

9 May 2008

Mr Gerry Brownlee MP
Chair
Commerce Select Committee
Parliament Buildings
Wellington

Dear Mr Brownlee

COMMERCE AMENDMENT BILL 2008

We welcome this opportunity to make a submission on the proposed new regulatory provisions contained in the Commerce Act 1986 (**Act**). The Commerce Amendment Bill 2008 (**Bill**), which sets out the proposed new Part 4 of the Act, involves draft legislation of a detailed and complex nature. For this reason, it has been necessary to address relevant issues in some detail in our attached submission on the Bill.

We make five key points in our submission, as follows.

1 The current thresholds under Part 4A (expiring on 31 March 2009) should continue to apply until 31 March 2010, and they should not be converted into enforceable control paths

The current thresholds applying to electricity lines businesses (**ELBs**) under Part 4A of the Act were only ever developed as screening mechanisms. Breach of them was only ever intended to trigger a “please explain” consequence.

It would be wrong to convert these thresholds into enforceable control paths, from 1 April 2008 to 31 March 2010, which could attract serious penalties for breach (up to \$5 million for bodies corporate and \$500,000 for individuals) as well as other forms of relief.

There have been numerous accidental and non-intentional breaches of the threshold since 2003 (some 98 in total). It is inappropriate to introduce a

prosecution path to apply to future breaches of this threshold, which will be inevitable.

2 Input methodologies should be introduced in two phases

Phase 1 (1 December 2009) – input methodologies relating to the set and reset of default price-quality paths

Under section 52O, the Commerce Commission (**Commission**) must in the set or reset of default price-quality paths refer to such input methodologies it considers may apply. There is, therefore, the prospect that the Commission may take few, if any, of the input methodologies into account in the set or reset of default price-quality paths because as presently drafted section 52S does not prescribe any input methodologies for this purpose.

This approach is problematic because the determination of default price-quality paths involves matters that clearly constitute key input methodologies that should fall within the scope of section 52S. Accordingly, we submit that section 52S should be explicitly extended to include the following input methodologies as being relevant to section 52O determinations:

Section 52S(d) -- Matters relating to the determination of default price-quality paths including –

- (i) The quality standards that are to apply to the supply of the goods or services;*
- (ii) The methodology by which the Commission seeks to measure the long-run average productivity improvement achieved by either or both of suppliers in New Zealand, and suppliers in comparable countries; and*
- (iii) The methodology by which the Commission derives the starting prices for the goods or services, to the extent they differ from the prices that applied at the end of the preceding regulatory period.*

These default price-quality path input methodologies need to be set by 1 December 2009 in order to enable the introduction of the second initial default price-quality path for ELBs on 1 April 2010, as proposed under section 54J(1)(b).

Phase 2 (February 2011) – the remainder of the input methodologies

We submit that all of the other input methodologies under section 52S should be set by February 2011. This would provide the Commission with sufficient time to approve a customised proposal for commencement on 1 April 2012.

There is a trade-off involved in this deadline for the set of the remaining input methodologies. On the one hand, the Commission will require sufficient time to properly set these input methodologies. On the other hand, any delays beyond 1 April 2010 (the start date for the default price-quality path regime) will deny ELBs the opportunity to lodge customised proposals.

We think that a February 2011 deadline provides an appropriate balance. Under this time-line ELBs will be denied the opportunity to submit customised proposals for 11 months (from 1 April 2010 to February 2011). However, the prejudice arising under this situation could be addressed by ensuring, under section 53V(2)(c), that an adjustment to prices to account for both the loss of revenue and the time value of money arising from the delay will be available where a higher price is ultimately set under a customised proposal than that which was applied under a default price-quality path.

3 The purpose statement remains problematic

The purpose statement proposed under section 52A will be likely to apply in the same manner as the current purpose statement provision – section 57E. These purpose statements contain a ‘shopping list’ of goals which are potentially in conflict (i.e. economic efficiency versus distributional objectives). This means that regulatory decisions are likely to continue to be inappropriately based on distributional goals rather than efficiency goals.

In accordance with evident international regulatory trends, it would be preferable to enact a single overarching efficiency goal, such as section 7 of the Australian National Electricity Act which provides that:

The purpose of this law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability, and security of supply of electricity and the reliability, safety and security of supply of the national electricity system.

4 Appeal rights should attach to ‘final’ decisions, rather than to input methodologies

It is obvious that appeal rights should attach to regulatory decisions made under Part 4, given that these decisions affect important rights and interests. Appeal rights exist under all other Parts of the Act, and such rights will serve to scrutinise and correct decisions, where necessary, and impose a discipline on primary decision-making.

The proposal in the Bill to limit appeal rights to input methodology decisions is flawed, because:

1. There are likely to be problems in deciding input methodologies in isolation, and in advance of full consideration of the relevant market information that may be required to determine input methodologies. In the absence of such information it may not be possible to reliably predict the outcomes of such methodologies.
2. The Bill confers rights of appeal in respect of input methodologies only once every seven years. Against this background, it can be anticipated that in July 2010 (and July 2017), appeals will be lodged in respect of each and every input methodology. This would have resource implications for the courts and for the Commission.

Appeal rights should instead attach to ‘final’ decisions (being default price-quality path decisions, customised proposal decisions and information disclosure requirements), because:

1. The courts would have benefit of the full facts of the matter, and this would enable them to properly exercise their appellate function.
2. Such appeal rights would only arise each time that there is a final decision. This would address the potential flood of litigation which can otherwise be predicted for 2010, as just mentioned.

5 The Commission should be required to consider more than four customised proposals in any given year, in certain circumstances

The Bill proposes to limit to four the number of customised proposals that the Commission may be required to consider in any one year. The reason for this is Commission resource constraints.

However, it is necessary to balance against this concern the need for ELBs to be able to make investment decisions. ELBs that are forced to wait to

have their customised proposal considered will be likely to defer investment decisions.

We submit that there is a compromise position which goes some way to address both of the concerns just noted. The Commission should be required to consider more than four customised proposals in a year if a business that would otherwise be forced to wait is able to make a prima facie case that it has urgent investment requirements and remaining on the default price-quality path would seriously prejudice its operations.

The background to, and reasons for, these five key points are set out in the attached submission.

We look forward to the opportunity to appear before you, and the other members of the Select Committee, to address our submission and to answer any questions you may have.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Roger Sutton', written in a cursive style.

Roger Sutton
Chief Executive Officer



Submission to the Commerce Select Committee

relating to the

COMMERCE AMENDMENT BILL 2008

made by

Orion New Zealand Limited

9 May 2008

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A BACKGROUND

- 1 This submission is made by Orion New Zealand Limited (**Orion**).
- 2 We wish to appear before the Select Committee to speak to our submission.
- 3 We can be contacted through Dennis Jones (Industry Developments Manager) on DDI 03 363 9526, or by facsimile 03 363 9899 or email dennis.jones@oriongroup.co.nz.
- 4 We submit that the Commerce Amendment Bill 2008 (**Bill**) should be recommended to Parliament, subject to certain amendments which are described in this submission.
- 5 For ease of reference, section references in this submission refer to the proposed amendment sections contained in the Bill. For example, we refer to the purpose statement proposed in new section 52A, rather than to clause 4 of the Bill.

About Orion

- 6 Orion is an electricity operator for the purpose of the Electricity Act 1992. We own the electricity distribution network in central Canterbury between the Waimakariri and Rakaia rivers, and from the Canterbury coast to Arthur's Pass. Our network covers 8,000 square kilometres of diverse geography, including Christchurch city, Banks Peninsula, farming communities and high country.
- 7 We deliver electricity to more than 186,000 homes and businesses via more than 14,000 kilometres of overhead lines and underground cables. Our network is slightly larger than Transpower's nationwide network of transmission lines. Our shareholders are the Christchurch City and Selwyn District councils.

B OUTLINE AND EXECUTIVE SUMMARY

IN GENERAL ORION SUPPORTS THE BILL

- 8 At a high level, Orion supports the amendments proposed in the Bill to the extent that they are likely to achieve the following goals:
 - 8.1 *Certainty*: The introduction of time limits for the determination of enforceable regulatory price-quality paths and customised proposals may give greater certainty to the operational decisions facing non-exempt electricity lines businesses (**ELBs**); and
 - 8.2 *Accountability*: The introduction of appeal rights is desirable and will, if they are properly fashioned, impose an appropriate discipline upon primary decision-making.
- 9 Having said this, we have some real concerns about certain aspects of what is proposed in the Bill. In particular, we are concerned that:
 - 9.1 future regulatory price-quality paths (which will be enforceable) may, in reality, simply involve a continuation of something akin to the current thresholds (without taking properly into account input methodologies);
 - 9.2 appeal rights may be confined to input methodologies and only exercisable once every seven years (i.e. in 2010 and 2017);
 - 9.3 the Commerce Commission (**Commission**) will only be required to consider four customised proposals each year; and
 - 9.4 the proposed new purpose statement, section 52A, will not solve any of the problems which have been acknowledged to exist in relation to the current section 57E purpose statement.
- 10 Against this background, our submission is confined to specific matters which we think require further consideration in respect of ELBs. We outline these matters below.

TRANSITIONAL ISSUES

The current thresholds under Part 4A of the Commerce Act (1986) (Act) should not apply as enforceable price-quality control paths for the period 2008-2010

- 11 The thresholds under Part 4A are not sufficiently robust to apply as enforceable price-quality paths. They were only ever developed as screening devices, and breach of them was only ever intended to trigger a “please explain” consequence.
- 12 The Commission has itself said that thresholds are not instruments of control and the Supreme Court has accepted that breaches of the thresholds do not give rise to any presumptions that there are serious concerns which need to be acted upon.
- 13 The thresholds have been developed in a manner which means that breach of them has been, and will continue to be, inevitable. We understand that 27 of the 28 ELBs have breached the thresholds, and that there have already been 127 breaches. We further understand that the majority of these breaches, some 98 in total, have been accidental or non-intentional breaches.
- 14 Against this background, it would be unsound and unreasonable to apply these thresholds as enforceable control paths, retrospectively from 1 April 2008 as is proposed under the Bill.
- 15 The thresholds are simply not fit for the purpose of bringing prosecutions. This concern is all the more exacerbated by the potential for such prosecutions to attract substantial penalties (\$5 million for bodies corporate and \$500,000 for individuals) and other forms of relief.

The current threshold regime under Part 4A (expiring 31 March 2009) should continue to apply until the commencement of the second of the proposed initial default price-quality paths (under section 54J(1)(b))

- 16 It is proposed under section 54J(1)(a) that the current thresholds, scheduled to expire on 31 March 2009, should continue to apply until the commencement of the second of the proposed initial default price-quality paths. This position is appropriate, assuming that these thresholds continue to apply up to this point only as screening devices in accordance with the current scheme of Part 4A. The proposed transitional provisions contained in section 54M(1) could be modified to enable the Commission to give notice of intention to declare control for breaches of the threshold occurring between the date the Bill is passed and the time the second initial default price-quality path commences.

- 17 It is acknowledged that there may be a perceived risk of gaming in this context. There may be a perception that the Commission would be unlikely to closely scrutinise breaches of the thresholds over this time because it will be preoccupied with other tasks (i.e. setting input methodologies and the second of the initial default price-quality paths). Nonetheless, the position remains that the Commission would be entitled to invoke the transitional provisions contained in section 54M, as just described. This will provide adequate safeguards in the circumstances of this limited transition period.

The basis for establishing the second initial default price-quality path is problematic – section 52S should prescribe input methodologies to be taken into account during this process

- 18 Notwithstanding that input methodologies are portrayed to be central to the new regime, it is unclear to what extent they will apply to the establishment of the second initial, and subsequent, default price-quality paths. Section 53P(1) stipulates that the determination of the second initial default price-quality path amounts to the reset of a section 52O determination. In undertaking such a reset, the Commission need only refer to those input methodologies that it considers to be relevant. Section 53P(3) further provides that reset default prices must be either the prices that applied for the preceding period or new prices having regard to further information that is before the Commission.
- 19 It is possible that the Commission may take the position that few, if any, input methodologies are relevant in this context. The Commission could therefore migrate from the first to the second initial default price-quality path without first preparing input methodologies specifically applicable to the default price-quality path, and ignoring the other methodologies explicitly contained in section 52S. This approach is problematic because the determination of the second initial default price-quality path involves consideration of matters that clearly constitute key input methodologies that should fall within the scope of section 52S, including:
- 19.1 the quality standards that are to apply to the supply of goods or services;
 - 19.2 the methodology by which the Commission seeks to measure the long-run average productivity improvement achieved by either or both of suppliers in New Zealand, and suppliers in comparable countries; and
 - 19.3 the means by which the Commission derives the starting prices for the goods or services, to the extent they differ from prices that applied at the end of the preceding regulatory period.
- 20 The same concerns described above about attaching liability to the current thresholds would continue to apply in relation to default price-quality paths

which are fashioned absent prior consideration of these critical matters. It follows that section 52S should be extended to require consideration to be given to the above matters as relevant to section 52O determinations.

The proposed time-frame for the development of input methodologies is potentially problematic

- 21 On the question of input methodologies, consultation to date in relation to the reform of Part 4 has only been undertaken at a high theoretical level. There has been no attempt to define the likely boundaries and content of input methodologies, or to explore the factual or market background which may be necessary to make decisions in respect of each of the input methodologies.
- 22 There is likely to be considerable devil in the detail.
- 23 Further, there is a substantial inclusionary checklist of seven input methodologies prescribed under section 52S. Two of these categories are themselves open-ended.
- 24 Much will depend on advice from the Commission about how it proposes to handle this matter. But progress to date on the development of one of the input methodologies (namely, the cost of capital) suggests that there is a real risk that all of the input methodologies currently proposed under section 52S will not be set by 30 June 2010 (or 30 December 2010).
- 25 Further, the scope of the task of determining input methodologies will increase, if our recommendation is accepted that section 52S should extend to include matters that should be taken into account when the price-quality paths are set and reset (as suggested in paragraph 19 above). Against this background, we suggest that there is a need to stagger the order in which input methodologies are prepared, having regard to the following goals:
- 25.1 a first goal is to ensure that those input methodologies that will be needed for the determination of the second initial default price-quality path on 1 April 2010 are available before that date; and
- 25.2 a second goal is to allow an appropriate time-frame for the Commission to determine the remaining section 52S input methodologies.

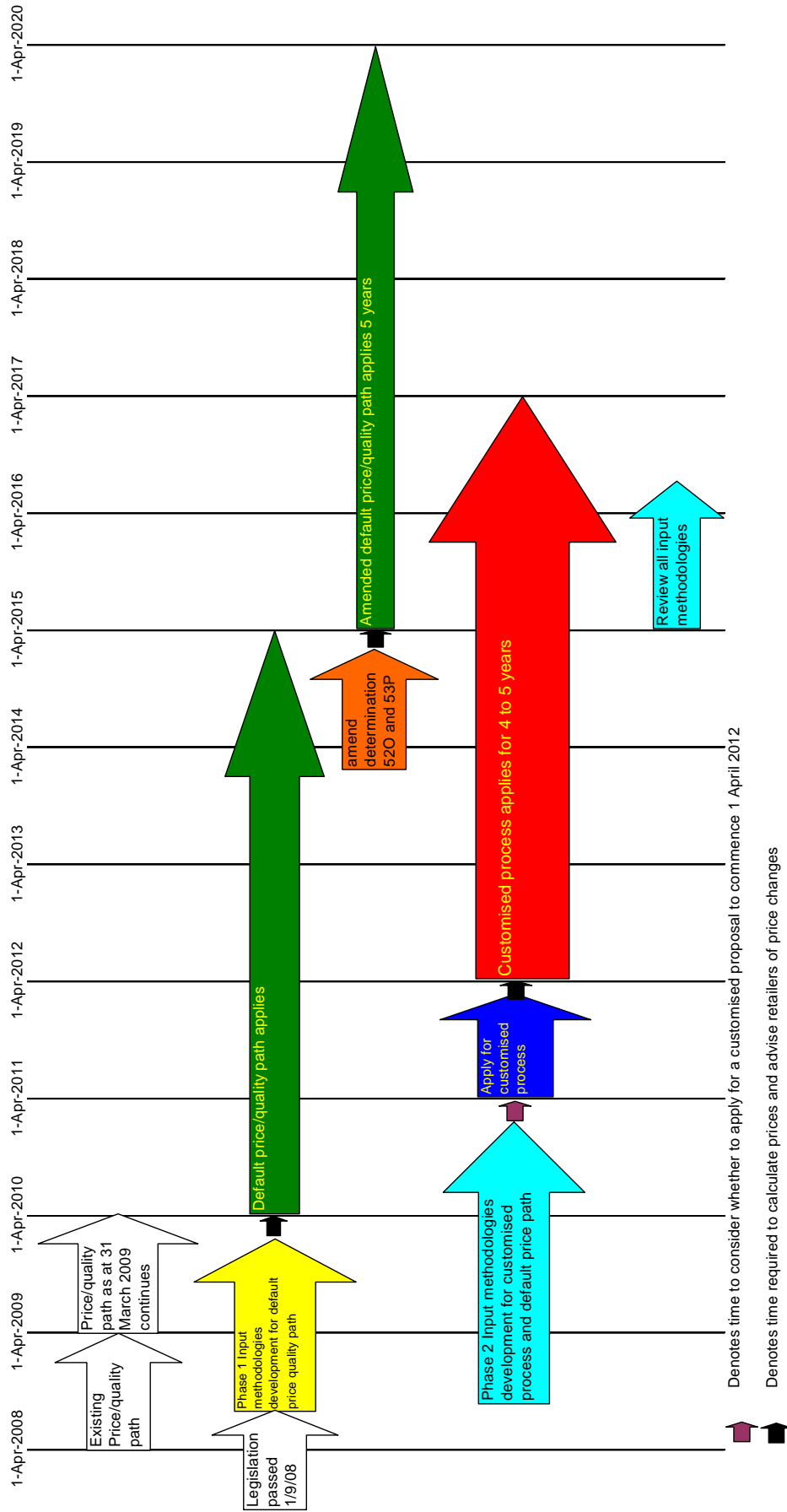
Suggested new timetable for the development of input methodologies

- 26 We suggest that input methodologies be set in two phases, as follows:
- 26.1 *Phase 1:* the input methodologies required for the introduction of the second initial price-quality default path should be set by 1 December

2009. This would enable the introduction of the second initial default price-quality path on 1 April 2010, as is currently proposed under the Bill. The ELBs will need to know this path by 1 December 2009 in order to give notice to retailers.

- 26.2 *Phase 2*: the deadline for the set of all of the remaining input methodologies (including those required for customised proposals) would be mid February 2011. This provides an additional eight months for the set of these input methodologies beyond the time-frame currently provided in the Bill.
- 27 We consider that these timelines will give the Commission adequate time to set all of the input methodologies under section 52S, including the additional matters of relevance to the introduction of the second initial default price-quality path, outlined above.
- 28 One issue with the timelines we propose is that it will not be possible for ELBs to apply for a customised proposal until 1 April 2011 with the proposal, if accepted, coming into effect on 1 April 2012. This would be two years after the date that the second initial price-quality path would come into effect. Under the Bill, it is proposed in section 52Q(1) that rights to submit customised proposals arise once default price-quality paths are set (i.e. 1 April 2010 in the case of the second price-quality default path). Therefore, the approach we propose involves some prejudice to the position of ELBs, although there would be the prospect that the effects of this would be ameliorated under section 53V(2)(c) whereby the Commission may make an adjustment to prices to account for both the loss of revenue and the time value of money arising from the delay.
- 29 In view of this delay relating to the ability to submit a customised proposal, we also consider that it is appropriate to truncate the time given for the consideration of customised proposals. We submit that the periods granted for the preliminary assessment of customised proposals under section 53S should be included in the overall decision time-frame for customised proposal applications under sections 53T and U. Therefore, in circumstances where there are no extensions, the first 40 working days for assessing whether the application complies with input methodologies should count as part of the 150 working days for determination of the application.
- 30 We set out in Figure 1 below the various timelines that would, under our proposal, apply to input methodologies, default price-quality paths and applications for customised proposals.

Figure 1 Orion's proposed timeline for transition



PURPOSE STATEMENT

31 The proposed purpose statement under section 52A is, in essence, based on the current purpose statement, section 57E. Some desirable additions are included in new section 52A. For example, express reference is made to:

31.1 the need for regulation to promote outcomes consistent with outcomes in a competitive market; and

31.2 the recognition that regulation needs to take into account incentives to innovate and invest.

32 But these matters are not new. Previous Commission deliberations under the current purpose statement, section 57E, reflect its belief that it is already taking these matters into account in its decision making.

33 There is therefore strong reason to believe that section 52A will continue to represent a shopping list of goals, some of which potentially conflict (i.e. economic efficiency versus distributional objectives).

34 We predict that section 52A will be applied by the Commission in the same manner as section 57E is currently applied. This means that regulatory decisions are likely to continue to be inappropriately based on distributional rather than efficiency goals.

35 There is an evident trend in regulatory design away from lists of multiple goals to a single overarching efficiency goal. A provision such as section 7 of the Australian National Electricity Law (see paragraph 81.2 below) is one such example. We urge that section 52A be based on a legislative precedent such as this.

APPEAL RIGHTS

36 The case for appeal rights is obvious and it is encouraging that this matter is now recognised in the Bill.

37 We say that such rights should be provided because:

37.1 regulatory decisions plainly affect important rights, interests and legitimate expectations of ELBs;

37.2 it would be illogical to deny appeal rights under Part 4 of the Act when they are available under all other Parts of the Act; and

- 37.3 appeal rights will also fulfil wider private and public purposes. They will serve to scrutinise and correct decisions, where necessary, and impose a discipline on primary decision-making.
- 38 The narrower form of merits review, such as that proposed in the earlier Cabinet Paper, would not achieve these goals. The proposal in the Cabinet Paper amounted to little more than a form of judicial review. Under this merits review model, decisions would be permitted to stand, even if the High Court (assisted by expert lay members) was of the view that the Commission got it wrong.
- 39 While we are encouraged by the Bill's incorporation of appeal rights, we do not think that appeals should be confined to input methodologies because:
- 39.1 uncertainty surrounds the concept of input methodologies. As earlier noted, the relevant concepts have only been addressed in high level theoretical terms in the consultation rounds leading up to this Bill;
- 39.2 decisions about input methodologies, in isolation, will often be in the nature of decisions about preliminary questions (e.g. what form of the capital asset pricing model (**CAPM**) should be used to calculate the cost of capital). Matters involved in appeals of such questions can be problematic because absent relevant market information it may not be possible to predict the outcome of such methodologies (e.g. the parameters that the Commission will feed into the CAPM and the resulting weighted average cost of capital (**WACC**) estimate);
- 39.3 we simply do not know enough around the potential design and implementation of input methodologies to know whether the confinement of appeal rights to these preliminary considerations will be sound. In particular, we do not know if input methodologies will engender a sufficient degree of specificity for there to be any confidence that the debate surrounding them will relate to anything more than hypothetical or abstract propositions or assumptions;
- 39.4 however, it can be predicted with confidence that such concerns would not attach to appeals of final decisions (i.e. determinations involving the set of default price-quality paths and customised proposals). In this setting, the court would have before it all of the relevant materials to make a properly informed decision.
- 40 A further matter of real concern about limiting appeals to input methodologies, as proposed, is that those rights may only be exercisable once every seven years (i.e. 2010 and 2017). Such an approach would be

unlikely to achieve appropriate accountability, and would be likely to result in extensive litigation in 2010 (and 2017), because:

- 40.1 appeal rights will first attach to the input methodologies set on 30 June 2010 (assuming that all methodologies are released on this date). Appeals must be lodged in 20 working days (i.e. by the end of July 2010);
 - 40.2 input methodologies will not need to be reviewed for a further seven years, during which time appeal rights will be unavailable. In particular, appeal rights will not attach within this seven year period to:
 - (a) the setting of the second initial threshold default price-quality path on 1 April 2010; or
 - (b) the reset of the default price-quality path on 1 April 2015;
 - 40.3 against this background there would be the incentive for appeals to be lodged in respect of each and every input methodology before the end of July 2010, resulting in extensive litigation; and
 - 40.4 the Commission would not have any incentive to amend the input methodologies before 30 June 2017, because this would trigger potential appeal rights. Meanwhile, up to this point, all default price-quality path and customised proposal decisions would not be subject to any form of appeal right.
- 41 It follows that the appeal rights contained in the Bill are ill-conceived and highly restrictive. All of the appeal problems identified above can be overcome by adopting what is the commonsense approach to appeals, and that is to expose only final decisions to appeals. This would:
- 41.1 enable the courts to properly exercise their appellate function; and
 - 41.2 address the potential flood of litigation which could otherwise be predicted for 2010.
- 42 Finally, we are uncertain as to the basis for the last minute inclusion of section 52Z(2) which proposes to deny the admission of any new material in appeals. There is no discussion of this point in the Explanatory Note and we do not understand the justification for it. It is standard practice in appeals under the Act for courts to exercise their discretion to admit new evidence where it relates to new industry or technological developments. To deny the admission of such evidence would potentially mean that the court would not be able to take into account all relevant evidence. This

means that the judgment would not be properly informed and this could bring the appeal process into disrepute. Further consultation is required on this point. Clearly, this proposed exclusion of evidence is not desirable.

CUSTOMISED PROPOSALS

- 43 The one matter which we think needs further consideration in the case of customised proposals is the potential restriction of such proposals to just four each year. The potential prejudice caused by this is obvious in the case of those ELBs who are forced to wait to have their proposal considered. Such ELBs may in the interim be deprived of revenue, and they may have no choice but to defer investment decisions.
- 44 The following points need to be considered in addressing this problem:
- 44.1 where a higher price is ultimately set under a customised proposal than that which has been applied under a default price-quality path, it follows that a full adjustment should be made to prices to account for the loss of revenue and the time value of money arising from the delay. At the moment section 53V(2)(c) provides that only “some or all” of the shortfall in revenue can be recovered. The reference to “some” here appears to have been made in error; and
- 44.2 another problem is to address the situation where a necessary investment decision is being deferred because of the delay in processing the customised proposal. It is not enough simply to include the need to undertake urgent investments as one of several factors that determine the order in which customised proposal applications are assessed under section 53Y(3)(b). There is a need to develop a greater degree of flexibility to cater for such situations, for example:
- (a) *Option 1:* One option may be to empower the Commission to grant an interim authorisation where an ELB has lodged a customised proposal and committed itself to that path, and made out a prima facie case for an increase in revenue to support new investment.
- (b) *Option 2:* Another option might be to require the Commission to consider more than four customised proposals in a year if a business that would otherwise be forced to wait is able to make a prima facie case that it has urgent investment requirements and remaining on the default price-quality path would seriously prejudice its operations.

Option 1 would be problematic because it is unlikely that ELBs will be prepared to invest on the basis of interim authorisations where the outcome of the customised proposal application is uncertain. The risk that the outcome of the customised proposal application may be less favourable than an interim authorisation would be likely to deter ELB's from making investment decisions under this option.

Option 2 would be preferable because it would go some way to address the Commission's resource constraints, which is the sole justification for this limitation in the number of customised proposals which may be considered in any year. At the same time this option would ensure that businesses with legitimate investment needs would not be unfairly prejudiced. Option 2 would strike an appropriate balance between these contrasting concerns.

Unless the Bill is amended to entail greater flexibility in relation to these situations, section 53Y(1), which requires the Commission to consider no more than four customised proposals per year, will need to be removed.

REMAINING SECTIONS OF THIS SUBMISSION

45 We set out below, in Sections C to F, our reasons for the above concerns.

C TRANSITIONAL ISSUES

46 Figure 2 below (not to scale) highlights the three central matters of concern in relation to the proposed transitional provisions for ELBs which we address in the following sections, namely:

46.1 the current price-quality threshold is to apply as an enforceable default price-quality path retrospectively from 1 April 2008 until 31 March 2010. This threshold would apply in two ways over this period. First, breach of the current threshold regime over the period 1 April 2008 to 31 March 2009 attracts potential liability under the new regime.¹ Then for the period 1 April 2009 to 31 March 2010, the current thresholds become the first of the two proposed initial default price-quality paths. Breach of this threshold/initial default price-quality path will also attract potential liability;²

46.2 the second of the initial default price-quality paths is to come into force on 1 April 2010.³ However, the input methodology work-streams currently proposed are not due for completion until 30 June 2010 (or potentially up to 30 December 2010). The linkage of this work stream to the set of the second initial default price-quality path is problematic because the Commission need only refer to those input methodologies that it considers to be relevant in this context.⁴ As we outline below, this position fails to appreciate that the derivation of the default price-quality path clearly involves a consideration of matters that constitute key input methodologies that should fall within the scope of section 52S. We submit that section 52S needs to be extended to specify input methodology matters which must be taken into account in the making of orders under section 52O to set or reset default price-quality paths; and

46.3 in addition to the point just made, the development of input methodologies is also central to customised proposals, and the first right to submit these arises on 1 April 2010 under the current version of the Bill. Under the Bill, it is presently proposed that input methodologies will not be known until 30 June 2010 (or possibly later). As to this last point, the remaining parts of this submission address (a) concerns as to the current structure of the Bill and (b)

¹ Section 54O(1).

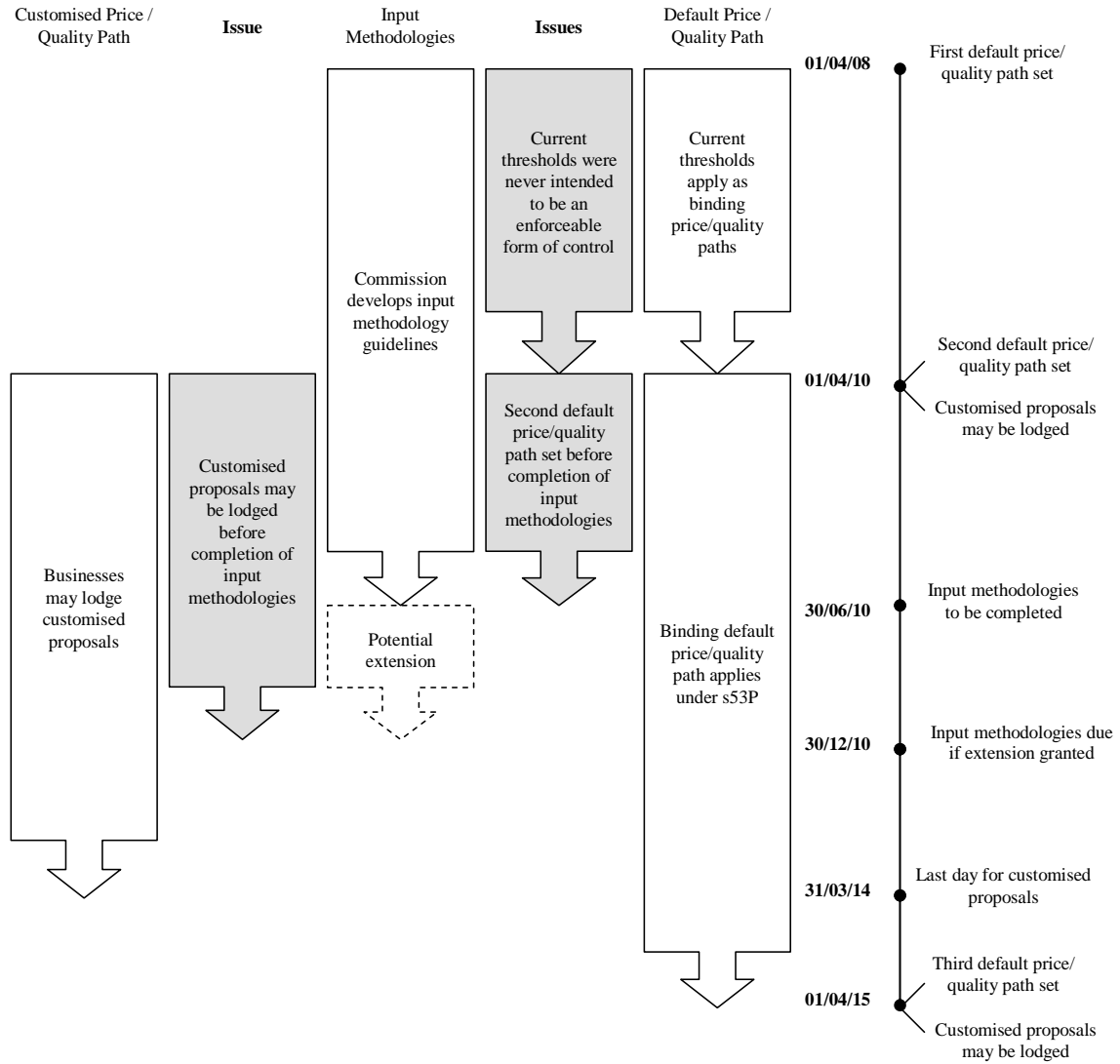
² Section 54J(1)(a).

³ Section 54J(1)(b).

⁴ Sections 53P(1) and 52O(2)(c).

the considerations on this point attaching to our suggestion that input methodologies be set in two phases.

Figure 2: Summary of timescales as set out in the Bill



TRANSITIONAL APPLICATION OF THE THRESHOLDS (2008-2010)

- 47 The current price-quality thresholds under Part 4A have only ever been intended to operate as screening devices. Breaches of the thresholds have simply triggered a “please explain” inquiry.⁵
- 48 The means by which these thresholds have been set has never been sufficiently robust to support applying them as an enforceable form of regulatory control. The Commission itself has observed that breaches of these thresholds have never been intended to attract liability. The Commission has put the matter this way:⁶

*The existing price path threshold is conceptually similar to the various forms of CPI-X price control that regulators commonly use in other jurisdictions. **However, the thresholds are not instruments of control and the price path threshold differs in many important respects from the price control mechanisms used elsewhere.** (Emphasis added)*

- 49 The courts have also observed that the thresholds have only ever been intended “to perform a screening or filtering function, which, over time, should capture those who are potential candidates for control”⁷ and that the thresholds are in reality just “a mandatory consideration of whether control should be imposed.”⁸ Further, the Supreme Court has concluded that breach of a threshold under Part 4A “does not convey any implication that [such] breach will give rise to a presumption that there are serious concerns over s 57E ends.”⁹
- 50 There have been numerous breaches of the price-quality thresholds for the period 2003-2007. We understand that over this period there has been a total of 127 breaches with 27 of 28 businesses breaching their thresholds at some time.
- 51 The manner in which the current thresholds have been specified and established means that ongoing breaches will be inevitable.¹⁰ For example:

⁵ See, e.g., Commerce Commission, Regulation of Electricity Lines Businesses, “Targeted Control Regime: Threshold Decisions”, 6 June 2003, para 16.

⁶ Commerce Commission, Regulation of Electricity Lines Businesses, “Targeted Control Regime: Threshold Decisions (Regulatory Period Beginning 2004)”, 23 December 2003, para 9.

⁷ *Unison v CC* (Court of Appeal, CA 284/05, 19 December 2006) para 46.

⁸ *Unison v CC* [2007] NZSC 74, para 65.

⁹ Above, para 66.

¹⁰ As already noted, we understand that 98 of the 127 breaches have been accidental.

- 51.1 prices must be set on a forecast of the CPI and estimates of pass through costs including Transpower's charges,¹¹ rates and Electricity Commission levies. Any divergences from the forecasts potentially result in unanticipated breaches; and
 - 51.2 in any year there is approximately a 50 per cent chance that the quality (SAIDI and SAIFI) thresholds will be breached due to the averaging process that is currently applied. In addition to this, extreme weather events have led to a considerable number of quality threshold breaches.
- 52 Orion currently sets its prices at a margin below the thresholds as a means of reducing the risk of an inadvertent breach of the price/quality thresholds. We do not consider that this would be appropriate for Orion to be forced to resort to this measure under actual control. Rather, ELBs would be entitled to know in advance all aspects of the price and quality control paths.
- 53 Against this background, it is a matter of concern that the Bill now proposes, in the case of non-exempt ELBs, to:
- 53.1 apply the current threshold as an enforceable control default price-quality path, initially for the period 1 April 2008 until 31 March 2009, with partial retrospective effect;¹²
 - 53.2 apply this same threshold as an enforceable default price-quality path for the period 1 April 2009 until 31 March 2010;¹³ and
 - 53.3 expose ELBs and their officers to the following penalties and remedies:
 - (a) for the period 1 April 2008 to 31 March 2009, penalties up to \$5 million for bodies corporate and \$500,000 for individuals, and compensation to aggrieved persons who suffer loss or damage as a result of the contravention;¹⁴ and
 - (b) for the period 1 April 2009 to 31 March 2010:

¹¹ We note that Transmission pricing should be less of an issue going forward.

¹² Section 54O(1).

¹³ Section 54J(1)(a).

¹⁴ Sections 54O, 87 and 87A.

- (i) the penalties and compensation mentioned in (a) above; and
- (ii) summary convictions leading to fines for offences which are knowingly committed by individuals (up to \$200,000) and bodies corporate (up to \$1 million); and
- (iii) injunctions to restrain breaches of the threshold.¹⁵

- 54 While it may be anticipated that the Commission would exercise enforcement discretion where there is a breach of thresholds during this transitional phase,¹⁶ an inappropriate risk of prosecution nonetheless attaches to the regime that is proposed. The current thresholds have not been designed to have, and should not have, prosecutorial status.
- 55 Transitional phases are typically difficult where there is a move from one regime to another regime which differs substantially. It is submitted that, in the current context, the existing threshold should only continue to have transitional application in its current form (i.e. just as a screening device) up to the point that the Commission sets the second of the proposed initial default price-quality paths (which is currently proposed for 1 April 2010).¹⁷
- 56 On this approach consequential changes would be required to proposed sections 54M and N.¹⁸ Given that it is inappropriate to prosecute threshold breaches under the proposed regime as outlined above, the current provisions under Part 4A should continue to apply to any threshold breaches up to the point of the introduction of the second of the initial default price-quality paths proposed under section 54J(1)(b).
- 57 One issue with this approach to transitional issues is the perception that ELBs may have an incentive to breach the current thresholds in the expectation that the Commission will not have sufficient time or resources to address such breaches. During this period the Commission would presumably, once the Bill is passed, give priority to the determination of

¹⁵ Sections 54J(1)(a), 52O, 87, 87A, 87B and 87C.

¹⁶ In this context, matters such as those relevant to the set of penalties under section 87(4) could be taken account. Section 87(4) states that, in assessing penalties for contravention of the regulatory part of the Act, the Court must take into account the following factors: (a) the nature and extent of the contravention; (b) the nature and extent of any loss or damage suffered by any person as a result of the contravention; (c) the circumstances in which the contravention took place, and (d) whether or not the person has previously been found to have engaged in similar conduct.

¹⁷ Section 54J(1)(b), following the section 53P process.

¹⁸ All that would be required would be adjustments to dates in these provisions. Section 54O(1) would also need to be repealed.

input methodologies and setting the second initial default price-quality path.

- 58 However, amendments to the transitional provisions, section 54M and N, as noted above would continue to address these transitional concerns in a manner consistent with what is already prescribed in the Bill. There would simply be an extended period for the assessment of whether or not the Commission may give notice of its intention to declare control, beyond the time periods currently anticipated in section 54M.

FURTHER TRANSITIONAL ISSUES

- 59 The content of and timing for the set of input methodologies and the second initial default price-quality path are also problematic. Further transitional concerns attach to:
- 59.1 the proposed content of and date for the finalisation of the input methodologies (30 June 2010, or 30 December 2010 upon the grant of an extension);¹⁹
 - 59.2 the proposed date for the specification of the second of the initial default price-quality paths (1 April 2010), including issues relating to lead times required for ELBs to calculate prices and notify retailers of new contract terms;²⁰
 - 59.3 the inter-relationship of these dates; and
 - 59.4 the impact of the date for the specification of input methodologies upon the right to submit customised proposals in response to the second of the initial default price-quality paths.

Preliminary observations on input methodologies in the scheme of the Bill

- 60 Before addressing these transitional issues, it is helpful to reflect upon the proposed role of input methodologies in the scheme of proposed new Part 4. It has been indicated that input methodologies would become a central

¹⁹ Section 52T(1) and (2).

²⁰ Section 54J(1)(b).

tool, applying to all regulatory decisions including the set of price paths.²¹
But on closer scrutiny, this does not appear to be the case under the Bill.

- 61 A crucial migratory point under Part 4 will be the specification of the second initial default price-quality path. This is to operate as an enforceable control path.
- 62 The provisions which apply to the detail to be contained in default price-quality paths are sections 53M, O and P. By virtue of section 54J(1)(b), the reset process under section 53P applies to the set of the second initial default price-quality path. Section 53P(1) provides that the second initial default price-quality path will amount to a reset of a section 52O determination. A particular problem which arises here is that the Commission may take the view that few, if any, of the input methodologies contained in section 52S will have a bearing on the default price-quality path to apply from 1 April 2010.
- 63 Specifically, in undertaking such a reset the Commission need only refer to those input methodologies that it considers to be “relevant” (section 52O(2)(c)). It is possible that the Commission might argue that few, if any, of the methodologies contained in section 52S have a bearing on the default price-quality path. This is problematic because the default price-quality path involves consideration of matters that ordinarily would be considered key input methodologies that *should* fall within the scope of section 52S. For example:
- 63.1 where the Commission proposes to make adjustments to the prices that applied at the end of the preceding period when setting ‘starting prices’ under the default price-quality path (i.e., undertaking ‘ P_0 adjustments’) (section 53P(3)(b)), on what basis will this be done?;²²
- 63.2 by what methodology will long-run average productivity gains achieved by suppliers in New Zealand and/or comparable countries be estimated when determining the X factor (section 53P(5))?; and

²¹ See, e.g., Office of the Ministers of Commerce and Energy, “Review of Parts 4 and 4A of the Commerce Act 1986”, April 2007, para 31 (stating that input methodologies “are a critical input for any inquiry and for the implementation of all forms of regulation, including information disclosure, negotiate/arbitrate and setting price paths”).

²² It cannot be assumed that the Commission will undertake a P_0 adjustment when it resets the default price-quality path. Past experience under the threshold regime would suggest that this is unlikely. Nonetheless, the legislation should be amended to preclude the possibility of unpredictable changes in starting prices. Indeed, even if the Commission does not anticipate making such an adjustment at present, there is little to prevent it from doing so in the future, potentially with retrospective effect.

- 63.3 on what basis will the Commission make adjustments to the permitted rate of change in prices to account for businesses' differing quality standards (section 53P(5))?
- 64 These factors will have a critical bearing on the prices that businesses are able to charge under the default price-quality path. However, notwithstanding their importance, the Bill provides no effective accountability mechanism for Commission decisions on these critical matters, in particular:
- 64.1 the Commission would have discretion to adjust starting prices limited only by the broad criteria contained within section 53P(2)(b)(i)-(iv), for example:
- (a) it might seek to account for relative profitability performance based upon information obtained under the disclosure regime;
 - (b) in so doing, it could effectively continue the approach it currently takes to deriving the much maligned 'C2 factors' (albeit by means of a one-off 'P₀' adjustment); and
- 64.2 it would be able to ignore relevant input methodologies, such as asset valuations, the WACC and depreciation.
- 65 It seems self-evident that the means by which the Commission may make such adjustments should be specified in input methodology guidelines. In this context, section 52S should be extended to include explicit reference to the following input methodologies as being relevant to section 52O determinations:

Matters relating to the determination of default price-quality paths, including –

(i) The quality standards that are to apply to the supply of the goods or services;

(ii) The methodology by which the Commission seeks to measure the long-run average productivity improvement achieved by either or both of suppliers in New Zealand, and suppliers in comparable countries; and

(iii) The methodology by which the Commission derives the starting prices for the goods or services, to the extent they differ from the prices that applied at the end of the preceding regulatory period.

These factors will have a critical bearing on the prices that businesses are able to charge under the default price-quality path. Accordingly, it is important that the Commission clearly articulate the methodologies that underpin these factors.

66 In other words, it is clear that the Commission cannot simply migrate the first initial default price-quality path into the second such path, without first developing the input methodologies that will underpin that revised path.

67 Moreover, practical constraints will also preclude the Commission from making any adjustment to *starting prices* when establishing the second default price-quality path. Although the Commission may have prepared its input methodology guideline in relation to this point the robust *application* of that guideline inevitably will require it to have at hand certain *other* input methodologies. It cannot, for example, undertake P_0 adjustments based on the relative profitability performance of a business without first having regard to critical input methodologies such as regulatory asset valuations, WACC and depreciation profiles.²³ The prospect of these methodologies being available prior to the establishment of the second default price-quality path is remote.

68 Consequently, the starting prices on 1 April 2010 at the outset of the second default price-quality path would, by necessity, be the prices applying at the end of the preceding period. This reset process necessarily would be guided primarily by the input methodologies relating to quality standards and long-term productivity benchmarks that govern the X-factor. The earliest date at which a robust P_0 adjustment could be undertaken is when the default price-quality path is reset in 2015, at which time all relevant input methodologies will have been developed.

Is the proposed time line for the set of input methodologies adequate?

69 The scope of the Commission's task in determining input methodologies is significant. Section 52S(1) sets out an extensive inclusionary list of input methodologies, that should be extended to include matters relating to the determination of default price-quality paths. At present, input methodologies will need to be set for:

69.1 cost of capital;

²³ It is not possible to capture actual levels of profitability with sufficient accuracy to undertake a P_0 adjustment without first considering these factors.

- 69.2 valuation of assets;
 - 69.3 allocation of common costs;
 - 69.4 treatment of taxation;
 - 69.5 pricing principles;
 - 69.6 regulatory processes and rules (such as those relating to the specification and definition of prices, including the identification of costs that can be passed through to prices); and
 - 69.7 matters relating to customised price-quality path proposals, including the criteria that the Commission will use to evaluate proposals.
- 70 The last two of these categories (regulatory processes and rules, and customised proposal criteria) are open-ended, and will not be known until the Commission has finalised all of the other input methodologies.
- 71 This list of input methodologies would be further extended if the provisions we suggest in paragraph 65 are adopted.
- 72 We do not underestimate the uncertainty and complexity of this task, and we have concerns that a complete set of input methodologies will not be achievable by either 30 June 2010 or 30 December 2010, as proposed under the Bill. Our reasons for this view are as follows:
- 72.1 In earlier submissions we have expressed the view that there are likely to be fundamental problems with specifying in advance an exhaustive set of input methodologies.²⁴ In particular:
 - (a) the definitional boundaries of what constitutes an input methodology under the legislation are likely to be unclear; and
 - (b) the formulation of input methodologies capable of being applied to all regulated entities is likely to be difficult in practice.

It follows that the advance set of input methodologies, in the abstract, will be potentially difficult.

²⁴ See Orion submission and NERA report, "Response to MED Discussion Document: Review of Regulatory Control Provisions Under the Commerce Act 1986", 6 July 2007, section 3.3, available on our website oriongroup.co.nz.

72.2 Take, for example, the first of the proposed input methodologies, the cost of capital. Presumably, it is not intended that one cost of capital number will apply to all regulated entities. Indeed, there is likely to be significant variation in the relevant cost of capital across different industries and over time due to prevailing market conditions.²⁵

72.3 This raises the critical issue of what the relevant input methodology on, say, the cost of capital, might look like. The Commission has much discretion in this regard. It might seek to:

- (a) provide only a high level statement but not attempt to define the particulars of the methodology used to calculate the cost of capital (e.g. specify the WACC formula) or the parameters that feed into the methodology (e.g. the equity beta, market risk premium, etc);²⁶ or
- (b) define the methodology used to calculate the cost of capital in each industry (e.g. specify a form of the CAPM model that should be used to calculate the WACC), but not attempt to define the parameters applicable for each industry (e.g. the equity beta that should be used for an airport as distinct from an ELB); or
- (c) define for each regulated industry the methodology used to calculate the cost of capital and the parameters of relevance.²⁷

72.4 The first two options outlined above would provide businesses with very little certainty. Put simply, a high-level policy statement or a methodology devoid of any indication of the parameters that will populate it will not provide any meaningful guidance to businesses. Only the third option listed above would achieve the improved certainty the Bill is intended to deliver. However, in developing such a methodology the Commission arguably would be going beyond mere preliminary questions. Rather, it would need to explore the particular facts and market circumstances applying in different regulated industries, and to individual regulated industries. In other

²⁵ It has also been argued that the appropriate cost of capital may even differ between businesses operating within the same industry.

²⁶ Clause 8.30 of the former Australian Gas Code is potentially illustrative. It states that "*the rate of return used in determining the reference tariff should provide a return which is commensurate with prevailing market conditions in the market for funds and the risk involved in delivering the reference service.*"

²⁷ For example, Rule 6A.6.2 of the National Electricity Rules outlines the WACC formula and the relevant parameters for electricity transmission businesses.

words, the analysis involved in the development of meaningful input methodologies is not easily distinguishable from the analysis involved in making final decisions on customised proposals.

73 The matters addressed in section 52S are complex and will take time to put in place. This is, in fact, reflected in the time the Commission has already taken to consider the appropriate WACC for ELBs. The matter was first canvassed in the Commission's "Regulation of Electricity Lines Businesses: Discussion Paper" of 21 March 2002 and there has been extensive consultation on this matter since that time. But, some six years on, the Commission is yet to provide any substantive indication of its views on the appropriate cost of capital in any regulated industry or on the appropriate methodology by which to derive such a figure.

74 This is, presumably, a matter that the Select Committee will wish to explore with the Commission. In this context we make two observations:

74.1 *Section 52S (current version under the Bill):* We anticipate that, if the proposed input methodology approach is enacted, the Commission is at least likely to require further time to produce a complete suite of input methodologies that are sufficiently detailed to achieve the improved certainty sought by the Bill. As outlined above, high level methodologies that are not industry specific would provide businesses with very little certainty and undermine the role of merits review in improving the accountability of the Commission (assuming merits review remains confined to input methodologies – a position we do not support for the reasons outlined below).

74.2 *Section 52S (if extended to include input methodologies for the set of the second initial default price-quality path):* If the section 52S list is expanded to include matters relevant for the set and reset of default price-quality paths, including –

(i) The quality standards that are to apply to the supply of the goods or services;

(ii) The methodology by which the Commission seeks to measure the long-run average productivity improvement achieved by either or both of suppliers in New Zealand, and suppliers in comparable countries; and

(iii) The methodology by which the Commission derives the starting prices for the goods or services, to the extent they differ from the prices that applied at the end of the preceding regulatory period

then we suggest that there be two discrete phases for the set of input methodologies at this stage. Under "Phase 1", the

Commission would be required to set those input methodologies of relevance to the implementation of the second initial default price-quality path²⁸ by 1 December 2009, so as to enable this path to commence on 1 April 2010, as is currently proposed under the Bill.

- 74.3 Under “Phase 2”, the Commission would be required to set all the other remaining input methodologies under section 52S by mid-February 2011. This should give sufficient time to ensure that these methodologies are of sufficient detail to provide an appropriate degree of certainty.

Co-ordination of the dates for the set of input methodologies and the second of the initial default price-quality paths – timing concerns attaching to customised proposals

- 75 The scheme of the Bill is such that all input methodologies relevant to customised proposals should be set in advance of the commencement of the second interim default price-quality path, for the reasons already noted above. A period of notice is required to provide regulated businesses with the opportunity needed to consider whether or not to submit customised proposals. This election requires careful consideration because, once an application is made for a customised proposal, there is no opportunity to withdraw.²⁹

- 76 Our comments on this topic are again made on the basis of two possible scenarios. The first is retention of the current framework of the Bill. The second assumes that input methodologies are prepared in two phases: the first encompassing those methodologies necessary for the establishment of the default price-quality path and the second containing the balance of the methodologies, including those for customised proposals:

- 76.1 *Current framework:* Under the Bill, there is an obvious flaw to the proposed timetable because the second initial default price-quality path is required to be set, and to commence, on 1 April 2010 which

²⁸ This is subject to the constraint outlined in paragraphs 67 and 68. Specifically, although the Commission may have prepared an input methodology guideline outlining its approach to establishing starting prices, the robust *application* of that guideline inevitably will require it to have at hand certain *other* input methodologies, including those pertaining to WACC, asset valuation and depreciation. These guidelines are unlikely to be available by 1 December 2009. The Commission would therefore be unable to make adjustments to starting prices when establishing the second default price-quality path because it would require other input methodologies that it will not have at that time. Starting prices would, by necessity, be the prices applying at the end of the preceding period. The reset process would be guided primarily by the input methodologies relating to quality standards and long-term productivity benchmarks governing the X-factor.

²⁹ Section 53R.

is before the date specified for the finalisation of input methodologies (being 30 June 2010 or up to 30 December 2010). Clearly these dates need to be brought into alignment. If the Bill proceeds in its current form, then the proposed commencement time for the second price-quality path will need to be set back to allow (a) the Commission sufficient time to set all relevant methodologies and (b) ELBs sufficient time to consider lodging customised proposals on the date that this price-quality path begins. This would potentially mean that the second price-quality default path may not come into effect until 1 April 2012.³⁰

76.2 *The two phase input methodology approach:* Under this proposed approach there would be no opportunity to lodge customised proposals until after the release of the Phase 2 input methodologies in mid-February 2011. This would mean that customised proposal applications could not be made until 1 April 2011, at the earliest. This opportunity to lodge a customised proposal would therefore arise at least one year after the start of the second initial default price-quality path on 1 April 2010. The actual exercise of this right would presumably be delayed beyond the year, during which time ELBs will consider whether or not to lodge a customised proposal. This position would prejudice ELBs making it all the more important to ensure that options are available to adjust prices to account for both the loss of revenue and the time value of money arising from the delay, in the event that a proposal for a customised proposal is successful. This matter is discussed further below in the section on customised proposals. As earlier noted, this position also warrants giving consideration to reducing the time allowed to the Commission to assess customised proposals by incorporating the preliminary assessment time-frame (under section 53S) into the full time allowance for the consideration of such applications (under sections 53T and U).

³⁰ This assumes that input methodologies may not be set until at least 31 Dec 2010, and this timetable would not provide ELBs sufficient time (a) to notify retailers in December 2011 of price movements and (b) consider whether or not to lodge a customised proposal on 1 April 2012.

D PURPOSE STATEMENT

- 77 Certain aspects of the proposed new purpose statement, section 52A, provide welcome changes to the current purpose statement applying to ELBs, namely section 57E. These changes include:
- 77.1 recognising that regulation should promote outcomes which are consistent with outcomes produced in competitive markets; and
 - 77.2 the recognition that regulatory decisions need to take into account incentives to innovate and invest.
- 78 But these changes do not, in reality, introduce new criteria. Section 52A simply proposes to codify matters that the Commission has previously recognised and said that it would take into account, either of its own volition or in accordance with considerations described in Government Policy Statements.³¹
- 79 There is, we expect, common ground between all parties that regulation must strive to promote the long-term benefit of consumers. But the problem, beyond this point, is that there are multiple goals in the proposed section 52A (as there also are in current section 57E) that inevitably will conflict. In particular, section 52A involves both economic efficiency³² and distributional objectives.³³
- 80 Where the transfer of wealth is counted as a benefit of regulation, this will inevitably form the primary basis of regulatory decision-making. Indeed, this has been the trend in the Commission's regulatory decision-making to date.³⁴ We do not consider that the changes proposed under new section 52A will address this concern.

³¹ From the outset of deliberations under Part 4A, the Commission has recognised that regulation seeks to promote outcomes consistent with outcomes produced in competitive markets. For example, in the first discussion paper the Commission said that "Part 4A appears intended to mimic the pressures that exist in competitive markets": Commerce Commission, Regulation of Electricity Lines Businesses, "Discussion Paper", 21 March 2002, para 4.28. See also the references to investment incentives contained in the Government Policy Statement, October 2004, paras 2(d) and 31.

³² Section 52A(1)(a) and (b).

³³ Section 52A(1)(c) and (d).

³⁴ See, e.g., Commerce Commission, Regulation of Electricity Lines Businesses, Targeted Control Regime, Intention to Declare Control, Unison Networks Limited, 9 September 2005, p.32. and Commerce Commission, Regulation of Electricity Lines Businesses, Targeted Control Regime, Intention to Declare Control, Vector Limited, 9 August 2006, p.39

- 81 In the course of earlier consultation rounds in relation to this Bill we have outlined that:³⁵
- 81.1 there are problems in treating distributional objectives as a benefit of regulation, because it is difficult to isolate the long-term welfare impact of regulation upon New Zealand consumers as distinct from New Zealand producers. The boundaries are blurred because every producer will also be a consumer (e.g. via individual or institutional shareholdings, or as employees);
 - 81.2 there is an evident trend in regulatory design away from lists of independent objectives towards the inclusion of a single overarching efficiency goal. For example, section 7 of the Australian National Electricity Law provides:

The purpose of this law is to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of supply of the national electricity system.
 - 81.3 this trend towards overarching efficiency goals is also apparent in other regulatory purpose statements in the New Zealand setting, such as that found under section 18 of the Telecommunications Act 2001; and
 - 81.4 a further problem with purpose statements which invite trade-offs to be made between goals of efficiency and wealth transfer is that they encourage decisions to be made on the basis of quantitative cost-benefit analysis. While such analyses can be invoked as a useful tool in certain settings, real reliability concerns must attach to any comparison of (i) short to medium term allocative impacts of wealth transfers and (ii) longer term dynamic efficiency considerations. We are not aware of any other jurisdiction that relies so heavily upon quantitative assessments in relation to equivalent decisions.
- 82 In summary, we do not believe that section 52A will solve any of the problems which have been acknowledged to exist in relation to the purpose statement contained in current section 57E. However, these problems can be addressed through the introduction of a single

³⁵ See Orion submission and NERA report, "Response to MED Discussion Document: Review of Regulatory Control Provisions under the Commerce Act 1986", 6 July 2007, section 3.1, available on our website oriongroup.co.nz

overarching purpose statement along the lines of section 7 of the Australian National Electricity Law, as noted above.

E APPEAL RIGHTS

The case for appeal rights is obvious

83 The Legislative Advisory Committee Guidelines (**LAC Guidelines**) provide the relevant criteria for consideration as to the appropriateness of appeal rights.³⁶

84 In accordance with the LAC Guidelines, appeal rights in the regulatory setting are justified on the basis that:

84.1 regulatory decisions affect “important rights, interests or legitimate expectations of citizens”. The prices set under such decisions impact directly on rates of return and network investment decisions for regulated utilities. Such decisions will also set the quality standards required for the provision of services. Clearly, decisions on price and quality involve the fundamental rights, interests and expectations of utilities and consumers in relation to all aspects of the delivery of services (e.g. price, quality and security of supply);

84.2 an allied point in support of this proposition is that all decisions under Parts 2 and 3 of the Commerce Act (pertaining to restrictive trade practices and mergers) are currently subject to standard appeal rights. There is no reason to believe that these decisions involve rights, interests or expectations which are more important than those applying to regulatory decisions; and

84.3 the discipline of appeal rights will also serve to achieve wider private and public purposes. The private purpose is to scrutinise and correct decisions of the Commission, where necessary. The public purpose arises through the overall discipline imposed on primary decision-makers by the prospect that their decisions may be subject to appeal.

85 The LAC Guidelines also articulate countervailing factors which should be balanced against the factors supporting the introduction for appeal rights which have just been described. None of these countervailing factors are sufficient to unsettle the obvious case for appeal rights because:

85.1 the costs of appeals would not be disproportionate to the rights, interests and expectations at issue;

³⁶ Legislation Advisory Committee Guidelines, “Guidelines on Process and Content of Legislation”, May 2001, para 13.1.1 and 13.1.2.

- 85.2 potential delay will not be an issue because it is proposed that decisions of the Commission will stand pending the determination of an appeal;³⁷
- 85.3 the significance of the subject matter is real and of substance, and clearly supports the application of appeal rights;
- 85.4 while due deference should be given by an appellate court to decisions of specialist tribunals, such as the Commission, the proposed membership of the appellate court means that this body will also have appropriate competence and expertise to hear and determine any appeal. It is proposed that judges of the High Court will be required to sit with either one or two lay members;³⁸ and
- 85.5 issues of finality do not count against appeal rights here. Standard appeal rights are only contemplated in the case of appeals to the High Court. Appeals from the High Court to the Court of Appeal will be confined to questions of law.³⁹
- 86 Accordingly, there is a clear and obvious case for the conferral of appeal rights in respect of decisions under the proposed new Part 4.

The Cabinet Paper merits review proposal was flawed

- 87 The Bill proposes to permit appeals to the High Court, but only in respect of input methodology decisions.⁴⁰ The position outlined in the Bill is the first point at which it has been proposed that appeal rights should be provided. The previous position under the Cabinet Paper was that there should only be restricted rights of merits review in relation to input methodology decisions.⁴¹
- 88 There is reference in the Explanatory Note to the Bill⁴² to whether narrower appeal criteria may be appropriate, which would be based on whether the Commission's decisions are unreasonable, rather than unsatisfactory. Presumably, the Explanatory Note is referring here to whether the merits

³⁷ Section 53(1).

³⁸ Section 52Z(3).

³⁹ Section 52Y(5).

⁴⁰ Section 52Y(1).

⁴¹ Office of the Ministers of Commerce and Energy, "Review of Parts 4 and 4A of the Commerce Act 1986", April 2007, para 40.

⁴² Page 7.

review position adopted in the Cabinet Paper should be re-instated. In our view, the previous merits review position should not be re-introduced.

89 The Cabinet Paper proposed that input methodology decisions should be subject to a highly restrictive form of merits review that amounted to little more than a judicial review. Four grounds of review were proposed, all of which were based on section 225 of the Australian National Gas Law Second Exposure Draft. These grounds in the Cabinet Paper proposal were as follows:

89.1 the first two grounds related to errors of fact, and applied to cases where the original decision-maker had made an error, or errors, of fact which were material to the making of the decision;

89.2 the third ground related to whether the exercise of the original decision maker's discretion was incorrect; and

89.3 the fourth and final ground related to whether the original decision maker's decision was unreasonable.

90 The following problems, which were not addressed in the Cabinet Paper, arise in relation to this limited model for merits review:

90.1 in the case of errors of fact in input methodologies, the following issues arise:

- (a) there is likely to be considerable uncertainty as to what are relevant "facts" in the case of input methodologies. It is not apparent from the Cabinet Paper that any consideration was given to this matter. There is Australian authority which establishes that the actual choice of any given input methodology does not involve findings of fact.⁴³ In addition to this proposition, there is likely to be considerable uncertainty as to what aspects of input methodologies may be factual. Further, it is conceivable that input methodologies could be developed without any "facts";⁴⁴ and

⁴³ *ACCC v ACT* [2006] FCAFC 83 (2 June 2006) para 172.

⁴⁴ Clause 8.30 of the former Australian Gas Code is again potentially illustrative. It states that: "the rate of return used in determining the reference tariff should provide a return which is commensurate with prevailing market conditions in the market for funds and the risk involved in delivering the reference service". If the Commission's cost of capital input methodology were framed along similar lines (an outcome that would be highly desirable), it arguably would contain no 'facts' to review.

(b) the Australian gas law model relied upon in the Cabinet Paper is, in fact, based on a different institutional framework. In Australia, input methodologies are set by the rule maker, which is the Australian Energy Market Commission (**AEMC**). A different body, the Australian Energy Regulator (**AER**), then monitors and enforces compliance with the rules set by the AEMC. It is the AER decisions which are subject to merits review. In New Zealand, the Commission would fulfil both the rule making and regulatory functions. This potentially creates an agency problem. Specifically, the Commission will have the ability, and also arguably the incentive, to develop its input methodologies in such a way to ensure that they are to the greatest extent possible devoid of 'facts'.⁴⁵ In so doing, it would minimise the prospect of those methodologies being subject to this ground of merits review; and

90.2 the remaining two grounds relate to the exercise of the Commission's discretion in making decisions, and are based upon whether decisions are incorrect or unreasonable. While such grounds for merits review may in theory not be confined to the strict limits of "unreasonableness" in the judicial review sense, in practice the distinction between such form of merits review and judicial review is largely illusory.⁴⁶ This proposed form of merits review will be limited because the Commission's decision will not be disturbed provided it has asked the right questions and applied the correct framework, taken into account all relevant considerations and reached a conclusion that is, at least, "open". The Commission's decision will stand so long as these tests are satisfied, even if the High Court (including relevant expert lay members) thinks that the decision is wrong and not one that it would have reached.

91 It follows that the Cabinet Paper merits review proposal is inappropriate, and of limited utility, because:

91.1 the first two grounds pertaining to factual error may be rendered redundant through the Commission developing input methodologies that are devoid of facts. Further, and in any event, there will be ample scope for uncertainty as to what are, or are not, facts in the context of input methodologies; and

⁴⁵ For example, it would have an incentive to avoid defining the parameters that would determine the cost of capital applicable in a specific industry (e.g. the market risk premium and equity beta etc).

⁴⁶ See *ACCC v ACT*, above, paras 175-178; *East Australian Pipeline Pty Ltd v ACCC* [2007] HCA 44 (27 September 2007), paras 79-80.

- 91.2 the second two grounds pertaining to the correctness and reasonableness of the decision will in practice be limited, and apply only in much the same way as judicial review proceedings, which would be available in any event.
- 92 It is encouraging that the Cabinet Paper proposal is no longer preferred, and we support the retention of appeal rights in the Bill.

What should appeal rights apply to?

- 93 The Bill limits appeal rights to input methodology decisions. The Explanatory Note states that this confinement is appropriate because extending such rights to final decisions would create additional costs and gaming risks.⁴⁷ The reference to gaming risks is curious, given that the Explanatory Note⁴⁸ goes on to acknowledge that such risks can be mitigated through allowing Commission decisions to stand pending appeal, which is precisely what is proposed.
- 94 While the Explanatory Note draws a clear distinction between input methodology and what it terms 'final' decisions, it does not clearly articulate the boundaries of the latter. In the case of decisions impacting upon ELBs, 'final' decisions would include determinations of the default price-quality paths, decisions on customised proposals and decisions on information disclosure requirements.
- 95 We accept that it would be inappropriate for appeal rights to attach to both input methodologies and final decisions. This would result in unnecessary duplication of judicial processes, and the dual appeal structure would potentially result in the re-litigation of the same issues in the High Court.
- 96 The question is, which of these two options should appeal rights attach to? The analysis of this issue in the Explanatory Note is, in its entirety, as follows:⁴⁹

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 and apply to all regulated (and potentially regulated) businesses.

⁴⁷ Explanatory Note, page 7.

⁴⁸ Page 29.

⁴⁹ Page 29.

- 97 We do not agree with this conclusion. We submit that appeal rights should instead attach to final decisions for the reasons outlined below.

Problems can attach to the advance decision of what are, in essence, preliminary questions

- 98 The justification for limiting appeal rights to input methodology decisions in the Explanatory Note is problematic for the following reasons:

98.1 just because input methodologies are “integral” to the regulatory process does not mean that appeal rights should be limited to such considerations. Input methodologies comprise a range of preliminary issues, the collective application of which will result in the establishment of regulated price-quality paths. It does not logically follow that, for this reason alone, appeal rights should be confined to each of these preliminary constituent parts;

98.2 the proposed regulatory design in essence attempts to formulate and apply input methodologies as if they are preliminary questions which are to be authoritatively determined, and applied in a binding manner. It is therefore possible to draw an analogy between the proposed design and application of input methodologies, and the determination of applications for declaratory judgments. The case law on declaratory judgments demonstrates the kind of problems that can arise in decision-making in this setting. It is well settled that courts may refuse to make a declaration where, for example:

- (a) the relevant facts are in dispute. In this setting, if evidence is required, then courts take the view that it is proper for the issue to proceed to be determined in the ordinary way, and not on the basis of preliminary declarations;⁵⁰
- (b) the ruling may involve an answer given on a hypothesis;⁵¹ or
- (c) there may be abstract questions;⁵²

98.3 as outlined above, we do not know what the input methodologies will look like, and how they will be determined and implemented. The

⁵⁰ *Sloan v R* [1990] 1 NZLR 474, 482.

⁵¹ *Sloan*, above, 482.

⁵² *NZI v Prudential Assurance Co Ltd* [1976] 1 NZLR 84, 85. For further discussion on declaratory judgment principles, see Joseph, *Constitutional and Administrative Law in New Zealand*, 3rd ed, 2007, 1083-85.

Commission will have a good deal of discretion in this regard, particularly surrounding the level of specificity included in each methodology. It therefore appears to us that there is a real prospect that the advance determination of input methodologies is likely to involve factual dispute or uncertainty, hypothetical propositions and abstract questions. Take again our earlier example of the cost of capital. It would be extremely difficult for the court to review a methodology that contained only a high level statement of principle, or a particular form of the CAPM model. Without also knowing the parameters that the Commission will use to populate the methodology (i.e. the equity beta, the market risk premium, etc) the review will likely involve little more than abstract issues. In particular, it is unlikely that the court will be able to foresee how the methodology will translate into regulatory prices for the affected businesses;

- 98.4 if this is correct, then clearly it is potentially unsound to enact a policy which attaches appeal rights only in this context. Of course, in the declaratory judgment context, the court may decline to rule when faced with problems of the kind described. That is unlikely to be an option in the context of the proposed appeal rights – the court must review the methodology that is put before it, however abstract. This is especially problematic in light of the incentive the Commission may have to ensure its methodologies are ‘non-specific’ so as to minimise the appeal risk. It is difficult to envisage the court fulfilling an effective review role in a setting characterised by such uncertainty;
- 98.5 the fundamental judicial predicament in this setting is that the basis for the decision may be artificially constrained. Put simply, the court may be privy only to high-level statements of principle or methodologies devoid of the parameters needed to determine the outcome. In contrast, if it were reviewing a final decision the court would have before it all relevant information. It will no longer have to speculate on the outcome of methodologies. Rather, it would be able to adjudicate on actual rather than abstract issues. This would have the advantages of:
- (a) ensuring the court exercises its review role effectively by reducing the degree of speculation involved in adjudications;
 - (b) removing any incentives the Commission may have to minimise the specificity of its methodologies to reduce the risks of appeals, and so improving its accountability; and

- (c) improving certainty for businesses and so better achieving the overarching objectives of the Bill; and

98.6 further, we note that the Explanatory Note may incorrectly assume that any given “final outcome” will be applicable to all regulated and potentially regulated businesses. For example, as noted in paragraph 72 above, the nature and the potential scope of the WACC input methodology may not have universal application in the manner envisaged in the Explanatory Note.

Appeals of final decisions will be safer and may be no more burdensome

- 99 These various factors identify a potential risk in decision-making which is easily overcome. The attachment of appeal rights to final decisions, rather than input methodology decisions, will eliminate all of the potential concerns which have just been outlined.⁵³ In the case of appeals of final decisions, the court will have before it all of the relevant background and facts. It will therefore be in a position to reach a fully informed decision.
- 100 In addition, appeals of final decisions may be no more burdensome than appeals of input methodology decisions. Indeed, if input methodology appeals involve disputes as to facts, hypotheses and abstract questions, appeals of such matters will be potentially more burdensome than appeals of final decisions where all relevant matters will be before the court. Moreover, for the reasons outlined below, the time-frame to lodge appeals on input methodologies is likely to lead to extensive litigation in July 2010. Appeals on final decisions are likely to be less concentrated, and so less burdensome.

⁵³ We assume that such appeal rights would not be framed in any restrictive manner which may result in input methodologies being excluded from review in the appeal process. Any such restriction would serve simply to frustrate the proper application of an appeal process. In this context it may, for example, be prudent to amend current section 53Q(2)(d) to clarify that the requirement for a customised proposal to apply or adopt the relevant input methodologies is simply a requirement relating to the form of the application, and does not restrict the reviewability of the substance of the input methodologies in the context of any customised proposal application, or any appeal of such an application. A check for other consequential amendments would also be prudent in the event that appeal rights are conferred upon final decisions.

Appeals limited to input methodologies, as proposed, will not provide appropriate accountability and will be likely to result in extensive litigation in 2010

- 101 As Figure 3 (not to scale) illustrates, the timing of appeals on the Commission's input methodologies, as proposed in the Bill, will serve to further reduce accountability because:
- 101.1 appeal rights under section 52Y attach only to input methodology determinations. These are defined to mean initial and amending input methodology decisions;⁵⁴
 - 101.2 appeals against these decisions must be commenced within 20 working days after they are published;⁵⁵
 - 101.3 the requirement to set initial input methodologies is conferred by section 52T, and the deadlines here are 30 June or up to 30 December 2010;
 - 101.4 input methodologies need not be reviewed for a further seven years;⁵⁶ and
 - 101.5 therefore under the appeal regime proposed in the Bill, the following may well happen:
 - (a) the second initial default price-quality path is likely to be set on 1 April 2010;
 - (b) the input methodologies will likely be finalised on 30 June 2010 (or perhaps more likely 30 December 2010);
 - (c) appeals will be lodged in the High Court in respect of each of these input methodologies before the end of July 2010 (or January 2011);
 - (d) a flood of litigation can be expected because this may be the only chance to appeal input methodologies until 30 June 2017 (or 30 December 2017);

⁵⁴ Section 52Y(2).

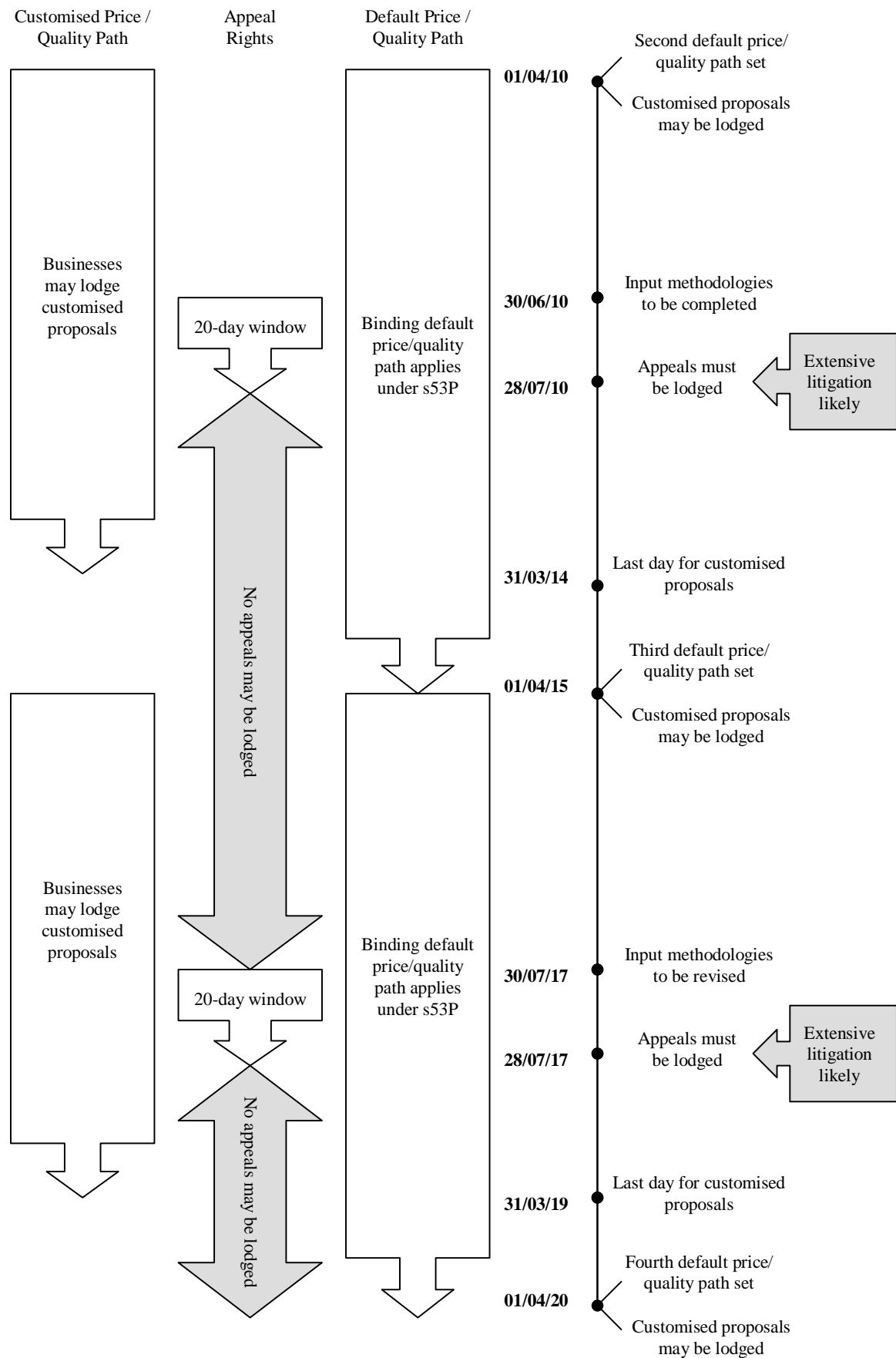
⁵⁵ Section 52Z(1).

⁵⁶ Section 52X.

- (e) the Commission would have little incentive to amend the input methodologies before 30 June 2017 because this would give rise to appeal rights; and
- (f) decisions in the interim (such as those for the reset of the default price-quality path in 2015⁵⁷ and customised proposals) would not be subject to appeal.

⁵⁷ Section 53M(2).

Figure 3: Appeal rights timescale as set out in the Bill



102 Accordingly, on closer analysis, the appeal rights contained in the Bill are:

102.1 highly restrictive; and

102.2 likely to result in extensive litigation in 2010 in respect of each and every input methodology.

103 All of these concerns would be overcome by permitting appeal rights for final decisions.

Should there be the ability to introduce new material at appeals?

104 Finally, on the question of appeals we note that it is proposed under new section 52Z(2) that appeals must be conducted solely on the basis of the documentary evidence that was before the Commission at the time it made its decision. No new material may be introduced.

105 This position differs from the procedures applying to other existing appeal rights under the Commerce Act.

106 It is surprising that there is no discussion of the justification for this position in the Explanatory Note, given that this issue has not arisen in earlier consultation.

107 In the case of appeals pertaining to decisions under Parts 2 and 3 of the Act, the court has discretion to admit new evidence. For example, evidence of new industry or technological developments since the Commission's decision would normally be admitted, particularly in dynamic markets.⁵⁸ Balanced against this may be the concern, in some cases, that the introduction of new evidence could effectively transform what is intended to be an appeal into a new trial.⁵⁹

108 No explanation has been offered for the blanket denial of the introduction of new material in the regulatory appeal setting. In our view, there are unlikely to be compelling reasons for this restriction. Rather, it may well be that the introduction of new material is necessary to enable an informed and relevant decision to be made. It makes little if any sense to require the court to determine an appeal and, in so doing, ignore crucial new industry developments, the admission of which might impact on the decision.

⁵⁸ See, e.g., *Power NZ Ltd v Mercury Energy Ltd* [1996] 1 NZLR 106, 113.

⁵⁹ See, e.g., *Telecom v CC* [1991] 2 NZLR 557, 558. See generally *Gault on Commercial Law*, CA91.06 for discussion of principles relating to the introduction of new evidence in Commerce Act appeals.

- 109 Some consultation needs to take place around this last minute development. There is the real risk that if section 52Z(2) is enacted as proposed, then this could bring the appeal process into disrepute in certain cases.
- 110 In summary, it is encouraging to see that the Bill incorporates full appeal rights. The review provisions contained in the Cabinet Paper proposal conferred little more than rights to judicial review and would have done little to deliver the improved accountability sought. However, we remain concerned that appeal rights attach to decisions on input methodologies rather than to 'final' decisions. This is likely to be problematic for a number of reasons, including:
- 110.1 uncertainty surrounds the concept of input methodologies. In particular, we do not know if input methodologies will engender a sufficient degree of specificity for there to be any confidence that the debate surrounding them will relate to anything more than hypothetical or abstract propositions or assumptions;
 - 110.2 the Commission will have the ability, and arguably the incentive, to develop its input methodologies in such a way as to ensure that they are to the greatest extent possible devoid of detail to minimise the prospect of those methodologies being overturned on appeal; and
 - 110.3 the timing of appeals on the Commission's input methodologies, as proposed in the Bill, will serve to further reduce accountability and will likely result in extensive litigation in July 2010 in respect of every methodology.
- 111 All of these problems are easily remediable by attaching appeal rights to final decisions and allowing the court the discretion to consider new material.

F CUSTOMISED PROPOSALS

- 112 There is one last point that we wish to address in relation to customised proposals. This relates to the provision that the Commission is not required to consider more than four such proposals in any one year.⁶⁰ This position has been adopted purely to cater for the limited resources the Commission has at its disposal to consider such proposals.⁶¹ There is no other substantive policy basis for imposing the limitation.
- 113 If more than four proposals are received in a year (which is a distinct possibility), those businesses that have their proposals deferred as a result of this restriction are clearly significantly disadvantaged. In particular:
- 113.1 adjudication of their proposals will be deferred for a year, at least;
 - 113.2 appeal rights that may attach to customised proposal decisions (assuming such rights are attached to final decisions rather than input methodologies) will likewise be deferred; and
 - 113.3 in the interim, those businesses awaiting their turn will be unable to set their prices above their default price paths. This may result in the deferral of critical investments.
- 114 This plainly unsatisfactory outcome is in part recognised in the design of the Bill. The Explanatory Note suggests that this problem is addressed through allowing the Commission to provide for revenue recovery where higher prices are ultimately determined under customised proposals.⁶² However, section 53V(2)(c) of the Bill actually provides that only “some or all” of the shortfall in revenues may be recovered, and that this recovery must be spread over time. Presumably, this reference to “some” in the Bill has been made in error.
- 115 However, in some situations, the ability to recover the shortfall in revenues will be an ineffective solution. In particular, it is a less than ideal solution for businesses with urgent investment needs in the immediate term, particularly if failure to undertake such investments might give rise to prosecution due to a breach of quality standards. Businesses in this position require certainty that they will recover their efficient investment costs before they reasonably can be expected to undertake such

⁶⁰ Section 53Y(1).

⁶¹ Explanatory Note, page 24.

⁶² Page 24.

investments – even if they are urgent. The Bill does not deliver that certainty.

- 116 It is not enough simply to include the need to undertake urgent investments as one of several factors that determine the order in which customised proposal applications are assessed under section 53Y(3)(b). Rather, this is a substantive market issue which cannot acceptably be the subject of delay. Clearly, there is a need to develop a greater degree of flexibility to cater for situations where increased revenues are needed to support investment decisions, but where a business cannot have its customised proposal assessed straight away.
- 117 One option may be to insert a further provision which enables the Commission to grant interim authorisation to a breach of the default price-quality path on the basis that:
- 117.1 the business has submitted a customised proposal and therefore committed itself to the outcome of that adjudication process;
- 117.2 the Commission has elected to defer consideration of this application until the following year; and
- 117.3 the business has made out a prima facie case that increases in revenue are necessary to support new investment.
- 118 The potential difficulty with such an approach is that there is likely to be too much uncertainty surrounding the eventual outcome of the customised proposal (particularly if there are no appeal rights for customised proposals). The risk that the outcome of the customised proposal application may be less favourable than an interim authorisation would be likely to deter ELBs from making investment decisions under this option.
- 119 A better option might be to require the Commission to consider more than four customised proposals in a year if a business that would otherwise be forced to wait is able to make a prima facie case that:
- 119.1 it has urgent investment requirements; and
- 119.2 remaining on the default price-quality path would seriously prejudice its operations.
- 120 The Commission would likely be responsible for evaluating such applications, which may be problematic since it will have an incentive to make its decision based on its resource limitations. However, judicial review of such decisions would be available, which would impose at least some discipline on the Commission.

- 121 This option may go some way towards striking an appropriate balance between, on the one hand recognising the Commission's resource constraints, whilst on the other hand ensuring businesses with legitimate investment needs are not unfairly prejudiced. Unless the Bill is amended to entail greater flexibility in relation to these situations, section 53Y(1), which requires the Commission to consider no more than four customised proposals per year, will need to be removed.

Orion New Zealand Limited
9 May 2008