



## Regulatory institutions and practices

Response to the New Zealand Productivity Commission's  
Issues Paper dated August 2013

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## 1. INTRODUCTION

### 1.1 Background

We have been instructed by Vector Limited to make observations on the New Zealand Productivity Commission's Issues Paper titled "Regulatory Institutions and Practices", dated August 2013 (**Issues Paper**). The Issues Paper is part of the Productivity Commission's inquiry pursuant to the document titled "Terms of Reference: Improving the Design and Operation of Regulatory Regimes" (**Terms of Reference**).

We provide our observations based on our experience in Australia as competition and regulatory legal advisers and, in the case of Liza Carver, as a previous Commissioner with the Australian Energy Market Commission and a member of the NSW Independent Pricing and Regulatory Tribunal (CVs attached). In addition Liza Carver has since 2009 been an adviser to Vector in relation to the determinations by the NZ Commerce Commission in relation to input methodologies for the purposes of Part 4 of the *Commerce Act 1986* and the subsequent appeals and litigation in relation to those determinations.

The purpose of the Productivity Commission's inquiry is improve regulatory design, existing regulatory regimes, and regulatory outcomes (Terms of Reference, items 1 and 2); in that context, our observations in this paper respond to:

- (a) Item 8 of the Terms of Reference, concerning "key factors which act as incentives or barriers to regulatory regimes and regulators producing the outcomes stated in legislation", such as the "institutional form of the regulator", "quality of regulatory design", and "approach to consultation and engagement with stakeholders";
- (b) Item 11 of the Terms of Reference, which seeks recommendations "to inform the design and establishment of new regulatory regimes and regulatory institutions and the allocation of new regulatory functions to existing institutions";
- (c) Question 8 in the Issues Paper, which asks "can you provide examples of where assigning a regulator multiple functions has improved or undermined the ability of the regulator to achieve the objectives of regulation?"; and
- (d) Question 39 in the Issues Paper, which asks "Can you provide examples of strengths and challenges in the way regulators monitor and enforce regulations? What are the consequences?".

While the Commission's inquiry is not specific to any one regulatory regime or subject matter, we make observations on these matters having specific regard to the frameworks for and experience with economic regulation (in particular the economic regulation of network businesses) in Australia and New Zealand.

### 1.2 Summary of observations

- (a) When designing, evaluating or reforming regulatory regimes it is critical to consider the nature of the rules applied under that regime – in particular, whether the regime involves "protective" rules which govern behaviour norms, or "functional" (or "facilitative") rules which promote the public interest through the prescriptive management of particular activities. Economic regulation typically involves predominantly functional rather than protective rules.
- (b) The application of functional rules requires inquisitorial and determinative regulatory skills, and a regulatory culture which is transparent, constructive and facilitates the ready flow of information. In contrast, investigatory and/or adversarial regulatory skills and culture, which are better suited to enforcing "protective rules", are antithetical to achieving the regulatory approach required for economic regulation, and so may frustrate the purposes of economic regulation.

- (c) There are serious risks where multiple regulatory functions are conferred on a single regulator, particularly where adversarial and investigative functions are conferred on a regulator charged with responsibilities for economic regulation. The Australian experience suggests that these concerns exist even where two independent regulators with conflicting functions simply share resources; however, the concerns are significantly more marked where, as in the case of the New Zealand Commerce Commission (**NZCC**), a single regulator is vested with conflicting functions.
- (d) On the basis of our experience in advising Vector in relation to the NZCC's determinations of input methodologies for the purposes of Part 4 of the *Commerce Act 1986* a significant factor that has resulted in the protracted, adversarial and litigious process that has occurred in relation to the determination of the input methodologies has been the lack of open, constructive, trusting and transparent engagement between the NZCC and the regulated businesses. The primary function of the NZCC is the enforcement of the prohibitions in the *Commerce Act 1986* in relation to anti-competitive arrangements and conduct. The skills and culture required to successfully discharge the enforcement functions under the *Commerce Act 1986* are antithetical to the skills and culture that are required to best achieve the objectives of economic regulation under Part 4 of that Act.
- (e) The Productivity Commission should carefully consider these risks and demonstrated experience when formulating its recommendations to government.

## 2. **BACKGROUND: ECONOMIC REGULATION UNDER PART 4 OF THE COMMERCE ACT**

We use the phrase "economic regulation" to refer to regulation which responds to perceived natural monopoly or market failure, and seeks to produce regulated outcomes which approximate the outcomes which would be achieved in a competitive market. Part 4 of the *Commerce Act 1986* (NZ) is a key example of economic regulation, and we focus our comments on this regime.

The purpose of Part 4 is to "promote the long-term benefit of consumers" in markets where "there is little or no competition and little or no likelihood of a substantial increase in competition", by promoting "outcomes that are consistent with outcomes produced in competitive markets" (ss 55, 52A). This is intended to ensure that regulated businesses have incentives to innovate, invest, improve efficiency and provide quality that reflects customer demands; that they share efficiency gains with consumers, including through lower prices; and that they are limited in their ability to extract excessive prices (s 52A).

To this end, Part 4 establishes specific regulatory regimes for electricity line services, gas pipeline services, and certain airport services. In particular, it applies:

- (a) **information disclosure regulation** to electricity line services, gas pipeline services and certain airport services; this mandated disclosure enables interested parties to be aware of, and the NZCC to monitor and report on, matters such as the price and quality of regulated goods and services (s 53B); and
- (b) **price-quality regulation** to some electricity line services and some gas pipeline services; this involves the NZCC determining the maximum prices that may be charged and/or revenues that may be recovered by a regulated supplier, and the quality standards that the regulated supplier must meet, for a particular regulatory period (s 53M).

Under Part 4, the NZCC is responsible for developing and applying the "input methodologies" necessary to conduct information disclosure and price-quality regulation. These methodologies govern the methodology for asset valuation, costing, and related matters used to determine the regulated price, quality and other standards the regulated business must meet (s 52T(1)). Part 4 also includes a process for new business types to become subject to regulation under Part 4.

Other examples of economic regulation in New Zealand include the NZCC's regulatory functions under the *Telecommunications Act 2001* (NZ) and the *Dairy Industry Restructuring Act 2001* (NZ).

### 3. **ECONOMIC REGULATION AND REGULATORY DESIGN: SOME KEY DISTINCTIONS**

#### 3.1 **Regulation involves the use of two distinct types of rules**

Regulation involves the application of two very distinct types of rules.

A **protective** rule prohibits or mandates a standard of conduct with the principal purpose of protecting persons or a class of persons from the consequences of that conduct or failure of a standard. Key examples of "protective" rules are the "restrictive trade practices" prohibitions in Part 2 of the *Commerce Act*, which prohibit conduct such as price fixing (s 30) and taking advantage of market power (s 36). These prohibitions establish norms of conduct with the clear purpose of protecting those likely to be affected by breach of those norms.

A **functional or facilitative** rule has the principal purpose of establishing a body of transparent and agreed standards or processes in order to promote the public interest through the effective or efficient management of activities. The requirements in Part 4 of the *Commerce Act* that regulated suppliers must comply with regulated "price-quality" paths, or mandated information disclosure requirements, are examples of such functional or facilitative rules (eg s 53B, 53M). These provisions promote the public interest by prescribing rules which seek to mandate how regulated suppliers conduct their activities, in order to approximate the outcomes that competitive markets might otherwise achieve.

Economic regulation overwhelmingly involves the application of functional rules, with limited, if any, protective rules.<sup>1</sup>

#### 3.2 **Economic regulators must have powers, skills and a regulatory culture which are appropriate to their role**

Broadly speaking, the powers conferred on regulators can be characterised as either **investigative and adversarial**, or **inquisitorial and determinative**. The nature of the powers conferred on a regulator necessarily shapes the skills and regulatory culture they develop.

**Investigative and adversarial powers** are usefully conferred on regulators whose role includes detecting, proving, and deterring (or disciplining) conduct which contravenes behavioural norms established by protective rules. The NZCC's powers to investigate contraventions of Part 2 of the *Commerce Act*, and seek cease and desist orders, and court-ordered pecuniary penalties for such contraventions, are examples of such powers (ss 74A, 74B, 80). In fulfilling this role, the NZCC is not, absent continuing or repeated contravention, involved in an ongoing regulatory relationship with those it investigates. Its role is properly and necessarily adversarial, and the development of associated legal and litigious skills and culture does not undermine its ability to detect, investigate and deter contravening conduct.

In contrast, **inquisitorial and determinative powers** are usefully conferred on regulators whose role is to apply and enforce functional or facilitative rules. The NZCC's powers under Part 4 of the *Commerce Act* to obtain information from regulated suppliers, and determine and apply regulatory instruments such as "price-quality" paths, are examples of such powers (eg ss 53B, 53M). Conferral of these powers is essential to achieving the facilitative objects of Part 4.

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<sup>1</sup> An example of a protective rule used in economic regulation is s 22A(2) of the *Telecommunications Act 2001* (NZ), which prohibits an access provider from acting in a way that is prejudicial to the interests of an access seeker.

The NZCC's role under Part 4 is sharply different to its role in relation to Part 2. It requires the NZCC to maintain a continuing relationship with regulated suppliers, in which the NZCC's function is inquisitorial (obtaining information), and determinative (creating and applying regulatory rules/methodologies). In order to fulfil its role in a way that achieves regulated outcomes which approximate competitive market conditions, the NZCC requires a deep understanding of regulated industries and businesses, and the technical, operational, financial and other imperatives they face (Box 1). In practice, the NZCC seeks to develop and apply this understanding through an iterative process of engagement between the NZCC, regulated businesses and the public. This process involves the regulated business submitting a proposal (eg a price or quality standard to apply to that business), which the NZCC then tests, questions, submits to extensive public consultation, and evaluates.

An open, constructive, co-operative and trusting relationship between the NZCC and those it regulates is essential to the success of this process. Taking an alternative approach, such as an adversarial approach to obtaining information, will encourage similar adversarialism and legalism from regulated businesses, whose rational response will be to limit frankness and free information exchange commensurately with the regulator's approach.

The potential for an adversarial, legalistic or litigious approach to hinder economic regulation has been acknowledged by the NZCC<sup>2</sup> and an expert panel in Australia, which observed that "constructive engagement" between a regulator and the network service providers it regulates is:

... important if improved regulatory incentives are to be developed, particularly in relation to matters such as capex and innovation, which may involve commitments and payoffs extending over relatively long periods. A significant part of the incentive effects of regulation derive from the existence of an ongoing relationship between the regulator and the NSPs [Network Service Providers]. For example, the longer-term relationship should, if it functions correctly, serve to discourage opportunism on both sides ...<sup>3</sup>

Accordingly, open, frank and cooperative engagement between a regulator such as the NZCC and the regulated business is *critical* to the effective functioning of Part 4 and other forms of economic regulation framework. An adversarial, legalistic or litigious approach to regulation would be antithetical to achieving the objectives of such regulation.

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<sup>2</sup> NZCC, *Improving New Zealand's Markets, Our Plan for 2013-2016*, p 3.

<sup>3</sup> Professor George Yarrow, the Hon Michael Egan, Dr John Tamblyn, "Review of the Limited Merits Review Regime, Stage Two Report", 30 September 2012, p 16.

**Box 1 – Complexity of the NZCC's role under Part 4 of the Commerce Act**

One of the NZCC's functions under Part 4 is to determine the price-quality paths which govern the price, revenue and quality standards which apply to regulated suppliers. This requires careful consideration and judgments on matters such as:

- (a) **the regulated business's costs**, including what costs are involved in developing, maintaining and operating an electricity, gas or other network businesses, whether those costs are prudently or efficiently incurred, and the impact on the regulated business's incentives of allowing it to recover particular costs;
- (b) **matters of financial and economic theory and analysis**, such as are required to determine the rate of return used to calculate the price and revenues a regulated business is allowed to charge, and the inputs into the rate of return (such as the appropriate allowances to be made under the Capital Asset Pricing Model for risk associated with debt and equity financing, and prevailing trends in debt and equity markets which influence that risk);
- (c) **the efficient design, and operation of, and investment in, large scale infrastructure**, including the costs and risks involved in operating, extending and expanding such infrastructure, and the impact of particular projects on network performance; and
- (d) **forecasting** matters such as future demand for the regulated good or service.

The complexity of the matters the NZCC must consider is illustrated by the NZCC's current consideration of the customised price-quality path to apply to Orion New Zealand Limited. As part of this process, the NZCC is considering matters such as the extent to which Orion should be able to recover from consumers the costs associated with repairing earthquake damage to its network, and charge higher prices to compensate for lower energy consumption following the Canterbury earthquakes. This in turn involves consideration of diverse matters such as the impact of the earthquakes on construction labour costs in Canterbury, consumer quality expectations following the earthquakes, and alternative strategies for investing to rebuild Orion's networks. Obtaining a clear understanding of information and analysis relevant to these issues, let alone making determinations on the basis of that information and analysis, requires an open and constructive relationship between the NZCC and those it regulates.<sup>4</sup>

**4. CONFERRING MULTIPLE FUNCTIONS ON AN ECONOMIC REGULATOR: RISKS AND RECENT EXPERIENCE**

**4.1 Risks from conferring multiple functions on an economic regulator**

Conferring adversarial or investigative powers on a regulator to investigate contraventions of, and enforce, protective rules will necessarily and desirably result in that regulator developing skills, expertise and culture which are tailored to fulfilling that function.

However, where a single regulator regulates both protective and functional (or facilitative) rules or regimes, it can be extremely difficult to prevent the adversarial, investigative techniques and culture it develops in fulfilling its protective role from undermining the efficacy of its inquisitorial and determinative function. Rather, the adversarial, investigative and often legalistic techniques developed in one capacity, and the culture associated with them, will unavoidably influence the skills, culture and attitude such a regulator brings to fulfilling their functions as an economic regulator. A regulator whose culture reflects its demonstrated skills and experience in investigating and prosecuting egregious competition law contraventions should not be expected to, and in practice cannot, simply "snap out" of that adversarial culture and approach in order to foster the collaborative, open and constructive approach required for economic regulation. In this context, it is relevant to recall that the Cabinet Economic Development Committee which recommended significant reform to Part 4, expressly noted concerns that the previous regulatory regime "tended to be punitive rather than to have a forward-looking focus on long-term incentive regulation", and was seen by several interested parties to have had "a negative backward-looking focus on control as punishment for bad behaviour and "breaches", rather than a forward-looking

<sup>4</sup> NZCC, *Invitation to have your say on Orion's proposal to change its prices and quality standards, Issues to explore and consider*, 1 May 2013, pp 13, 16, 20, 21.

incentive-based approach where the regulator and the firm seek to mimic the outcomes of competitive markets."<sup>5</sup>

The desirability of separating economic regulation from other regulatory functions is reflected in the very clear separation in the United Kingdom between the Office of Fair Trading (which has responsibility for regulation and enforcement of competition and consumer law), and sector-specific economic regulators such as Ofgem (the Office of Gas and Electricity Markets), Ofwat (the Office of Water) and Ofcom (the Office of Telecommunications).

#### 4.2 Recent Australian experience

The risks of undermining the efficacy of economic regulation by conferring multiple, and inconsistent, functions on an economic regulator are reflected in current concerns regarding arrangements between the Australian Competition and Consumer Commission (**ACCC**) and the Australian Energy Regulator (**AER**). The ACCC and AER are separate statutory bodies. The ACCC's role includes investigation and often adversarial enforcement of Australian competition and consumer law. In contrast, the AER's role includes network price setting, monitoring and reporting obligations regarding Australian gas and electricity markets. However the AER shares key resources (including staff) with the ACCC. Concerns have recently been expressed about the impact of these arrangements on the AER's ability to fulfil its functions as an economic regulator (see [Box 2](#)). Notably, these concerns have arisen where the ACCC and AER share resources, despite being two distinct regulators. Similar but more marked issues are likely to arise where distinct regulatory functions are conferred on a single regulator.

##### **Box 2 – Concerns that the AER's closeness to the ACCC frustrates its regulatory purpose**

The Australian Productivity Commission has noted concerns expressed by industry participants about the AER's "combative" approach and lack of consultation,<sup>6</sup> and expressed its own view that:

*A particular risk is that the ACCC's roles as competition watchdog and consumer protection regulator can spill over and affect its approach to its role, and that of the AER, as an economic regulator of infrastructure. In the former roles, the ACCC prosecutes civil or criminal offences, such as those associated with deceptive or anticompetitive conduct, and is inevitably (and appropriately) adversarial. In contrast, the role of an economic regulator of networks is quite technical in nature, with a requirement for extensive ongoing consultation and communication with the businesses it regulates and other stakeholders, rather than being adversarial.<sup>7</sup>*

In response to these concerns, the Productivity Commission recommended that the AER should "have greater control over, and accountability for, the resourcing and management of its functions", and made six prescriptive recommendations to increase the AER's independence from the ACCC, and assist the AER to develop the particular skills, expertise and culture it requires to fulfil its functions. This included a recommendation that the AER "develop a program for regular ongoing communication and interaction with network businesses, their customers and other relevant stakeholders, with those interactions not just confined to periods of regulatory determinations."<sup>8</sup>

Similarly, an expert panel established to review the merits review regime which applies to determinations by Australian energy regulators stated that "the evidence that it has heard, and the

<sup>5</sup> The Hon Lianne Dalziel, Minister of Commerce, and the Hon David Parker, Minister of Energy, paper addressed to The Chair, Cabinet Economic Development Committee, "Review of Parts 4 and 4A of the Commerce Act", 2008, pages 1 and 4.

<sup>6</sup> Australian Government, Productivity Commission, "Electricity Network Regulatory Frameworks, Productivity Commission Inquiry Report", No 62, 9 April 2013, p 767.

<sup>7</sup> Australian Government, Productivity Commission, "Electricity Network Regulatory Frameworks, Productivity Commission Inquiry Report", No 62, 9 April 2013, p 783-4.

<sup>8</sup> Australian Government, Productivity Commission, "Electricity Network Regulatory Frameworks, Productivity Commission Inquiry Report", No 62, 9 April 2013, recommendation 21.1, p 778.



recommendations that it has made in relation to the merits review regime, combine to strengthen the case for AER independence from the ACCC.<sup>9</sup> Further, the federal Minister for Industry, Ian Macfarlane, has previously described plans for the then-opposition to separate the AER from the ACCC;<sup>10</sup> however, no such reforms have yet been implemented by the current federal government.

## 5. CONCLUSIONS FOR ECONOMIC REGULATION AND REGULATORY DESIGN IN NEW ZEALAND

Our observations above point to the following conclusions in relation to the matters of regulation and regulatory design being considered by the Productivity Commission.

- (a) When designing or considering the efficacy of regulatory regimes, and particularly regimes for economic regulation, it is critical to consider the type of rules being applied by a particular regime. There is a clear distinction between "protective" rules and "functional" (or "facilitative") rules, and recognising this distinction is important to the design and effective operation of regulatory regimes.
- (b) Regimes for economic regulation, such as the regulation of network businesses under Part 4 of the *Commerce Act*, tend to be overwhelmingly comprised of functional or facilitative rules, rather than protective rules.
- (c) The application of functional rules regarding economic regulation typically requires the supply, evaluation, testing and application of large volumes of complex technical, operational, financial, legal and economic information.
- (d) This role is best suited to a regulator with inquisitorial and determinative functions, who can develop an ongoing relationship with regulated entities which is transparent, certain, cooperative and constructive. In contrast, applying adversarial or investigative regulatory functions to the task of economic regulation will be antithetical to achieving this type of relationship.
- (e) Experience to date suggests that there are serious challenges where an economic regulator is influenced by the skills, expertise and culture developed in fulfilling functions such as competition or consumer law enforcement, which are more investigative, adversarial and litigious. These challenges are manifested in clear and serious concerns expressed in relation to the arrangements concerning the ACCC and the AER, two independent bodies which share resources. Such concerns are significantly more serious where a single regulator such as the NZCC is required to fulfil both adversarial/investigative functions (such as acting as the competition law regulator) as well as the more inquisitorial/determinative functions associated with economic regulation.
- (f) The Productivity Commission should be highly cognisant of these risks and demonstrated experience when formulating its recommendations to government regarding the design and implementation of regimes involving economic regulation of networks and other businesses.

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<sup>9</sup> Professor George Yarrow, the Hon Michael Egan, Dr John Tambllyn, "Review of the Limited Merits Review Regime, Stage Two Report", 30 September 2012, p 62.

<sup>10</sup> "Coalition plan to tackle power costs", Australian Financial Review, article by Marcus Priest, 13 July 2013.