MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

# Part 4 of the Commerce Act 1986: Merits Review Regime Evaluation

## Summary Findings from Interviews with Stakeholders

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# Executive summary

Part 4 of the Commerce Act 1986 provides for the regulation of the price and quality of goods or services supplied in markets with monopoly characteristics. A critical element of the Part 4 regime is the requirement for the Commerce Commission (the Commission) to specify key regulatory parameters, methodologies and processes upfront, before their application in the economic regulation of goods or services (collectively termed *input methodologies*, or *IMs*).

In light of their high importance in the regulatory regime, Part 4 provides for IMs determined by the Commission to be appealed against on their merits to the High Court (merits review).

In December 2010 the Commission determined the IMs, which were subject to merits appeals between September 2012 and February 2013, with the High Court issuing its decision in December 2013. The Court dismissed all the appeals, ruling in favour of the Commission's IM determinations on all but two relatively minor points out of at least 58 challenges.

In the aftermath of the Court's decision, regulated suppliers, consumer groups, and the Commission have all raised issues about aspects of the merits review process and whether it is as effective and efficient as it could be in achieving the purpose of Part 4.

## Merits review regime evaluation

As part of its regulatory stewardship of the Commerce Act, the Ministry of Business, Innovation and Employment (the Ministry) is performing an evaluation of the merits review regime to capture and assess the learnings from the 2012/13 merits review process. The first stage of this evaluation has been to conduct a series of interviews with various stakeholders to obtain their views on the regime. We have interviewed appellants and interested parties involved in the merits appeals, the Commission's staff, various legal counsels involved in the merits appeals, the presiding judge (Justice Clifford), and the two expert lay members of the High Court (Mr Shogren and Mr Davey), among others.

In the course of the interviews, these stakeholders discussed a number of themes and issues with us, most notably:

- whether the merits review promoted regulatory certainty;
- the extent to which the merits review regime has contributed to making the Commission more accountable;
- whether the voice of consumers had a fair opportunity to be heard in the merits review (and also in Part 4 regulatory processes more generally);
- whether the processes and rules employed in conducting the merits review promote the best decisions concerning the quality of IMs;
- the statutory threshold (the "materially better" test) for deciding whether an IM should be amended or substituted as a result of merits review; and
- the cost of participating in the merits review.

We are grateful to all those who gave their time to participate in the interviews.

## Conclusions

The interviews were invaluable, producing a prolific amount of information from various stakeholders and directing the Ministry to several important themes and issues.

The interviews indicated to us that the fundamental policy goals for instituting the merits review regime appear to have mainly been realised; in particular, to make the Commission more accountable for its IM determinations and to improve regulatory certainty. We would expect the breadth of issues considered by future merits appeals to reduce, resulting in significant reductions in the costs of future appeals and the time for cases to be heard and decided.

That being said, the interviews identified key areas where the merits review regime potentially could be improved. Our preliminary view is that further work to explore the following three issues may be warranted:

- Whether the level of consumer engagement in the Part 4 regulatory processes generally (including merits review), which has been minimal to date, needs to be lifted and how this could be achieved. Consumers or different consumer groups often have a diverse range of perspectives and interests. Experience from international jurisdictions suggests there is no easy answer in ensuring a balanced and effective consumer voice in regulatory processes akin to Part 4. However, there may be scope for improvement in the way that various aspects of the Part 4 regulatory system interact with consumers (for example, targeted consumer engagement processes).

- Whether there are options for improving the effectiveness and efficiency of the processes and rules employed in merits review. For instance, whether the High Court's adopting an inquisitorial approach (including hot-tubbing experts) and relaxation of the closed record requirement in Part 4 could yield better regulatory outcomes.

- Whether the materially better test is the appropriate benchmark for the Court's deciding that an IM determined by the Commission should be amended or substituted.

# Background

1. Part 4 of the Commerce Act 1986 provides for the regulation of the price and quality of goods or services supplied in markets with monopoly characteristics. Part 4 was comprehensively reformed in 2008 to improve clarity, certainty, timeliness and predictability for regulated suppliers as a means of promoting the long-term benefit of consumers. Three key elements of the reforms were:

    a. A dedicated Part 4 purpose statement 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 consistent with competition such that suppliers of regulated goods or services:

        i. have incentives to invest and innovate;

        ii. have incentives to improve efficiency and provide services at a quality required by consumers;

        iii. share the benefits of efficiency gains with consumers; and

        iv. are limited in their ability to extract excessive profits.

    b. A requirement for the Commerce Commission (the Commission) to specify key regulatory parameters, methodologies and processes in advance of their application in the economic regulation of goods or services (collectively termed *input methodologies*, or *IMs*).[1] The Commerce Act provides that the purpose of IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation of goods or services under Part 4.

    c. Subjecting the IMs determined by the Commission to appeal to the High Court regarding the merits of any or all IMs (merits review). If the Court is satisfied that an amended or substituted input methodology is "materially better" in promoting the purpose of Part 4, the purpose of IMs, or both, it can:

        i. amend the IM; or

        ii. revoke the IM and substitute a new one; or

        iii. refer the IM determination back to the Commission with directions as to the particular matters that require amendment.

2. The merits review regime for IMs was conceived as a mechanism for imposing accountability upon the Commission, serving at least three important purposes:

    a. to incentivise the Commission to make well-considered IM determinations;

    b. to provide an avenue for determinations to be reviewed for possible errors of substance or fact and, if necessary, rectified; and

[1] IMs include methodologies for evaluating or determining the cost of capital, valuing the regulatory asset base, allocating common costs, and the treatment of taxation.

c. to improve the quality of future determinations made by the Commission by establishing precedents which would increase the certainty (and therefore confidence) of stakeholders engaged in future regulatory processes.

3. Part 4 regulation currently applies to three classes of services:

   a. electricity lines services supplied by 29 local electricity distribution businesses and Transpower;

   b. (natural) gas pipeline services supplied by five gas pipeline businesses; and

   c. specified airport (that is, aeronautical[2]) services supplied by the three major international airports at Auckland, Wellington and Christchurch.

4. In December 2010 the Commission determined the IMs for the electricity distribution businesses, Transpower, gas pipeline businesses, and the specified airport services at Auckland, Wellington and Christchurch Airports. A number of parties appealed the Commission's IM determinations as to their merits.[3]

5. However, before the merits appeals could be heard, the Court first needed to address Vector and Transpower's judicial review of aspects of the Commission's decision-making process. Without needing to get into the details of these judicial reviews, the end result was that the Commission re-determined aspects of the IMs over the period from June to September 2012. These re-determinations allowed the merits appeals to be heard over 39 days from September 2012 to February 2013, with the High Court issuing its decision on 11 December 2013. The Court dismissed all the appeals, ruling in favour of the Commission's determinations on all but two relatively minor points out of at least 58 challenges.

6. In the aftermath of the Court's decision, regulated suppliers, consumer groups, and the Commission have all raised issues about aspects of the merits review process and whether it is as effective and efficient as it could be in achieving the purpose of Part 4.

# Merits review regime evaluation

7. As part of its regulatory stewardship of the Commerce Act, the Ministry of Business, Innovation and Employment (the Ministry) has undertaken work to capture and assess the learnings from the 2012/13 merits review process to establish if further work in this area is desirable with a view to making improvements to the process.

8. The importance of evaluation to effective government and governance was communicated in a Cabinet decision of 4 March 2013[4] obligating departments, in exercising their stewardship role over regulatory regimes, to (among other things)

[2] Aeronautical services are those services associated with aircraft take-offs and landings.

[3] The appellants were Vector, Powerco, Wellington Electricity Lines, Transpower, Auckland International Airport, Wellington International Airport, Christchurch International Airport, Air New Zealand, and Major Electricity Users' Group. Maui Development was an interested party to the merits appeals relating to the IMs for electricity distribution businesses and gas pipeline businesses. In addition to being an appellant, the Major Electricity Users' Group was an interested party to the airports/Air New Zealand cost of capital IMs appeals.

[4] See Cabinet Minute of Decision, *Regulatory Systems: Improving New Zealand's Regulatory Performance*, CAB Min (13) 6/2B.

monitor, and thoroughly assess at appropriate intervals, the performance and condition of their regulatory regimes to ensure they are fit for purpose, and to act on problems and opportunities for improvement in the design and operation of those regimes.

9. The Ministry has conducted a series of interviews with various stakeholders to inform an assessment of the effectiveness and efficiency of the merits review regime.

10. These stakeholders included the parties directly involved in the merits appeals as either appellants or interested parties. Interviews were also conducted with the presiding judge (Justice Clifford) and the two High Court expert lay members (Mr Shogren and Mr Davey), the Commission's staff, PricewaterhouseCoopers[5], Unison[6], Board of Airline Representatives New Zealand (BARNZ)[7], and various legal representatives involved in the merits appeals process.

11. A copy of the questionnaire used to prompt discussion is contained in the **Appendix**. All interviewees were sent the questionnaire in advance of the interviews.

# Key evaluation themes and issues

12. Based on the interviews conducted, we identified several key themes and issues:

- whether the merits review regime has contributed to improved regulatory certainty;
- whether the merits review regime has made the Commission more accountable, providing the Commission with stronger incentives to make well-considered and high-quality decisions;
- whether the institutional arrangements and processes for conducting merits reviews facilitate effective and efficient decisions concerning the IMs;
- whether the statutory "materially better" test is the appropriate benchmark for deciding whether an IM should be amended or substituted as a result of merits review;
- whether the merits review process (and Part 4 regulatory processes more generally) was accessible to consumers; and
- whether the cost of participating in a merits review is too high.

13. The remainder of this report contains a more detailed discussion of the themes and issues raised in the interviews.

## Improved regulatory certainty

14. The statutory purpose of IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation of goods or services under Part 4.

[5] PricewaterhouseCoopers is a long-standing advisor on Part 4 matters to a client group of 20 electricity distribution businesses.
[6] Unison is the electricity distribution business based in the Hawke's Bay.
[7] BARNZ is the representative body for 21 member airlines operating in New Zealand, including Air New Zealand.

*Many interviewees agreed that in general merits review contributed to regulatory certainty …*

15. One view expressed was that the nature of regulatory certainty and predictability is transitory, that is, it needs to be thought of in a temporal context. In the short term there is greater uncertainty and unpredictability as a new regulatory system is bedded down and understanding of how it will work in practice is limited. In the longer term, however, once precedents have been established and familiarity with how the regulatory system operates is acquired by stakeholders, there should be an increase in regulatory certainty and, in turn, confidence about the system and its likely outcomes.

16. While a merits review may decrease regulatory certainty over the short term, it would be expected to increase regulatory certainty over the longer term, by providing a constraint on the ability of the Commission to make arbitrary changes to the IMs, or to depart from evidence-based consensus about how the IMs can best achieve the purpose of Part 4.

17. Many interviewees expressed the view that the first merits review has made a significant contribution to regulatory certainty. They observed that the merits appeals traversed a broad range of fundamental IM issues for the first time, which were comprehensively addressed by the Court and established important precedents.[8]

18. The implication of this is that many long-standing regulatory issues that had been festering before the merits review, including under previous regulatory regimes, have now been substantially laid to rest (for example, the appropriate basis for valuing the regulatory asset base). As a result, most interviewees were generally confident that any future movement of them as part of further IM reviews by the Commission was likely to be incremental rather than radical, and hence the scope of any future merit reviews would be much reduced.

*But for many interviewees the delay in the merits appeals was not conducive to regulatory certainty …*

19. One aspect of the merits appeals, however, that many interviewees said detracted from regulatory certainty was the length of time it took for the Court to hear the appeals. While the Commission had determined IMs in December 2010, it was September 2012 before the Court began hearing the appeals, with the Court's judgment coming at the end of 2013. Interviewees claimed that the resulting uncertainty in the meantime discouraged capital investment in the long-term interests of consumers. However, they also acknowledged that the timeline was greatly affected by earlier judicial review proceedings brought against the Commission with respect to the IMs, the breadth of issues appealed (given it was the first merits review) and probably also the new and unfamiliar nature of the merits review regime. The implication of this is that any future merits reviews may be expected to be undertaken more expeditiously.

*And the Commission's review of the WACC percentile was seen as undermining regulatory certainty*

20. Another common criticism of the merits appeals with respect to undermining regulatory certainty was the Commission's decision to review the cost of capital point estimate (or percentile) in the weighted average cost of capital (WACC) IM for price-quality path

[8] Every IM was appealed, and many aspects of each IM.

regulation of electricity distribution and gas pipeline businesses soon after the appeals judgment.

21. The Commission's review of the WACC percentile was instigated in response to the High Court's comments regarding the WACC percentile, expressed in its judgment. The Court indicated that the Commission's chosen WACC percentile was not well supported by analytical and empirical evidence. The outcome of the review was the Commission's decision in October 2014 to lower the WACC point estimate from the 75$^{th}$ percentile to the 67$^{th}$ percentile, with the effect being to reduce the Commission's estimate of regulated suppliers' cost of capital (in effect, reducing allowable revenues for regulated suppliers).[9] While the Court's expectation was that the Commission would review the appropriateness of using the 75$^{th}$ percentile at the time of the Commission's statutory 7-year review of IMs due in 2017, the Commission concluded it had to immediately consult on the WACC percentile on the grounds that the Court's comments created too much uncertainty concerning the appropriate WACC percentile. This decision was, however, criticised by many of the regulated suppliers and their advisors who were interviewed on the grounds that the Commission had acted opportunistically and created regulatory uncertainty, rather than reduced it.

## Accountability of the Commission

*In general, interviewees thought the possibility of merits reviews disciplines the Commission*

22. A general comment by interviewees was that the potential for merits appeals rendered a firm discipline over the Commission's decision-making processes – in short, that the Commission had a stronger incentive to ensure it made well-considered and high-quality IM determinations in light of the potential for its determinations to be challenged in the High Court on their merits.

23. While the benefit of having an accountability mechanism overarching the Commission's decision making was not refuted in general, some interviewees (mainly regulated suppliers and their legal representatives) observed that a Court-based process was both time-consuming and expensive, and Commission decisions were proven difficult to overturn. In their minds, this created the risk of an 'accountability vacuum' emerging, whereby the Commission would become emboldened and less robust in its decision-making processes in future, in the expectation that it was unlikely to have its decisions challenged in the Court.

24. Others, on the other hand, challenged this position. They argued that regulated suppliers will continue to have a significant motive in challenging IM determinations because relatively small amendments to an IM, such as an amendment to the asset valuation IM, could have a substantial effect on a supplier's profitability.

25. Some interviewees wondered whether a different approach could be taken in future; for example, whether the Ministry could be assigned the role of monitoring the Commission to see if the Commission is achieving the Part 4 purpose, and/or by appointing a panel of experts to periodically scrutinise and publicly report on a selected sample of the Commission's decisions.

[9] To be sure, the Court did not direct the Commission to amend the WACC percentile in its WACC IM; the comments were obiter dicta (that is, incidental to the decision in the judgment) following the Major Electricity Users' Group appealing the WACC percentile adopted by the Commission and the Court's scepticism of the Commission's using a WACC substantially above the mid-point (50$^{th}$ percentile).

## Institutional arrangements and processes

26. The Ministry also tested with interviewees whether the current institutional arrangements and associated processes for merits reviews create barriers and/or incentives which impact on the effectiveness and efficiency of merits reviews (and ultimately on the outcomes sought from Part 4). In particular, we discussed with interviewees:

    - whether the High Court would have benefitted from having the ability to ask questions of experts and allowing experts to give concurrent evidence and cross-examine each other ('hot-tub' – the inquisitorial approach), rather than being limited in addressing questions to lawyers only (the adversarial approach);

    - whether the 'closed record' requirement for merits reviews under Part 4 – which requires merits appeals to be conducted solely on the basis of the documentary information and views that were before the Commission when it made its IM determinations – is appropriate; and

    - whether the High Court is the appropriate body to hear merits appeals, or alternatively whether a specialist tribunal would achieve a better outcome.

### Adversarial vs inquisitorial approach

27. Court proceedings in New Zealand are traditionally run according to an adversarial system – a two-sided structure that pits one party against another. The aim is for each adversary to convince the judge or jury that their perspective on the case is the correct one. This approach is appropriate where the Court is asked to determine the rights of the parties involved, but may be less helpful where its function is to adjudicate on the rules of a regulatory regime and potentially develop alternative rules.

*The majority of interviewees did not favour the adversarial system …*

28. The majority of interviewees were highly critical of the adversarial approach used in the merits appeals, saying that the quality of oral arguments made to the Court was poor. In particular, while the written submissions before the Court covered the issues comprehensively and contained evidence from experts, they observed that the lawyers struggled in their understanding of the complex economic and finance issues and arguments, and therefore in articulating their answers to questions posed by the Court.

*And instead would prefer an inquisitorial process, including hot-tubbing …*

29. These interviewees considered it would have been desirable to instead permit the Court to directly question the experts used by the parties in order to obtain a more profound understanding of technically complex economic and finance issues and arguments. This is commonly referred to as the inquisitorial approach, which permits more meaningful engagement and debate to take place in a merits review, rather than simply reducing the proceedings to a litigious contest between respective lawyers. In short, the interviewees wished that the Court could have engaged in a more mature conversation over the issues and arguments put in front of it.

30. They also thought that allowing hot-tubbing could have produced a better outcome. Hot-tubbing is where experts (typically economists) are available to the Court for the purpose of attempting to agree between themselves, or to better illuminate areas

where they disagree, in order to assist the Court in understanding technically arcane issues.

31. An idea favoured by one interviewee was for the judge to hold judicial conferences before the merits appeals commence. Under this option, conferences involving the experts would be targeted at clearly delineating what issues the parties agree and disagree on so that the issues presented before the Court could be narrowed.

32. Another suggestion made was that the Commission should routinely incorporate hot-tubbing into its pre-determination processes, and to not do so is a weakness in the Commission's processes. According to this view, permitting the experts to hot-tub before the Commission makes a final decision would better inform the Commission's decision making and consequently potentially help reduce the extent of any future merits appeals against the final decision.

*But some interviewees had reservations about the inquisitorial approach*

33. However, not all interviewees supported the inquisitorial approach. These interviewees cautioned that the inquisitorial approach, including permitting hot-tubbing, would inevitably steer merits reviews beyond the confines of the closed record (see below), including the promulgation of new theories and analyses. They considered that the effect of this would be to significantly lengthen the time and increase the cost of proceedings. Further, this situation would be exacerbated if, in addition to being questioned by the Court, the experts were allowed to cross-examine each other. A rebuttal to this concern, however, was that the Court is capable of adequately managing hot-tubbing so as to ensure that any expert testimony preserved the integrity of the closed record requirement. For instance, the Court could impose a limit on any new information admitted, in particular regarding evidence that the parties did not have an opportunity to previously consider.

## Closed record requirement

34. Part 4 requires that merits appeals are a rehearing conducted solely on the basis of the documentary information and views that were before the Commission when it made its IM determinations (the closed – or frozen – record).

35. The closed record requirement was intended to prevent parties from 'gaming' the merits review regime by holding back evidence from the Commission, only to then produce it at the time of the merits appeals. Such behaviour could occur where a party believes they have a better chance of persuading the Court than the Commission of their arguments. The prospective appellant may reason that their resources are better spent in developing evidence and formulating arguments for the Court process than the Commission. The strategy may also prevent the Commission from fully analysing and responding to the appellant's arguments in advance of the hearing, making the appellant more likely to prevail in the appeal.

*The closed record requirement received significant criticism from most interviewees …*

36. The closed record requirement attracted significant criticism from most interviewees. One complaint mentioned was that there is an incentive for each party to have included in the closed record all materials and evidence they have accumulated even if at the time they think it might not be relevant to the merits appeals. As a result, the record placed before the Court was enormous, consisting of approximately 40,000 pages.

Moreover, the Commission was inundated with new submissions very late in its decision-making process, including in the week of its IM determinations, which it then needed to process within an extremely tight timeline.

37. Another common criticism was that the Commission engaged experts to provide advice on its pre-final determinations, which was then included in the closed record but without regulated suppliers or other interested parties (and their experts) having the opportunity to analyse the advice and formally submit on it for the purpose of the closed record. The concern is that the Commission enjoys a last-mover advantage with respect to what evidence is admissible into the closed record. In this circumstance, interviewees said parties should be permitted to seek the Court's leave to introduce new evidence at the time of the merits review. However, it should be noted that these criticisms were not necessarily a pleading for removing the closed record requirement altogether.

*But there was some qualified support for the closed record requirement*

38. Some interviewees expressed a concern that allowing the introduction of fresh evidence would extend the length of the merits review considerably and make the process much more costly. In this regard, many interviewees highlighted the importance of allowing the inquisitorial approach (including hot-tubbing) as a quid pro quo for keeping the closed record requirement.

39. That being said, several interviewees nonetheless thought that a strict application of the closed record requirement means new evidence cannot be admitted when that evidence could potentially lead to improved regulatory outcomes. They considered that the financial burden associated with Court processes significantly disincentivised parties from holding back information. But even if a party's intention was to deliberately withhold information from the Commission at the time of the Commission's decision-making processes only to then introduce it at the time of the merits review (the sort of gaming of the merits review regime that policymakers had been concerned to prevent), these interviewees felt that the Court was well-placed to assess whether the information was unreasonably withheld from the Commission.

### High Court vs specialist tribunal

40. An issue raised with interviewees was whether the High Court – using technical experts as lay judges – had the institutional capability and expertise to hear the merits appeals, or alternatively whether a specialist tribunal would be a more appropriate body. (Related to this issue, if the Court is considered to be the appropriate body, is the question of whether the High Court Rules are capable of effectively and efficiently dealing with the merits appeals.)

*Views on which body is most appropriate for hearing merits appeals were mixed*

41. The responses to the issue of which body is most appropriate for hearing merits appeals were mixed. Many interviewees thought the High Court had the credibility and expertise to hear merits appeals. However, some of them only gave partial support, qualifying their view by saying that the success of the merits appeals could be attributed largely to the particular judge and two lay members who constituted the Court, all of whom were experienced in adjudicating over economic regulatory matters. They were concerned that there is no guarantee that the Court would be similarly qualified in future merits appeals, and therefore whether the Court would be able to deal with merits appeals as

competently. An opposing view given was that there are a number of judges in New Zealand with good commercial and competition law credentials who would be able to competently deal with any future merits appeals.

42. Other interviewees, on the other hand, while recognising and complementary of the good performance exhibited by the judge and lay members in the merits appeals, questioned whether the High Court is the best body to consider merits reviews. In particular, they wondered whether highly esoteric regulatory areas, such as the WACC IM, would be better handled by a specialist tribunal that could have employed an inquisitorial approach to the review process to examine expert witnesses. In saying that, they noted that the inquisitorial approach is not natural to the Court. There was, however, an acknowledgement by many of these interviewees that New Zealand's small size and infrequency of merits reviews may not justify setting up a specialist tribunal, particularly because of the tiny pool of potential independent experts that could sit on a tribunal.

43. A smaller number of interviewees were unequivocal in their opinion that the High Court was out of its depth in dealing with merits appeals, and questioned whether the Court was able to arrive at a better outcome relative to the Commission (as the decision maker in the first instance). They were adamant that a specialist tribunal, similar to the Australian model, with the advantages of the inquisitorial approach, would be more effective than the High Court. They suggested that while a specialist tribunal might not necessarily render a more predictable outcome, it would produce a better quality decision in the sense that there would be more confidence by stakeholders in the process.

44. Further, some interviewees wondered whether using lay members from Australia who did not have a deep understanding of the history of monopoly regulation in New Zealand, the way the Commission operates and the relationship between the Commission and regulated suppliers, made the Court less effective in dealing with merits appeals and gave the judge a false sense of confidence in the proceedings. Taking this argument a step further, one interviewee suggested that a judge sitting alone would be capable of adjudicating merits appeals, just as judges sitting alone in other complex areas of law, such as taxation, are fully capable. However, they thought that for this to happen, a judge sitting alone could not be constrained by the closed record requirement.

45. Some interviewees noted that the High Court Rules were never tested because the merits appeals were conducted within the traditional litigation paradigm based on an adversarial contest. Nonetheless, they recommended that it would be worthwhile for Ministry officials to approach the High Court Rules Committee to see if any improvements to the Rules may be appropriate with respect to merits appeals. Alternatively, they suggested, legislative change may be necessary to ensure the Court was better equipped in its rules and processes in dealing with merits appeals.

46. Two interviewees wondered if the merits review regime was too complex and time-consuming and should perhaps be substituted by an arbitration body made up of independent experts for the purpose of considering limited issues or whole decisions of the Commission, brought to it by individual regulated suppliers. They thought that the current options are undesirable: the regulated supplier has to engage in an overly onerous and unpredictable merits review process or else abstain and accept the risk that a merits review decision could have a materially detrimental effect on its business.

## The materially better threshold

47. If the Court allows a merits appeal against an IM determination made by the Commission, it may amend the IM, revoke the IM and substitute a new one, or refer the IM determination back to the Commission with directions as to the particular matters that require amendment. However, Part 4 requires that the Court may only exercise these powers if it is satisfied that the amended or substituted IM is, or will be, "materially better" in meeting the purpose of Part 4, the purpose of IMs, or both.

*The majority of interviewees did not support the materially better test*

48. The dominant comments about the materially better test were that the threshold was not well understood since it is not defined (either in Part 4 or through the Court's guidance), and that it presented too high a hurdle for successfully appealing the Commission's IMs.

49. Many interviewees were convinced that the challenge of satisfying the threshold would make future appeals unlikely, which, in turn, would render merits reviews redundant as a means to holding the Commission to account.

50. One interviewee suggested that there is no need for the materially better threshold, unless there is evidence of the merits review regime being gamed without the threshold. Instead, the Court should be allowed to use its own discretion as to whether or not an IM should be amended or substituted. An opposing view given was that in the absence of the materially better threshold, regulated suppliers would be opportunistic and cherry-pick the issues to appeal based on what would be most profitable to them. It was pointed out that this had been the situation experienced in Australia, which forced a law change there to introduce the "materially preferable" threshold for merits reviews.

51. Some interviewees observed that the Commission was not bound by the materially better test in its decision-making processes and therefore could determine amendments to IMs on the basis of some lower than materially better threshold if it so chose to. An example cited was the Commission's decision to amend the applicable percentile in the WACC IM, discussed earlier, where in doing so it did not have to show that the amended IM was materially better relative to the status quo. A counter argument presented, however, was that while Part 4 does not require the Commission to have regard to the materially better test, in practice the Commission observes the standard. This is because the Commission realises that if a materially better IM than the one it determines is available, the outcome will likely be a merits appeal with a good probability of success for the appellant(s). For this reason, it was suggested that the materially better test is the appropriate standard to apply in merits appeals.

52. One interviewee spoke of the risk of merits appeals in the future that focused on very narrow issues, thus excluding the consideration of IMs in a broader sense. This interviewee thought it important that merits reviews be conducted in the context of the entire set of IMs because of the interrelationships between the IMs, and suggested this matter could be usefully reviewed by policymakers.

## Consumer engagement

53. A key objective of the merits review regime evaluation is to assess whether the merits review is accessible to all interested stakeholders, including consumers.

54. Given the overriding purpose of Part 4 is to promote the long-term benefit of consumers, the proposition that consumers' interests should be adequately represented in regulatory-setting processes seems reasonable. Also, consumer engagement transcends the normative question of the extent to which such processes should be democratic and whether impediments to effective participation by consumers amount to a breach of consumers' democratic rights. But how to improve consumer engagement in regulatory affairs is notoriously complex and currently a fertile area of debate and research internationally.

*Two opposing views on whether the Commission acts as a proxy for consumers emerged*

55. The interviews drew out two clear, opposing, views on whether the Commission acts as a proxy for consumers, not only in the merits review but more generally in the Part 4 decision-making processes. On the one hand, it was claimed that the Part 4 purpose statement, which fundamentally is aimed at promoting the long-term benefit of consumers, implicitly compels the Commission to be the consumers' advocate in both its decision-making processes and merits reviews.

56. A variation of this view was that the Commission, as a consequence, is biased in its Part 4 work in favour of the short-term benefit of consumers, which is contrary to its Part 4 remit. It was claimed that the reason for this is that the Commission's organisational culture is conflicted vis-à-vis its roles as an economic regulator under Part 4 on the one hand and a competition/consumer watchdog on the other. Interviewees considered that the dominant culture relates to the competition/consumer watchdog role, which is premised on yielding immediate consumer protection and outcomes.

57. The contrary view presented was that the Commission's Part 4 regulatory role, while required to be directed at the (long-term) interests of consumers, is, and must be, a dispassionate one; the Commission is an advocate for no particular party or side, but is a neutral decision maker. Moreover, if the Commission were required, or chose, to act as a proxy for consumers, it would necessitate it taking a very different approach in its decision-making processes compared to the processes it currently employs.

58. Interviewees supporting the view that the Commission's stance is not one of advocating for consumers considered that consumers' interests have been grossly neglected (both in the Commission's Part 4 decision-making processes generally and in the merits review particularly) because of the absence of any significant representative consumer engagement. In their opinion, consumers would, if they were engaged, be capable of providing a very good counterfactual argument to the regulator. They observed, however, that the involvement of consumers in Part 4 processes (including the merits review) has to date been largely dominated by the Major Electricity Users' Group (MEUG) and Air New Zealand (supported by BARNZ). Interviewees felt that both MEUG and Air New Zealand represent sectoral interests which cannot be said to necessarily be representative of consumers' interests in all instances.

*Some interviewees saw the lack of consumer engagement as a policy problem that needs fixing*

59. Those interviewees observing a lack of consumer engagement firmly believed this is a genuine policy problem that needs to be addressed and resolved. They considered that the problem is principally driven and perpetuated by two factors:

a. the technical complexity of regulation and the issues deliberated under Part 4 (where advice from experts in economics and finance especially is essential); and

b. the substantial monetary costs associated with effectively engaging in Part 4 regulatory affairs, including the costs of engaging experts and specialist legal counsel.

60. It was suggested that by far the more significant of these factors is the cost constraint. This is because without adequate funding provided, the necessary expertise cannot be sourced to deal with the technical complexity.

61. Some interviewees proffered options for dealing with the problem of lack of consumer engagement, such as introducing a 'consumer challenge panel' and government-provided or industry-levy-based funding to encourage and enable effective consumer engagement to be implemented.

62. While arguing the importance of and need for consumer engagement, some interviewees warned of the need to be aware that the contribution of consumers to a merits review may in reality not be very effective or be limited. One reason given is that consumer groups may be focused on only a relatively small element of the regulator's decision making. For instance, a consumer group may be focussed on the current price charged by a regulated supplier, whereas the regulator's remit is much wider (the *long-term* welfare of consumers), which necessitates the regulator taking a much more holistic set of factors into consideration. It was suggested that in this situation, it is important that the court stipulates in advance what issues can be raised by consumers. Another potential problem identified was that consumer groups may be susceptible to being captured by industry, with the consequence being that the desired advocacy of consumers' interests falls to the wayside.

## Cost of merits review

*Many interviewees considered the cost of merits appeals to be too high*

63. A common refrain by many interviewees was that the costs of participating in the merits appeals were very high, and in the case of all but the largest stakeholders, with the deepest pockets and most to gain or lose, prohibitive. Interviewees pointed out that deciding whether or not to be involved in merits review necessitates considering paying for expensive economic and finance experts and legal representation, and this would deter them from undertaking merits reviews in the future.

64. Moreover, merits review costs are in addition to those incurred in participating in the Commission's Part 4 decision-making processes, and it was claimed that smaller stakeholders anticipated more benefit from prioritising their engagement in those processes than in merits reviews, where the outcome of appeals may be extremely uncertain.

65. One interviewee suggested, however, that any decision to challenge the Commission's IM determinations is a carefully calculated one; that is, regulated suppliers had a significant incentive to appeal because relatively small amendments to an IM, such as to the asset valuation IM, could have a significant effect on their profitability.

# Appendix: Merits review evaluation stakeholder questionnaire

## Evaluation of Input Methodology Merits Review

## Stakeholder Questionnaire

As part of its regulatory stewardship of the Commerce Act, MBIE is undertaking an evaluation of the input methodologies merits review procedure provided under Part 4 of the Act. Your responses to the questions raised in this stakeholder questionnaire are intended to inform and assist that process. It is intended that this questionnaire be provided to stakeholders ahead of meeting with MBIE to prompt discussion on whether the merits review is achieving policy objectives.

### Objectives of the input methodology merits review regime

Part 4 of the Commerce Act was comprehensively reformed in 2008 to improve clarity, certainty, timeliness and predictability for regulated suppliers as a means of promoting the long term benefit of consumers. Three key elements of the reforms were:

1. A dedicated Part 4 purpose statement (s52A) to promote the long term interests of consumers in markets where there is little or no competition and no likelihood of a substantial increase in competition, by promoting outcomes consistent with competition such that suppliers:
    a. have incentives to invest and innovate;
    b. have incentives to improve efficiency and provide services at a quality required by consumers;
    c. share the benefits of efficiency gains with consumers; and
    d. are limited in their ability to extract excessive profits.

2. A requirement for the Commerce Commission to specify key regulatory parameters methodologies and processes in advance of their application in economic regulation of goods and services (collectively termed *input methodologies* or *IMs*). The Act provides that the purpose of these IMs is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation of goods or services (s52R).

3. Subjecting the IMs determined by the Commerce Commission to merits appeal to the High Court. If the Court (assisted by expert lay members) is satisfied that an amended or substituted input methodology is materially better in promoting the purpose of Part 4 and/or the purpose of IMs, it can amend the IM, revoke the IM and substitute a new one, or refer the IM determination back to the Commerce Commission with directions as to the particular matters that require amendment.

The explanatory note to the 2008 Amendment Act noted that the merits appeal process was desirable to: (i) provide accountability for the Commerce Commission; (ii) help ensure that input methodologies deliver on the Part 4 purpose statement; and (iii) promote business confidence.

## Approach

This questionnaire is structured around the objectives of the merits review regime as set out above.

*Part A – Improved regulatory certainty, transparency, and predictability*

Q1. Do you believe the merits review regime has contributed to improved regulatory certainty, transparency and predictability to regulated suppliers and their customers? If not, why?

Q2. Over time, do you think that the scope of issues being challenged through merits review will reduce?

*Part B – Higher quality decisions*

Q3. Do you believe the High Court has the requisite expertise and credibility to efficiently and effectively conduct the merits review?

- Q.3A Was the review body able to detect errors and omissions, and able to exercise sound judgement on matters related to economic regulation?
- Q.3B Are there any areas that in your view warrant improvement? If so, why?

Q4. Did the review body have the best evidence in front of it, and appropriate powers of inquiry?

- Q4A. Was the review body able to consider the issues most relevant to achieving the purpose of Part 4?
- Q4B. Would a more inquisitorial approach or 'hot tubbing' have resulted in a more efficient and/or effective merits review process? If so, why?
- Q4C. Does s52Z provide the High Court with the range of orders necessary to promote higher quality decisions?
- Q4D. Are there any other areas you believe warrant improvement?

*Part C – Accessibility of decision review*

Q5. Is merits review available to the full range of interested stakeholders?

- Q5A. Did the 'significant interest' test in s52Z disadvantage anyone or prevent any appeals that may have contributed to the policy objectives?
- Q5B. Were the range of appeals reasonably balanced in terms of the issues raised by regulated suppliers and consumer groups?
- Q5C. Do the costs of participating in the merits appeals process unreasonably limit the accessibility of the process?

*Part D – Efficiency of procedure*

Q6. Did the 'materially better' test in s52Z appropriately limit opportunistic, cherry-picked or undesirable appeals?

- Q6A. Did the materially better test impose an unduly high threshold for appeals?

Q7. Did the court's decision to consider all matters under appeal together aid or hinder the achievement of the policy objectives outlined above?

- Q7A. Would certain types of issues (e.g. WACC) benefit from a different kind of appeals or decision making process?

Q8. Did the presence of parallel judicial and merits review appeal rights assist or hinder the achievement of policy objectives?

Q9. What, if anything, should policymakers take from the fact that there have been no appeals on s52P determinations under s91?

Q10. What incentives did the 'closed record' of written evidence put on the parties, and did these contribute positively or negatively to the achievement of outcomes?

Q10A. Should the Court have greater discretion to admit new information?

Q10B. Are there any other areas for improvement?

Q11. Do you believe the High Court Rules were able to efficiently deal with merits appeals?

Q12. Acknowledging that merits reviews have an inherent trade-off between the quality and timeliness of decision making, is there anything about the general timeliness of the merits review process that has materially affected the achievement of the policy outcomes outlined above?

*Part E – Role of the regulator*

Q13. Do you consider that the presence of merits review provides the Commerce Commission with stronger incentives to make well considered and high quality decisions?

Q14. How does the role of the regulator potentially impact on the relevance of the accessibility of decision review?

Q15. Are there any aspects of the Commerce Commission's role and approach to merits review that may have had an impact on the achievement of policy objectives outlined above?

*Part F – Other*

Q16. Are there any other issues with the merits review regime that you wish to raise?