of Part 5 of the Commerce Act [EDC Min (07) 7/13];
- 2 Note that the Ministers of Commerce and Energy propose a comprehensive re-focus of Parts 4 and 4A to move away from punishment-oriented “control” to more incentive-based regulation for sectors where competition is not possible and where there is scope for exercise of market power;
- 3 Note that detailed specifications for proposed amendments are provided in Appendix B to this paper;

Purpose statement

- 4 Note that there is currently no purpose statement for Part 4;
- 5 Agree to a purpose statement for Part 4 along the following lines (subject to drafting by Parliamentary Counsel):

The purpose of this Part is to provide for regulation of prices and quality of goods and services for the long term benefit of consumers in markets where there is little or no competition and prospect of competition. Any regulation provided for under this Part should promote outcomes such that suppliers:

- (a) *have incentives to innovate and to invest, including in replacement, upgraded and new assets and in related businesses;*
- (b) *face strong 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;*
- (d) *are limited in their ability to extract excessive profits.*

Forms of regulation

- 6 Agree that the Act should provide for the following forms of regulation:
 - 6.1 Information disclosure
 - 6.2 A negotiate/arbitrate regime
 - 6.3 A ‘default/customised price-quality path’ regime for sectors like electricity lines to replace Part 4A
 - 6.4 Customised (conventional) price-quality control for individual businesses;

Test and processes for imposing incentive regulation

- 7 Agree that the test for whether regulation may be imposed, and the form of regulation, should be:
 - 7.1 there is little or no competition and prospect of competition and there is substantial scope for the exercise of market power, taking into account the effectiveness of existing regulation or arrangements (including ownership arrangements); and
 - 7.2 The benefits of regulation in meeting the objectives of the purpose statement clearly exceed the costs and risks of regulation;
- 8 Agree that the Commerce Commission should undertake qualitative analysis concerning this test, with quantification where possible and practical;
- 9 Agree that the Minister of Commerce should make decisions on whether to impose or amend regulation in consultation with sector Ministers and after considering recommendations by the Commerce Commission;

Input methodologies

- 10 Note that submissions strongly supported the early preparation of “input methodologies” (for example on how to determine the cost of capital) in order to provide certainty and predictability to businesses and other interested parties;
- 11 Agree that the Commerce Commission should prepare and set input methodologies and that its decisions should be subject to appeal (merits review) to the High Court;
- 12 Note that the Commission estimates its costs for preparation of methodologies (excluding the cost of defending appeals) at \$1.000 million in 2007/08, \$2.000 million in 2008/09 and \$1.000 million in 2009/10;
- 13 Note that these costs will be met by levy on parties subject to regulation under Parts 4/4A;

Information disclosure

- 14 Agree that information disclosure may require the disclosure of forward-looking information, including asset management plans, investment proposals, prices, projected regulatory accounts and expected quality out-turns;

Negotiate/arbitrate

- 15 Agree that the Commission may set the detailed specifications for a negotiate/arbitrate regime where that form of regulation has been agreed to by the Minister of Commerce in consultation with the relevant sector Minister;

Default/customised price-quality path

- 16 Agree that the Act should provide for a default/customised price-quality path regime whereby:

- 16.1 the Commerce Commission should set a default price-quality path for a regulatory period based on information like productivity trends and comparative benchmarking;
- 16.2 firms should have a time-bound ex-ante opportunity to propose a customised path to the Commission, with a requirement for the Commission to make a decision within a specified period;

Merits review

- 17 Agree that appeals on Commerce Commission decisions on setting price-quality paths should be restricted to points of law, and that its decisions should apply without limit pending resolution of any appeals and judicial reviews;

Electricity lines businesses

- 18 Note that electricity lines businesses are currently subject to the Part 4A thresholds regime and that the Commerce Commission has commenced consultations on re-setting thresholds for 2009-14;
- 19 Agree that 100 percent consumer trust-owned electricity lines businesses (meeting criteria specified in Appendix B) should be subject only to information disclosure;
- 20 Agree that the consumers of such lines businesses should have an opportunity to petition the Commerce Commission for stronger regulation;
- 21 Agree that other electricity lines businesses should be subject to the 'default / customised price-quality path' regime, which should replace Part 4A thresholds;
- 22 Agree that the re-set of thresholds under Part 4A of the Commerce Act should become the default price-quality price path from 1 April 2009;

Gas pipelines

- 23 Note that the gas pipelines of Vector and Powerco are subject to price control under Part 5 of the Commerce Act and that the Commerce Commission is currently in the process of setting control terms;
- 24 Agree that all gas pipelines (except those of Nova Gas and the Taranaki pipelines) should be subject to a 'default/customised price-quality path' regime;
- 25 Agree that the gas pipelines of Vector and Powerco should be subject to the 'default/customised price-quality path' regime on expiry of authorised control terms for the first regulatory period;

Other sectors

- 26 Note that a companion paper makes recommendations regarding an amended regulatory regime for airports;

- 27 Note that no changes are proposed for other sectors;

Financial

- 28 Agree that the scope of the non-departmental output expense Enforcement of Electricity Sector Regulation within Vote: Energy be amended to allow for the development of input methodologies as follows (amendment in italics):

For the provision of development of input methodologies under Part 4 and 4A of the Commerce Act 1986, the review of asset valuation methodologies, collecting and disclosing information, assessing performance against thresholds and implementing price controls as necessary in relation to electricity lines businesses and Transpower;

- 29 Agree that the scope of the non-departmental output expense Control of Natural Gas Services within Vote: Energy be amended to allow for the development of input methodologies as follows:

For development of input methodologies under Part 4 of the Commerce Act 1986 and the costs of administering the Commerce Act 1986 Part 5 control regime over the gas pipeline services of Powerco and Vector;

- 30 Approve the following changes to appropriations within Vote: Energy to enable the Commission to develop input methodologies for the electricity lines and gas pipeline businesses currently subject to Parts 4A and 4 of the Commerce Act, with no impact on the operating balance or debt:

Vote Energy Minister of Energy	\$m – increase/(decrease)				
	2007/08	2008/09	2009/10	2010/11	2011/12& Outyears
Non-Departmental Output Expense: Enforcement of Electricity Sector Regulation	0.750	-	-	-	-
Non-Departmental Output Expense: Control of Natural Gas Services	0.250				

- 31 Agree that the above changes to appropriations for 2007/08 be included in the 2007/08 Supplementary Estimates and that, in the interim, the increases be met from Imprest Supply;
- 32 Note that the above funding increases have no impact on the government's operating balance because the funding will be recovered through levies on relevant businesses;

- 33 Note that funding for 2008/09 and outyears (also to be recovered by levy) will be requested separately following further consultation and the opportunity to better estimate what those costs will be; subject to the constraints and timing of consultation, that request is targeted for inclusion within the Budget 2008 process;

Legislation

- 34 Invite the Minister of Commerce to issue drafting instructions to Parliamentary Counsel based on the detailed specifications provided in Appendix B;
- 35 Note that the Ministers of Commerce and Energy propose to recommend that the 2008 Legislative Programme include introduction and passage of legislation amending Parts 4, 4A and ss70-73 of Part 5 of the Commerce Act;
- 36 Invite the Ministers of Commerce and Energy to undertake informal consultations with interested parties on design details in Appendix B in parallel with the preparation of draft legislation;
- 37 Authorise the Ministers of Commerce and Energy, in consultation with the Ministers of Finance and Transport, to make consequential decisions which are consistent with the overall approach in the recommendations of this paper;

Publicity

- 38 Invite the Ministers of Commerce and Energy to announce the decisions in this paper;
- 39 Agree that this paper may be publicly released on the Ministry of Economic Development's website.

Hon Lianne Dalziel
Minister of Commerce

Hon David Parker
Minister of Energy

Date signed: _____

Date signed: _____

LIST OF SUBMITTERS**APPENDIX A**

AgResearch
Air New Zealand
Auckland Energy Consumer Trust
Auckland International Airport
Aurora
Babcock & Brown Infrastructure
BARNZ
Case Associates (retained by Powerco)
Christchurch International Airport
Commerce Commission
Consumer Coalition of Energy
Consumer Owned Distributors
Counties Power Consumer Trust
Eastland Network
Electricity Distribution Lines Businesses in NZ
Gas Industry Company Limited
Horizon Energy
International Air Transport Association
The Lines Company
Major Electricity Users' Group
Meridian Energy
Mighty River Power
NZ Council for Infrastructure Development
NZ Law Society
NZ Shipping Federation
Orion NZ
Peet Aviation
Port Companies
Powerco
PowerNet
Price Waterhouse Coopers
Priority One
Stephen Littlechild (retained by Vector)
Tauranga Chamber of Commerce
Telecom
Transpower
Unison
Vector
Virgin Blue
Vodafone
Waikato Federated Farmers
Waitaki Power Trust
Wellington International Airport
Wellington Regional Chamber of Commerce
Wintec

Detailed specifications**Appendix B****A. Purpose statement**

1. The purpose of this Part is to provide for regulation of prices and quality of goods and services for the long term benefit of consumers in markets where there is little or no competition and the prospect of little or no future competition. Any regulation provided for under this Part should promote outcomes such that suppliers:
 - a have incentives to innovate and to invest, including in replacement, upgraded and new assets and in related businesses;
 - b face strong 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;
 - d are limited in their ability to extract excessive profits.
2. Note: throughout these specifications, the term “price(s)” includes individual prices, aggregate prices and revenues.

B. Forms of regulation

1. The Act should provide for the following forms of incentive regulation:
 - a Information disclosure
 - b A negotiate/arbitrate regime
 - c A ‘default/customised price-quality path’ regime for sectors (replaces Part 4A)
 - d Price-quality control for individual businesses.
2. Note: the above forms of regulation may apply in combination.

C. Test for whether regulation may be imposed

1. Goods or services in a market *may* be subject to regulation where:
 - There is little or no competition and prospect of competition and there is substantial scope for the exercise of market power, taking into account the effectiveness of existing regulations or arrangements (including ownership arrangements)
 - The benefits of regulation in meeting the objectives of the purpose statement clearly exceed the costs and risks of regulation.
2. In providing recommendations to the Minister, the Commission should undertake a *qualitative* analysis of all material long-term efficiency and distributional considerations.

As part of this analysis, the Commission should, as far as possible and practicable:

- a. quantify material effects on market efficiency
 - b. quantify material distributional and welfare consequences on suppliers and consumers
 - c. assess the direct and indirect costs and risks of the forms of regulation considered, including administrative and compliance costs, transaction costs, and spill-over effects.
3. Any regulation should be the least intrusive necessary to meet the objectives of the purpose statement.
 4. Where competition develops in a market so that the test for whether regulation may be imposed is no longer met, regulation should be removed.
 5. 'Whether to regulate' and 'how to regulate' should, to the extent practicable, be determined at the same time. (Repeal current requirement in the Act to undertake separate inquiries on "whether" to regulate and "how" to regulate.)

D. Processes for making decisions on whether and how to regulate

1. Regulation under this Part may be imposed on goods and services by Order in Council on the recommendation of the Minister of Commerce in consultation with any sector Minister (such as Energy, Transport).
2. The Minister may only make a recommendation following consideration of recommendations from the Commerce Commission. The Commission may only make recommendations following an inquiry.
3. The Commission may undertake an inquiry on request by the Minister or on its own initiative. An inquiry by the Commission must include consideration of submissions from interested parties. The Commission may hold one or more public conferences.
4. The same processes are required for any change in the form of regulation, including removal of regulation.

E Input methodologies

1. The Commission's input methodologies must set a methodology or methodologies for calculating or determining the following matters:
 - a. cost of capital
 - b. valuation of assets (including depreciation)
 - c. allocation of common costs, including between businesses, customer classes and geographic areas
 - d. treatment of taxation
 - e. preparation of regulatory accounts
 - f. regulatory specifications (where applicable), including:
 - duration of regulatory period
 - excluded costs
 - circumstances for re-considering terms during the regulatory period

- processes for re-setting terms and conditions
 - g. requirements for a proposal under 'default / customised price-quality path' (where applicable)
 - h. pricing principles.
2. The Commission may adopt, with modifications where required, methodologies used by regulatory bodies in similar overseas jurisdictions
 3. The Commission may determine the level of prescription of the input methodologies
 4. The Commission should consolidate the development and release of its decisions on methodologies to the extent possible and practical because of the interrelated nature of the methodologies and to minimise costs to businesses and for appeals processes
 5. *Appeals*. Any materially affected party may appeal to the High Court for a merits review on input methodologies:
 - Any appeals must be made within 20 working days of the release of Commission decisions on input methodologies
 - The Court may appoint up to two lay members with expertise in economic regulation to assist it
 - The court may only consider submissions and associated material relied on by the Commission to make its decisions
 - The Commission may raise before the court a possible outcome or effect should the court make a determination setting aside or varying the original decision
 6. Criteria for appeals:
 - a. The Commission made an error of fact in its findings of facts, and that error of fact was material to the making of the decision
 - b. Commission made more than one error fact in its findings of facts, and those errors of fact, in combination, were material to the making of the decisions
 - c. The exercise of the Commission's discretion was incorrect, having regard to all the circumstances
 - d. The Commission's decision was unreasonable, having regard to all the circumstances.
 7. No further appeals may be taken except on points of law.
 8. The Commission must apply input methodologies when making decisions on any of the forms of regulation referred to in B above.

9. The Commission may, at any time, make amendments to input methodologies, but:
 - Must follow the processes specified above before setting the amended input methodology
 - May not complete inquiries or set default or customised price-quality paths until the process is complete
 - May not re-open default or customised price-quality paths within a regulatory period on the grounds of changes in input methodologies. (See also section H 11).
10. The Commission must consult with interested parties on whether any amendments should be made to the input methodologies every seven years following the promulgation of initial methodologies.

F. Information disclosure: powers and processes

1. The Commission may set requirements for the disclosure of information which specify:
 - What information must be disclosed
 - How information is to be disclosed and the form of disclosure
 - The timing of disclosure
 - Methodologies which must be used in the preparation of disclosed information. These methodologies may be methodologies specified as input methodologies.²⁰
2. Disclosed information may include proposed or forecast investments, prices/revenues, quality standards, regulatory accounts and asset management plans.
3. Information disclosure may be required in combination with any other type or form of regulation.
4. The Commission may undertake monitoring and analysis and comment on disclosed information.

G. Negotiate/arbitrate: powers and processes

1. *Purpose:* The purpose of negotiate/arbitrate is to provide an opportunity for, and to incentivise, the supplier and its customers to reach agreement on prices and/or revenues and quality standards for the supplier for a specified period. This incentive is provided by providing for an arbitrated settlement if the parties are unable to reach agreement within a specified period. (May be combined with information disclosure).

²⁰ This power is of the same type as the powers in s57T of the Commerce Act to set information disclosure requirements. The powers are also the same as those in the Financial Reporting Act 1993 (whereby the Accounting Standards Review Board, an independent Crown entity, sets financial reporting standards) and the Hazardous Substances and New Organisms Act 1996 (whereby the Environmental Risk Management Authority may set standards and issue notices of transfer). In both latter cases, requirements are subject to the Regulations (Disallowance) Act 1989.

2. The Commission must set requirements for negotiate/arbitrate including:
 - Processes for negotiations, including the parties to be involved and the form of involvement, and the form, scope and coverage of any negotiated settlement;
 - Time limits for negotiations (including stages in negotiations);
 - Provide for the supplier to pay the reasonable costs of a representative or representatives of smaller consumers;
 - Processes for setting up arbitration and the conduct of arbitration where negotiated settlements have not been reached within the time limit(s). The Commission must:
 - a Allow the parties to agree on an arbitrator or arbitrators;
 - b Appoint an arbitrator or arbitrator, including itself as arbitrator, where the parties are unable to agree on an arbitrator;
 - Specify requirements regarding the public disclosure of negotiated or arbitrated settlements;
 - The Commission may require particular forms of arbitration, including final offer arbitration;
 - Specify the input methodologies to be used by the parties in their negotiations and in the arbitration; and
 - Providing for cost recovery by the arbitrator.

H. Default/customised price-quality path

1. *Purpose:* The purpose of this form of regulation is to provide for a relatively low cost approach to setting price-quality paths while allowing the opportunity for individual businesses to propose an alternative path which better meets their particular circumstances, such as a requirement for abnormal investment to continue to meet customer expectations concerning service quality over the long term.
2. The Commission must set a default price/revenue path(s) (eg CPI-X) and quality standards for a specified regulatory period. The standard regulatory period should be 5 years
 - The default path(s) should be based on factors such as productivity/efficiency trends and comparative benchmarking (domestic or international). The Commission may not undertake a building blocks or detailed forward-looking investigation of firms in setting default paths.
 - The Commission may specify price-quality paths in any form or in any way it sees fit, but may not include a P_0 adjustment except on the basis of information disclosed pursuant to the information disclosure requirements.
3. In setting quality requirements the Commission should, as far as possible, provide incentives for firms to maintain and improve quality.

4. A firm may propose a customised price/revenue/quality path to the Commission:
 - May make a proposal by annual dates specified by the Commission (the first annual date must be on or prior to the date at which default price paths take effect)
 - May make only one proposal during a regulatory period
 - May not make a proposal within 12 months of the expiry of a default regulatory period
 - The proposal must be made public
 - The proposal must use and comply with the input methodologies specified by the Commission
 - The proposal must comply with requirements set by Commission (as part of input methodologies) for a complete proposal. Requirements may include:
 - Scope and specificity of information required
 - Extent of independent verification and audit
 - Extent of consultations and agreement with customers
 - The proposal must be accompanied by any reasonable fees set by the Commission to recover its costs.

5. If a firm makes a proposal, it may not subsequently opt to revert to the default price path.

6. The Commission must determine within 40 w/days whether the firms' proposal complies with the criteria set by the Commission for a complete proposal. If the proposal does not comply, the Commission, at its discretion, may
 - a. Reject the proposal, or
 - b. Request the firm to remedy within 40 w/days any deficiencies in the proposal. If the firm fails to provide the additional information requested by the Commission the Commission may reject the proposal.

7. The Commission must provide an opportunity for interested parties to comment on the firm's proposal.

8. Subject to 9, 10 and 11 below, the Commission must make a determination on the proposal within 150 w/days of receiving a complete proposal
 - Commission must consider submissions on the proposal from any interested party received within time-limits set by the Commission
 - Commission may exercise its information gathering powers with regard to any further information it requires in order to make a determination
 - The Commission may determine to apply the default price path or a more stringent path
 - The Commission must publish reasons for its decisions within 10 days of announcing a determination

9. The Commission may prioritise consideration of proposals as it sees fit (similar to s57K). The Commission is only required to consider 4 proposals from firms within a sector in any one year and may defer additional proposals to a subsequent year. Criteria for Commission decisions on priorities (replaces s57K(2)) include:
 - a. Quality and completeness of proposal

- b. Urgency of any proposed additional investment (compared to historic rates of investment) required to meet consumer requirements on quality
 - c. Materiality of proposal relative to size and revenues of the firm.
10. The timeframes specified above may be extended by 30 w/days with the agreement of the firm and the Commission
 11. If the Commission does not make a determination within the set timeframe:
 - a. The default path should take effect where the Commission has made reasonable requests with reasonable deadlines for additional information it requires in order for it to make a determination, and the firm has not (in the view of the Commission) sufficiently complied
 - b. The firm's proposal should take effect where the firm has complied with the Commission's reasonable requests for additional information.
 12. In considering a proposal and making a determination, the Commission may, at its sole discretion, vary an input methodology applying to that firm with the agreement of the firm.
 13. The default price-quality paths apply pending a determination by the Commission on a proposal. The Commission may provide for revenue-recovery where it subsequently sets a higher customised price path, or for revenue claw-back where it subsequently sets a lower customised price path. (In providing for revenue recovery or revenue claw-back, the Commission must set timeframes which minimise price shocks to consumers or undue financial hardship to the firm respectively).
 14. Any customised price path must apply for 5 years
 - At the end of this period, the firm reverts to whatever default price paths are applicable at that time (but the firm may make a subsequent proposal for customised terms as above)
 - The Commission may set a shorter period than 5 years where it considers this would better meet the purpose statement, but in any event may not set a term less than 3 years

I. Price-quality control for individual businesses.

1. The Commission may set price-quality control terms in any way it sees fit, but must use the set input methodologies. It may seek proposals from firms.
2. The current powers in the Act (s72) to accept alternative undertakings to be replaced by an amended penalties/remedies regime (see below).

J. Appeals

1. Appeals on points of law. [Judicial review is also available].
2. Commission decisions take full effect, including enforcement, on promulgation and until appeals are fully resolved.

K. Remedial action and penalties for failure to comply with price-quality paths

Where a firm has failed to comply with its price-quality path, the Commission may:

- a. Decide to take no action after taking into account:
 - Any previous failures to comply
 - Whether the firm has taken all reasonable steps to prevent failure to comply
 - The gravity or seriousness of the breach
 - Action taken by the firm to remedy the breach
- b. Require the business to take steps to ensure that the breach does not occur again
- c. Apply penalties and remedies provided for in s70C.

L. Electricity lines businesses

Consumer trust-owned ELBs

1. Consumer trust-owned ELBs should be subject only to information disclosure, where
 - a. the ELB is 100 percent owned by an entity which is governed by elected consumer representatives, such as a cooperative, consumer trust or community trust
 - b. at least 90 percent of consumers of the ELB are eligible to vote in elections
 - c. all of the ELB's customers benefit from profit or fund distributions by the ELB or the entity that owns the ELB
 - d. the ELB has fewer than 100,000 ICPs. (ICP means a point of connection on a local or an embedded network which the distributor nominates as the point at which the retailer will be deemed to supply electricity to a consumer, and has the attributes set out in rule 1 of schedule E2 of Part E of the Electricity Governance Rules 2003).
2. The Minister may impose a 'default/customised price-quality path' regime on ELBs which would otherwise be subject only to information disclosure where
 - The Commission advises that an ELB no longer meets the above criteria
 - The Commission recommends that the 'default / customised price-quality path' regime would better meet the purpose statement. The Commission may only make such a recommendation following consideration of a petition by at least:
 - 15 percent of residential consumers of the ELB, or
 - 20 percent of non-voting (ie not eligible to vote) residential consumers, or
 - 25 percent of non-residential customers (by number or by consumption of that class of consumer)
3. Trust-owned businesses to which this regime applies should be named by notice in the *Gazette*.
4. The Commission may require trust-owned ELBs to disclose their performance against quality and price standards set by the Commission for other ELBs, and may analyse and comment on that performance.

Other ELBs

1. Other ELBs should be subject to the 'default/customised price-quality path' regime. This regime replaces Part 4A.

2. Transitional arrangements:

- The Commission should continue its current work programme under Part 4A to re-set thresholds from 1 April 2009
- The 'default / customised price-quality path' should apply from 1 April 2009 with the re-set thresholds becoming the default price-quality path
- Until the input methodologies are set, any proposals by firms should be based on the Commission's (non-statutory) Guidelines.
- Conventional penalties/remedies (section K above) apply to breaches of default or customised paths
- Any administrative settlements under Part 4A in place at 31 March 2009 continue for their term
- Breaches of thresholds under Part 4A older than six months expire when the legislation comes into force except where the Commission has notified the company of its intention to undertake an inquiry.

Energy Efficiency

The Commission must provide incentives to improve energy efficiency/demand side management and to reduce energy losses when administering the regime for electricity lines businesses.

M. Gas pipelines

1. All gas pipelines²¹ should be subject to 'default/customised price-quality path' regulation.
2. *Transitional arrangements:* Prices set by the Commission for the gas pipelines of Vector and Powerco under Part 5 should continue to apply until the end of the regulatory period set by the Commission. At that time, these businesses should transition to the regime applying to all other gas pipelines.

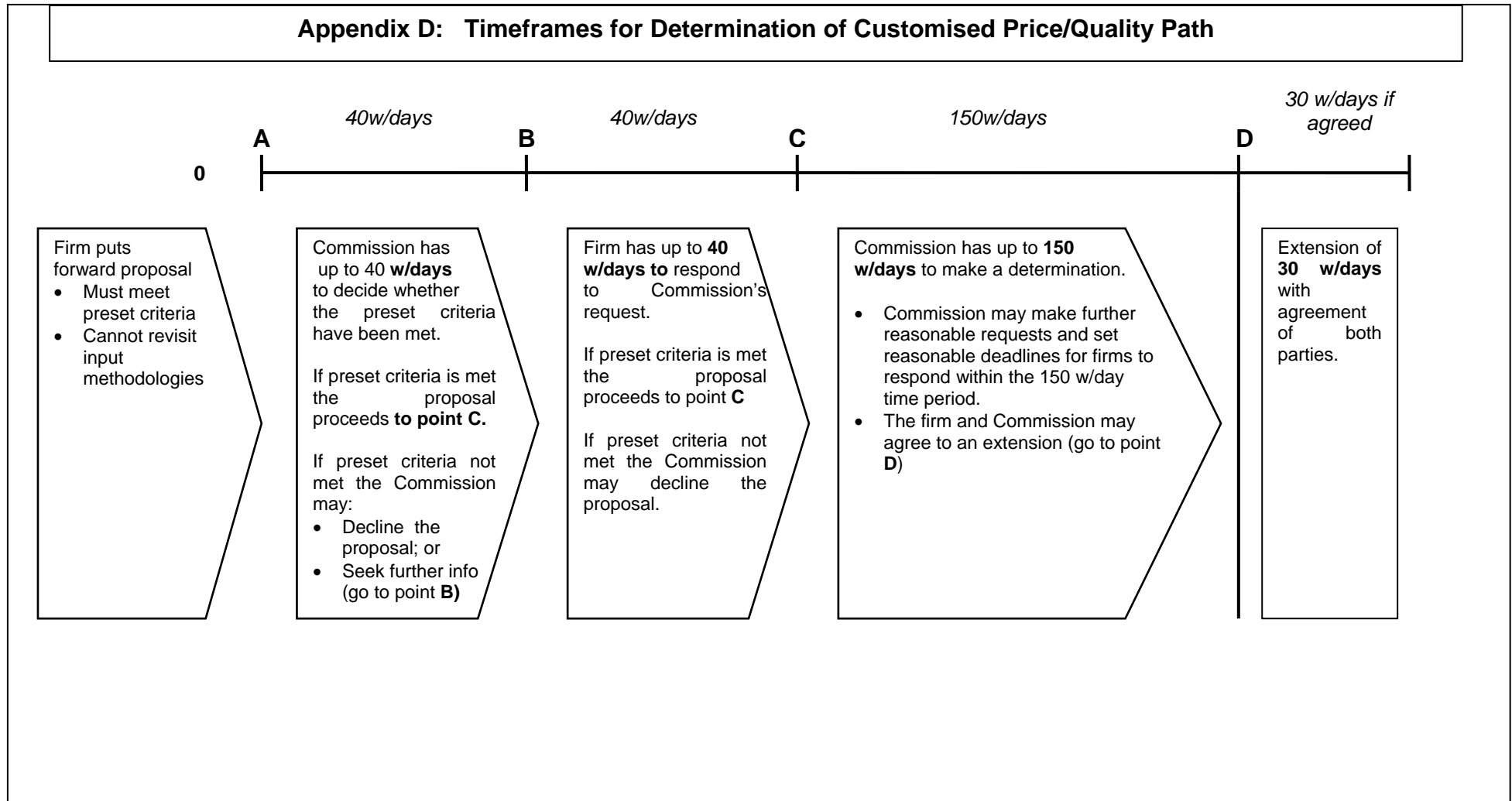
²¹ Except gas pipelines owned by Nova Gas and the Taranaki pipelines.

Appendix C

Indicative list of ELBs (qualifying trust-owned businesses are shaded)

Company	100% consumer owned or controlled	More than 90% overlap customers and voting consumers	All consumers benefit	Below 100,000 ICPs
Alpine Energy	* 60% council-owned	N/A	N/A	29,000
Aurora Energy	* Council-owned	N/A	N/A	76,000
Buller Electricity	✓	✓	✓	4,000
Centralines	✓	✓	✓	8,000
Counties Power	✓	✓	✓	35,000
Eastland Network	✓	✓	✓	25,000
Electra	✓	✓	✓	40,000
Electricity Ashburton	✓	✓	✓	16,000
Electricity Invercargill	* Council-owned	N/A	N/A	17,000
Horizon Energy Distribution	* 77% owned by trust but publicly listed	✓	*	24,000
Main Power NZ	✓	✓ (90.6%)	* Only to trust beneficiaries	31,000
Marlborough Lines	✓	✓	✓	23,000
Nelson Electricity	* Investor-owned	N/A	N/A	9,000
Network Tasman	✓	✓	✓	34,000
Network Waitaki	✓	✓	✓	12,000
Northpower	✓	✓	✓	51,000
Orion New Zealand	* Council-owned	N/A	N/A	181,000
OtagoNet Venture	* Investor-owned	N/A	N/A	14,000
Powerco	* Investor-owned	N/A	N/A	304,000
Scanpower	✓	✓	✓	7,000
The Lines Company	✓	✓	✓	26,000
The Power Company	✓	✓	✓	32,000
Top Energy	✓	* Trust appointed by local MPs and council chair	✓	28,000
Unison Networks	✓	* (57%)	* Only to trust beneficiaries	105,000
Vector	* 75% trust-owned but publicly listed	* (45%)	*	660,000
Waipa Networks	✓	✓	✓	22,000
WEL Networks	✓	✓	✓	79,000
Westpower	✓	✓	✓	12,000

Appendix D: Timeframes for Determination of Customised Price/Quality Path



REVIEW OF THE REGULATORY CONTROL PROVISIONS OF THE COMMERCE ACT 1986 REGULATORY IMPACT STATEMENT

Executive Summary

- 1 The discussion document released earlier this year and subsequent submissions have identified a number of problems with the current legislation, including, unclear policy objectives, inefficient decision making processes, regulatory uncertainty, constraints on regulatory approaches, lack of certainty for efficient and timely investment for electricity lines businesses under Part 4A, and a relatively weak accountability regime for the Commerce Commission as regulator.
- 2 To address these problems the following key amendments are proposed:
 - i Specifying a regulatory specific purpose statement for Part 4;
 - ii A more conventional, qualitative test for when regulation may be imposed;
 - iii Broadening the range of forms of regulation available under the Act to include information disclosure, a negotiate/arbitrate regime, and a 'default/customised price-quality path' regime to replace Part 4A;
 - iv A requirement that "input methodologies" (how to determine the weighted average cost of capital, value assets, allocate common costs etc) should be set as soon as possible by the Commission with the aim of improving certainty and predictability for businesses; and
 - v Providing for merits review of Commission decisions on input methodologies.
- 3 It is also proposed that 100% trust-owned electricity lines businesses be subject to information disclosure only, while the 'default/customised price-quality path' regime would apply to non-trust electricity lines businesses, and to gas pipeline businesses.

Adequacy Statement

- 4 The Regulatory Impact Analysis Unit has reviewed the RIS and considers the RIS is adequate according to the adequacy criteria.

OBJECTIVES

- 5 The objectives are to provide for a regulatory regime for businesses not subject to competition that:
 - i Is credible and coherent, provides sufficient disciplines on firms in markets with natural monopoly characteristics and provides for incentives to invest in infrastructure;
 - ii Provides clarity, certainty, transparency, timeliness and predictability for businesses and appropriate accountability mechanisms; and
 - iii Is appropriate for New Zealand's small size (with small firms and limited resources).

STATUS QUO AND PROBLEM

- 6 Electricity lines businesses (ELBs) have argued that the Part 4A regime has increased uncertainty in the sector. This uncertainty can affect their cost of capital, thereby deterring investment. While industry complaint is not by itself proof of a problem, analysis of the current regulatory mechanisms indicates that the current regulatory model in Part 4 and 4A has not kept pace with changes in the regulatory environment and international best practice. For instance, Part 4A devolves a significant amount of discretion and flexibility to the regulator, but that has come at the cost of increased uncertainty for business.
- 7 The purpose of the review was to identify whether the regulatory control provisions within the Act were achieving the intended regulatory objectives (outlined in paragraph 4). The following issues were identified as part of the Review:

Unclear regulatory objectives

- 8 Currently there is no specific purpose statement for the generic regulatory control provisions in Part 4 of the Act, while the overall Commerce Act purpose statement is to promote competition (which is not feasible in natural monopoly markets). Submissions on the Commission's two draft price control inquiry reports to date indicate that the purpose of the regulatory provisions may be unclear. In particular, there has been debate around whether Part 4 requires consideration of economic efficiency only, or whether consumer protection/distributional considerations should also be taken into account in the context of regulating firms, and if so what the relative weighting between these objectives should be. There is also debate about whether the current purpose statement for Part 4A of the Act is appropriate given that there is no explicit reference to a key regulatory objective of providing for incentives to invest. Such debate and uncertainty does not fit well with the key regulatory objectives of clarity, certainty, transparency and predictability.

Inefficient decision making processes

- 9 The review identified weakness with the current tests for whether or not to impose regulation. The existing competition test is relatively low and it is likely that it applies to many markets in New Zealand including where control is clearly undesirable, and thereby fails to provide business certainty for when regulation is likely to be imposed.
- 10 The current acquirers benefit test (whether there are net benefits to acquirers from control) may not be appropriately targeted as it does not require explicit consideration of efficiency effects.
- 11 Currently the Act requires separate processes for decisions on *whether* and *how* control should be imposed. This means that a Ministers decision taken on whether to regulate will be based on incomplete information with regards to how control would be applied. If a Minister decides to regulate the Commission is charged with doing the analysis again in order to identify how to regulate. This largely duplicative process can be costly and time consuming.

- 12 The Act currently does not require that the key technical decisions (“input methodologies) relating to how regulation will be imposed be set in advance of control inquiries and the imposition of control. This has resulted in uncertainty and dispute throughout the regulatory process (such as the airports and gas inquiries).

Inadequate accountability arrangements

- 13 The Commission’s regulatory decisions are subject to judicial review only. There is a general perception that the accountability regime for the Commission is weak, as judicial review applies to questions of law and process only and not the substance of a decision. Thus the regime is less capable of correcting regulatory error or improving the regulator’s decision making over time. This can impact on business/investor confidence in the regime.

Constraints on regulatory approaches.

- 14 The Act only allows a choice between no control or conventional price control. Broadening the choice of regulatory options provides a wider range of regulatory tools to ensure that the most ‘fit for purpose’ form of regulation is implemented in a given circumstance.

Part 4A failing to achieve policy objectives

- 15 Part 4A is generally regarded by electricity lines businesses as unsatisfactory. The key weaknesses include:
- a Uncertainty for firms over what happens in the event of a breach and the process, timeframes and criteria for assessing administrative settlement processes;
 - b Absence of a mechanism for ex ante approval for major capital expenditure;
 - c Lack of timeliness in decision making. There is no set timeframe for when the Commission can open an inquiry following a breach or for making decisions. Once a firm has breached a threshold they can remain open to Commission action for a number of years ;
 - d Unusual penalties for a breach. Breaches may be minor, technical and historic while the consequences can relate to any aspect of a firm’s activities; and
 - e Administrative settlements do not provide sufficient transparency, consistency or precedent for the sector going forward.
- 16 Investors are less likely to make long-term investments spanning multiple regulatory periods under a regime where the rules are unclear or applied inconsistently.

ALTERNATIVES

- 17 Various options were considered for addressing the specific problems identified above. Individual proposals could be packaged in several different ways. For example, retaining the Part 4A thresholds while improving regulatory certainty by including the feature of input methodologies set in advance. The different options and the associated costs, risks, benefits and opportunities are discussed below.

STATUS QUO

- 18 The status quo was considered for each of the proposed changes outlined below. In each case the failure of the current arrangements to meet the quality of regulation objectives listed above has counted against retaining the status quo. It is considered that the short term regulatory uncertainty resulting from change is mitigated by the long term benefits of a well functioning regulatory environment.

PREFERRED OPTION

- 19 The preferred option contains the following features:
- a A regulation specific purpose statement for Part 4;
 - b A more conventional qualitative test for when regulation may be imposed;
 - c Provision for additional forms of regulation, including a default/customised price-quality path regime for sectors to replace Part 4A;
 - d A requirement that “input methodologies” should be set upfront of any major decision-making, as a stand-alone process; and
 - e Providing for merits review of Commission decisions on input methodologies.

A purpose statement for Part 4

- 20 The following options were considered:
- a No purpose statement for Part 4 (status quo);
 - b A purpose statement that focuses only on improving efficiency upfront, with the implicit expectation that overtime all consumers will benefit; and
 - c A purpose statement that explicitly states that the objective of regulation is to improve efficiency and to protect consumers from excessive prices - similar to the Part 4A purpose statement (preferred approach).

Analysis

- 21 It is considered unsatisfactory for there to be insufficient clarity about the objectives of economic regulation so option (a) was discarded.
- 22 Option (b), on balance, is problematic in the context of natural monopoly sectors. A key objective of economic regulation in New Zealand is the protection of consumers from excessive prices over the long term. This is achieved by explicitly providing for this objective in regulation. Thus, variants of the purpose statement developed in the context of option (b) were not considered appropriate and were discarded.

23 Option (c) includes both efficiency and distributional objectives, to provide for an appropriate balance between the protection of consumers and that of producers and investors. The proposed purpose statement is similar to the Part 4A purpose statement. Building on the Part 4A purpose statement will mitigate the risk of losing case law.

A new test and process for imposing regulation/new processes

24 Several options were considered:

- For the test when regulation may be imposed: status quo, competition/market power only, or both market power and distributional considerations and net benefits (preferred option);
- For the form of analysis: status quo, quantitative cost benefit analysis, qualitative assessment only, or qualitative with quantitative analysis where possible and practical (preferred option); and
- On the number of inquiries: A separate inquiry for whether to control/regulate and a separate inquiry for how control will be imposed (status quo), or one inquiry only (preferred option).

Analysis

25 The benefit of the preferred options for the test for when control may be imposed is that they improve clarity and certainty for business. They also move away from the more controversial net acquirers benefit test which requires a trade off between two things (i.e. net economic cost against benefits to consumers) that cannot be compared in a meaningful way.

26 Providing guidance to the Commission provides comfort that qualitative analysis (with quantification wherever possible) is appropriate and will allow for timely and transparent analysis.

27 The main argument against a single process for the decision on whether and how to regulate is that it risks predetermining the processes and outcomes relating to control before a decision has been made to regulate. It could also result in the initial inquiry being more intrusive than if the two processes are considered separately. This risk is considered relatively low and is outweighed by the benefits of having more complete information for the decision on whether to control and the avoidance of costly and largely duplicative processes, i.e. essentially two separate inquiries into the activities of firms.

Providing additional forms of regulation

28 It is proposed that a range of regulatory tools be provided for under the Act.

Analysis

29 The availability of different regulatory options will enable the Commission to ensure that the most cost effective, 'fit for purpose' form of regulation is recommended in a given circumstance.

30 A number of submitters were concerned that providing specifically for less costly, 'lighter' handed forms of regulation may lower the threshold for intervention, noting that even 'lighter' forms also impose additional costs on business. This risk is mitigated by the legislative test for whether to impose regulation. The test will require the Commission to conduct an analysis to ensure that regulation is both necessary and is the least intrusive necessary to meet the objectives of the purpose statement and should also take into account the effectiveness of existing regulatory arrangements.

31 The exact cost of enhanced information disclosure and negotiate/arbitrate options will depend on the final design detail. While there is general agreement regarding the benefits of information disclosure as a low cost tool to constrain the abuse of market power, the case for negotiate/arbitrate is more contentious. The costs and benefits for negotiate/arbitrate are outlined in the table below.

Arguments in favour	Arguments against
<ul style="list-style-type: none"> • Provides incentive for parties to negotiate a settlement • Less costly for regulator • Parties able to customise settlement to meet own circumstances • May improve relationships between suppliers and customers (some evidence from overseas) • Arbitrator/regulator only involved if parties fail to agree • Over time, parties get better at predicting arbitrated outcomes, speeding up settlement processes 	<ul style="list-style-type: none"> • Parties look to the end-game (i.e. arbitration/regulation) and position themselves to get the best outcome from arbitration/regulation • Some submitters argue it could stall and frustrate investment • Arbitration can be complicated where there are multiple services and parties • Very difficult to get agreement of all parties, so arbitration is inevitable • May be less efficient than price control

32 It is accepted that the negotiate/arbitrate model will not suit all circumstances. But as there may be cases where the benefits outweigh the risks (e.g. where there are a few large parties) it is considered that the regime would be strengthened by providing specifically for this form of regulation.

Default/customised price quality path regime (within Part 4)

- 33 A key feature of the new regime is the replacement of Part 4A with a default/customised price quality path regime (within Part 4). It is proposed that ELBs (except for 100% consumer trust owned businesses) and all gas lines business, except Nova Gas and the Taranaki pipelines, will transfer to this regime.²²
- 34 The two options considered were to:
- a *Retain the Part 4A threshold regime with a few changes* such as requiring the Commission to set input methodologies in advance of the reset of price-quality paths; or
 - b *Replace Part 4A threshold regime with a 'default/customised price-quality path' regime (within Part 4)*. This would provide for the Commission to set a default price-quality path for a sector (similar to the setting of sector-wide thresholds under Part 4A), and in addition would provide an ex ante, time-bound opportunity for an individual firm to seek a customised path. Under this regime, any 'breach' of a firm's customised price-quality path (or the default price-quality path if a firm remains on it) would be subject to conventional Part 5 penalties and remedies that are proportionate to the breach (preferred option).
- 35 The arguments that have been made in favour of retaining the status quo and for option (a) above are broadly the same. These are that:
- Much of the current uncertainty for businesses with the Part 4A regime is due to the current regulatory regime still bedding in (the current regime was introduced in 2001 and has only been through one five year regulatory period). It has been argued that certainty will evolve over time, as precedent is set, for example as the Commission makes more decisions on administrative settlements;
 - As the Commission develops the regime further, future threshold resets under Part 4A could take into account future investment requirements to address the need for firms to have certainty around making substantial capital investment.
- 36 The main disadvantages with the retention of Part 4A are listed in paragraph 110 above. Most submitters thought that these flaws were inherent features of the regime rather than issues that could be resolved over time. For these reasons option (a) was discarded.

²² Note: the gas pipelines of Powerco and Vector will be transferred to this regime at the end of their current regulatory period.

- 37 There will be little additional cost to those firms that decide to remain on the default path as the default price-quality path will be set in a similar way to the current thresholds. For customised proposals the firm may choose whether or not to put forward a proposal. Firms that choose to put forward a proposal will face costs in the form of management/staff time and external expertise. Many of these costs are evident in the status quo, for instance, the cost incurred as part of an administrative settlement process. To minimise costs and potential for delay the proposal includes strict timeframes, input methodologies set upfront, preset criteria for proposals, and statutory timeframes.
- 38 There is a risk that the Commission may be overwhelmed by proposals. To address this risk the Commission will only be obliged to make determinations on four proposals a year, and prioritise its work. Other proposals would be deferred to the following year, with the affected firms having to comply with the default price path in the meantime.
- 39 This creates a risk that some firms might make losses whilst their proposal is being considered because the default price path will apply. This risk has been addressed through allowing the Commission to provide for revenue recovery by the firm where the Commission subsequently sets a higher price path.
- 40 There will be additional costs to the regulator of administering the new regime, relating to:
- i The preparation of input methodologies. However, the Commission already does much of this work anyway.
 - ii Administering a default/customised price-quality path regime for gas pipelines. In this area, the Commission should also be able to use the extensive information gathered during the inquiry.
 - iii Processing proposals for customised price-quality paths for electricity lines businesses. The additional costs from this compared to the current regime will be offset by Part 4A no longer applying to 17 trust-owned electricity lines businesses, and the Commission and firms no longer needing to negotiate administrative settlements.
 - iv Defending merits review on input methodologies. The additional costs from this should also be partially offset by fewer judicial reviews.
- 41 The benefit of option (b) is that it builds on the strengths of the Part 4A regime (namely setting sector wide price paths based on comparative information) while addressing its main weaknesses through providing an opportunity for firms to seek Commission approval of a customised path. The proposal will provide an effective regime that over time provides more timeliness, certainty and incentives for investment. Almost all submitters supported some sort of replacement for the Part 4A regime. On balance, these benefits are considered to outweigh the incremental regulatory and business costs and short term costs of uncertainty for regulated firms arising from changes to the status quo.

Input methodologies set in advance

42 It is proposed that input methodologies be set up front in a stand alone process at the start of an inquiry and any reset of price quality paths. The purpose is to provide greater certainty, transparency and predictability to business.

Analysis

43 A statutory provision that would require input methodologies to be set up front as a stand alone process is consistent with approaches adopted in other jurisdictions such as Australia. There was support from almost all submitters for this proposal.

44 Setting input methods in advance will reduce the flexibility that is inherent in the current regime. It is considered that this risk is outweighed by the significant increase in business certainty. The replicability of the input methodologies will also benefit those in non-regulated sectors. For instance, it will ensure that those negotiating with monopolies can point to a standard model. It will also reduce the number of disputes and areas of contention when considering the appropriate control terms.

45 There is a risk that having to set input methods in advance will delay the decision making process. To ensure input methods are developed in a timely, cost effective manner the body responsible for preparing the input methodologies will be able to adopt, with modifications where required, methodologies used by other regulatory bodies in similar overseas jurisdictions. Any delay in setting input methodologies will likely be offset by the reduction of delays and disputes later on in the process of setting control terms.

46 Two main options have been considered for who should prepare the input methodologies:

- a Prepared and set by the Commerce Commission;
- b Prepared by an independent expert panel, and set as regulations/rules.

47 There are specific benefits and risks associated with each of the options relating to who prepares the inputs methodologies. The performance against key criteria is outlined in the table below.

Criteria	The Commission(Option (a))	Independent Panel (Option (b))
Availability of expertise	Uses the Commission's expertise and integrates well with the Commission's current work streams.	It will be necessary to recruit the appropriate expertise to sit on the panel.
Quality of outcomes	The Commission is experienced at developing input methodologies and has extensive knowledge of the electricity sector. However, the Commission is likely to have a more conservative approach to developing input methodologies than an independent panel. The availability of merits review of input methodologies provides a check	Would enable a fresh look to be taken at input methods and this approach is more likely to pick up suitable overseas examples. There is a trade-off between striving for 'best practice' and certainty and timeliness, and this option improves the chances of striking a good balance. It provides for separation of rule

	of the quality of the proposed methodologies.	making from rule implementation, thereby limiting conflicts of interest.
Political Independence	No Ministerial/political involvement.	The Minister would be involved in appointing the panel and accepting or rejecting the recommendation of the Panel.
Cost	The Commission has estimated that the cost of developing the input methodologies will be \$4 million over three years, depending on whether a form of merits review is available and the level of specificity required.	It is estimated that the work would cost \$3 million (over two years).
Timeliness	The Commission estimates a timeframe of over three years to develop methodologies and frameworks. Appeals to the High Court would involve additional time delays and costs to the Commission.	It is expected a Panel could make a recommendation by the end of 2009.

- 48 An independent panel has the advantage of separating rule making from rule implementation thereby reducing the likelihood of regulatory bias. However, a robust accountability arrangement (merits review) for the Commission is proposed. There is also a reduced risk of undue political interference under option (a). It would be more difficult to ensure the neutrality and quality of decisions issued by an independent panel.
- 49 On balance, the advantages of the Commission's sector specific knowledge, expertise in developing input methodologies, political independence and proposed accountability arrangements outweigh the advantages of option (b).
- 50 The cost of the developing input methodologies could either be government funded (i.e. tax) or levy funded. As consumers will be the direct beneficiary of the proposed changes the use of levy powers is most the most appropriate option.

Accountability mechanisms

- 51 In addition to the status quo the review considered the whether to make available limited merits review by way of appeal to the High Court for a re-hearing. Consideration was given to whether to provide merits review for decisions on input methodologies **and** control terms or for decisions on input methodologies only (preferred option).

Analysis

- 52 Businesses submitters generally supported the introduction of merits review of the Commission's decisions, noting the importance and far-reaching effects of regulatory decisions. The main arguments for and against merits review can be summarised as follows:

For	Against
<ul style="list-style-type: none"> a) Improves accountability for the regulator <ul style="list-style-type: none"> i. Likely better quality decisions over time b) Allows for correction of errors of fact or judgement c) Improves business confidence in the regulatory regime d) Consistency with the rest of the Commerce Act <ul style="list-style-type: none"> i. Merits review is available on clearances and authorisations 	<ul style="list-style-type: none"> a) Gaming risk. Though can be mitigated by providing for full implementation of decisions pending conclusion of appeals b) Cost (most likely recovered by way of a levy on regulated parties) c) Ties the Commission up (time, resource and management focus) in the courts d) Courts lack the specialist expertise of the regulator (notwithstanding lay members) and decisions may be different as opposed to better e) Results in delays and uncertainty f) Likely pressure to extend to other sectors, such as telecommunications and electricity g) Judicial review provides an effective discipline on Commission processes and ensures that decisions are not unreasonable.

53 For accountability and transparency purposes some jurisdictions separate the rule-maker from the rule-enforcer. For example, in Australia, where the rule maker for the energy market is the Australian Energy Market Commission while the rule enforcer is the Australian Energy Regulator (AER). Decisions on the rules are not merits reviewable, though Australia is in the process of introducing limited merits review on AER decisions. In other jurisdictions merits review is often available on regulatory decisions at the end. For example, in the UK they do not separate the rule maker from the rule enforcer, but have merits review by the Competition Commission on regulatory decisions.

54 The associated risks of delay and gaming can be mitigated though careful design, for instance, by allowing the Commission's decision to stand while the courts are considering the case. The overall improvements to the decision making process outlined above may have the effect that relatively few decisions would go to appeal, thereby limiting the costs of making merits review available. Taking into account the ability to mitigate the risks of merits review and the high cost associated with regulatory error, there is a strong case for providing for merits review of Commission decisions relating to specific matters.

- 55 The proposals being recommended as part of this review, i.e. clearer regulatory objectives, the ability for firms to propose control terms, and the provision of merits review of input methodologies will strengthen the regulatory process and will limit the scope for error and dispute. The resulting stronger regulatory process weakens the case for merits review.
- 56 The case for having merits review of input methodologies, before a decision on whether and how to regulate is made, is stronger than for review at the end for decisions on the control terms. Decisions on input methodologies are considered integral to the regulatory process as a whole as they have a significant impact on the final outcome.
- 57 Different options for who should review input methodologies were considered. The two main options considered were:
- a An independent expert panel appointed by the Minister chaired by a person with significant legal experience; and
 - b Appeal to the High Court (with specialist lay members) (preferred option).
- 58 The pros and cons of each option are outlined below.

High Court	Independent Panel
<p><i>Pros</i> Established processes and procedures</p> <p>Low risk of further appeals (process or proper interpretation of law)</p> <p>No suggestion of 'political' involvement</p> <p><i>Cons</i> Timeliness issues (may take up to 2 years)</p> <p>Courts may prefer to deal with case-specific applications rather than methodologies in the 'abstract'</p> <p>May be difficult to assign judge with specialist expertise</p>	<p><i>Pros</i> Faster decisions than High Court</p> <p>May allow for more tailored expertise</p> <p>Costs met by affected parties (levy)</p> <p><i>Cons</i> Higher risk of further appeals</p> <p>Slightly higher risk of further appeals</p> <p>Perception of political involvement</p> <ul style="list-style-type: none"> • More difficult to manage conflict of interest issues <p>Need to develop rules for processes and procedures</p> <p>Levy design may be difficult ('fairness' issues)</p> <p>Costs of members may be high</p>

- 59 There is a risk that the review of decisions about input methodologies are not suited for judicial decision-making since they relate to fact, rather than interpretation and application of the law. There may also be difficulties in assigning judges with specialist knowledge in this area. While many judges have particular areas of interest and particular specialist knowledge, their role is to interpret and apply the law to a particular factual situation, rather than be the principal decision-maker in matters which require highly specialised knowledge about input methodologies.
- 60 It can be argued that an independent body made up of specialists would have access to a greater level of expertise in this field as an independent panel will enable the appointment of people with the appropriate technical knowledge and skills. To mitigate this risk the proposal allows for the High Court to appoint lay members with specialist knowledge.
- 61 An appeal to the High Court is likely to take more time than an independent panel which could dedicate resource to such reviews. This could impact on the timeliness of inquiries under the Commerce Act as well as implementing regulation. However, establishing a panel is also likely to be a costly and time intensive process, with the increased risk of subsequent appeal, when compared to the High Court option.
- 62 On balance, the consideration of appeals by the High Court is a more conventional approach, minimises the risk of further appeals and reviews (because processes are likely to be better) and minimises the difficulties of managing conflict of interest problems. There is also a reduced risk of undue political interference.
- 63 It is difficult to estimate the likely costs which will be demand driven. However, it is likely that there will be appeals for the first set of input methodologies with the number and extent of appeals reducing over time.

100% consumer trust-owned electricity lines businesses (ELBs) subject to information disclosure only

- 64 The following options were considered for regulating 100% consumer trust owned ELBs:
- a 100% consumer trust owned business subjected to the same form of regulation as other ELBs;
 - b 100% consumer trust owned business subjected to lighter handed regulation (such as information disclosure) (preferred option).

Analysis

- 65 With respect to option (a), in principle the case for economic regulation is relatively weak where the customers are the owners of the firm. This is because the incentives of trusts to charge excessive prices is relatively low because excess profits are returned to the customer. Their relatively small size means that the cost of heavier handed regulation may outweigh the benefits.

- 66 A number of risks were identified for option (b) including:
- the risk of cross subsidies where voters may vote for trustees favouring lower prices for residential consumers subsidised by business;
 - voters/consumers may favour lower price at the expense of long-term security of supply;
 - increased cross subsidy to other activities or investments;
 - discourages efficiency improving amalgamations (though there is little incentive to do so under option a or the status quo);
- 67 The availability of information disclosure under option (b) will provide pressure on prices and efficiency. The Commission will be able to make a recommendation to the Minister that the default/customised price quality path regime be imposed on a trust firm under certain conditions, for instance where it no longer qualifies for the lighter regime or where a substantial proportion of its customers have petitioned the Commission and the Commission concludes that a change in the form of regulation would better meet the purpose statement.
- 68 The ability for consumers to respond to increased prices or quality concerns by replacing trustees also mitigates the above risks.

IMPLEMENTATION AND REVIEW

- 69 Implementation of the proposals above requires amendment to the Commerce Act 1986. It is proposed that the Commerce Act Amendment Bill will be passed by mid 2008.
- 70 There will be a transition period for electricity lines businesses. The following transitional arrangement is proposed:
- The Commission should continue its current work programme to re-set thresholds from 1 April 2009 (this includes updating its non-statutory Guidelines, which can be regarded as a pre-cursor to statutory 'input methodologies');
 - the 'default/customised price-quality path' regime should apply from 1 April 2009 with the thresholds becoming the default path;
 - Until the input methodologies are ready, any proposals by firms for a customised path should be based on the Commission's Guidelines. Conventional Part 5 penalties/remedies would apply to breaches;
 - Any administrative settlements in place at 31 March 2009 would continue for their term;
 - Breaches older than six months will expire when the legislation comes into force (except where the Commission has notified the company of its intention to undertake an inquiry).

- 71 The Commission is currently developing guidelines on input methodologies. Until statutory input methodologies are ready under new legislation it is proposed that any proposals from firms be based on the Commission's Guidelines. This will ensure that the transition from Part 4A to the new default/customised price quality path regime is not unnecessarily delayed.
- 72 The Commerce Commission will be responsible for implementing and giving force to the proposed regime. Officials from the Energy and Communications Branch will monitor the implementation and outcomes from the new regime as part of regular monitoring of the effectiveness of policy outcomes.

CONSULTATION

- 73 Ministry officials undertook extensive consultation with industry and consumer representatives. This included running an expert advisory group process to identify the key issues that should be addressed in the discussion document. A discussion paper was released in April 2007 with a three month consultation period. Submissions were received from 45 submitters. Opportunity was provided for those submitters who wanted to convey their key messages verbally to meet with MED officials. The key messages relating to each of the proposals is discussed in the main body of the RIS. Detailed consultations on design issues have been held with the Treasury and the Commerce Commission.
- 74 In the light of the complexity of some of the design issues, a brief and informal period of consultation on design detail is proposed in concert with the legislative drafting process.