

Changes to the regulatory environment

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Abstract

It is likely that mergers leaving only two major firms in a market will no longer be able to get Commerce Commission clearances: the competition standard is likely to be pulled back from preventing a firm gaining “effective market control” to preventing a “substantial lessening of competition”. This highlights the importance of identifying credible efficiency gains in gas retailing and gas electricity mergers.

Gas pipeline prices may be subject to increased scrutiny. Price regulation may seek to avoid simply locking in ODV-based revenues by reverting to a US rate base model. One link is that “optimisation” may depend on likely actual replacement.

Introduction

The last Government signalled its intentions to change the Commerce Act and explore the options for regulating network industries. Labour, then in opposition, indicated that it was prepared to go further. Now in Government, Labour has initiated inquiries into the electricity and telecommunications sectors and is apparently proceeding with the review of the Commerce Act. The changes to merger guidelines, penalty provisions, and the treatment of particular trade practices were discussed extensively last year in the media. The options for regulation will be a focus for many of us for the next few months. The purpose of this paper is not to seek to answer all the major outstanding questions but to draw attention to some key features for the debate in the two areas.

Merger thresholds

For the energy sector, one major change being developed for the Commerce Act is the adjustment of the thresholds in section 47. At present, a merger must be granted a fast track “clearance” if it is clear that the merger will not lead to the firms involved acquiring or strengthening a “dominant” position. Where the Commerce Commission considers that dominance might be created or strengthened, applicants are required to submit to a longer authorisation process where the economic damage thought likely to result from the reduction in competition is traded off against efficiency gains (usually cost savings) that the merger can be expected to produce. Lowering the threshold for clearances is thus a shift the point of presumed “innocence”. Fewer mergers will be simply cleared.

The problem perceived with the “dominance” threshold is that the term has been redefined progressively in judicial decisions to the point that it is now taken to mean “effective market control”. As a result, there is currently no mechanism

to prevent, or even require detailed scrutiny of, mergers or acquisitions that might produce results such as:

- a move from four oil wholesalers to two in New Zealand;
- spectrum allocations that led to a cell phone duopoly for the foreseeable future;
- Tasman air routes only being available to two airlines; and
- a move from four electricity generating firms back to two.

The likely move is to lower the threshold from dominance to “substantially lessening competition” – the Australian standard.

The loss to the country of such a change in the legislation is the cost of the authorisations that should have been clearances. The gain is the prevention of some mergers that do not lead to “effective market control” but still reduce competition sufficiently that the value for money provided for consumers is seriously eroded.

As has been widely discussed, the task of identifying where a merger from say, three to two firms, will substantially lessen competition will be difficult since predicting reliably where tacit collusion will be feasible and where it will not, and the degree to which it will be successful, is known to be demanding. The relevant trade-off is not between attempting these judgements and abandoning the issue, but rather between the economic savings made through preventing damaging mergers and the economic losses resulting from the uncertainties foisted on firms through a less predictable regulatory regime.

Overall, the change should not prevent many worthwhile mergers, other than those between small businesses unable

to carry the costs of the authorisation process. The basic balancing provided by the authorisation process will still be available.

Accordingly it is worth highlighting a couple of features of the assessment of the “public benefits” that must be produced if a questionable merger is to be authorised.

There is a growing body of empirical literature indicating the efficiency gains from liberalisation. This has underpinned the economic reforms of the past decade or so and the presumption that reductions in competition will be economically damaging. The studies provide a reasonable range for the percentage reductions in production costs, retail prices etc that might be expected to follow any significant strengthening of competitive pressures. While there are problems inferring effects going the other way – from a workably competitive setting to something more concentrated – general presumptions are working their way into the Commerce Act folk lore. Serious losses of competitive pressures may produce economic losses amounting to around ten to twenty percent of turnover.

Of course, realistic quantification exercises will need to assemble an itemised catalogue of the component efficiencies – price effects, quality impacts, innovation losses etc, and mix and match accordingly. Nevertheless the regulatory “barriers” to questionable mergers are likely to be of this order.

Given fixed benefit hurdles or the applicant’s expectation of the Commission’s detriment estimates for the actual case, applicants must come up with offsetting public benefits. Knowing the general scale of the Commission’s view of mergers that may create dominance, there will be no more “marginal” acquisitions. All will have to have benefits exceeding 20% of market turnover, or whatever the expectation is. Just as the Commission’s view becomes somewhat predictable, so too will the applicant’s benefit assessment. “What would we expect them to say?”

Alert to this cynicism, applicants must attempt to substantiate their benefit claims. One approach has been to present “audits” by experts. Notwithstanding the independence of the experts, the Commission will be wise to be discerning, in particular identifying when and for what purpose the audit was done.

Our view has been that for these audits to be credible, the purpose should clearly have been to advise management or owners. Most credible would be the Board papers flowing out of the independent audit and relating to actual decisions to proceed with the acquisition or trade practice. Similarly, if an analysis was done before the issue of Commerce Act authorisation arose, then it should be given more weight.

Applicants will have to trade off the risks of making commercially sensitive material available to the Commission and to opponents’ expert witnesses against the value of demonstrating the clear private, and hence (generally) public,

benefits. Where there are public benefits that are not private benefits, auditing is more difficult.

Whatever the process, the Commission and opponents of the acquisition or practice will be sceptical. This creates a problem for applicants (and their advisors).

The only counter available to the “auditors” is to preserve sufficient independence so that it is clear to the applicants, the Commerce Commission and the Court that the auditing business has more to lose from a reduction in its credibility than it can possibly gain from the relationship with the particular client.

Regulation

Objectives

The aim of regulation is to improve the economic efficiency of the sector. Economic efficiency is the *primary* aim of most economic interventions in the energy sector. The Commerce Act promotes *competition* but only because we are not sure how to secure efficiency in all circumstances. Where regulation is imposed, competition is already presumably a lost cause, so regulators have to seek to promote efficiency directly.

Economic efficiency is normally discussed in terms of three aspects – allocative, productive and dynamic. For the purposes of practical energy policy, the first two mean:

- that tariffs should face customers with the costs of their consumption decisions; and
- that the sector’s structure and rules should be designed to encourage firms to produce the price and reliability combinations most desired by consumers using the least-cost combination of inputs.

Dynamic efficiency refers to achieving these results in the long run as well as in the short run, i.e. allowing for investment and innovation.

Regulatory priorities

As a consequence, the normal riding instructions for regulators are to keep costs and prices down, costs because the resources can be usefully applied elsewhere, and prices because elevated tariffs stifle worth-while consumption.

In the case of energy (pipe)lines, the effect of prices on consumption is small: these are services fundamental to most normal household and business activity. Thus regulation of distribution tariffs – reducing tariffs from what firms would like to charge to what they ought to be allowed to charge – will not make much difference to energy use and hence to will not make much difference to economic efficiency.

Rather the key focus of sector reforms has been to intensify the pressures on firms to reduce costs, to cut out waste, especially in respect of investment. Hence the prominence

of price cap regulation, where the actual caps may be questionable but where holding them fixed for some time gives firms the incentive to cut costs. Investments are recoverable only if they are demonstrably prudent.

With the privatisation of many networks and the increasing extent of foreign ownership, we can expect this regulatory perspective to change somewhat.

Consider for a moment the international oil market. When OPEC succeeds in reducing supply so that world crude and product prices increase, we don't regard the damage to New Zealand as just the consequent *reduction* in demand.¹ With imports, the entire increase in the cost of the products is a loss to New Zealand.

There is a parallel with an energy network in New Zealand that happens to have been bought by an overseas company. In purchasing the company from New Zealanders, the new owner will have paid "the country" for the assets and may also contribute to New Zealand through the know-how of the new parent company – the post-tax profits that flow out of New Zealand will generally be just a compensation for those inflows. However, to the extent that the prices paid for the services become higher than they need be, going beyond a reasonable compensation for the inflows, the loss is simply the extra revenue flowing out of the country.

What about the costs of production? The foreign-owned network will generally employ New Zealanders and use some locally produced input materials but these will be paid for at what they cost and provide no particular benefit to New Zealand other than economic activity *per se*. If the firms operate inefficiently, they use more local New Zealand labour and materials and the issue is not a special concern unless the increased costs feed through into prices.

Where the network prices are set by what the market will bear or by caps imposed by a regulator, the link between costs and prices may be weak.

To summarise:

- Where infrastructure is New Zealand owned, what the firms charge is less important economically because demand is largely unaffected, and New Zealanders are paying New Zealanders. Costs on the other hand are important because we lose by wasting resources.
- Where infrastructure is foreign-owned, prices become more important and cost cutting incentives less so.

The purpose here is not to promote concerns about foreign ownership *per se*. The only point to be taken from the observation that infrastructure may increasingly be owned

by foreign firms is that it somewhat heightens the stakes in choosing reasonable pricing benchmarks.

Regulatory approaches

ODV vs historic costs

What is the fuss about ODV? To many it seems clear that if a firm invests prudently in an infrastructure facility that subsequently is fully utilised, then the firm is entitled to a return of and on that investment. A stream of payments based on an ODRC calculation will achieve this. Moreover, if *prospective* investors thought the regulatory regime would allow less, they would not participate.

The ODRC construct allows prices to be set at those of a new facility, i.e. at the limit set by duplication of the network – were it not for the practical difficulties of achieving access to a comparable corridor of rights of way. The approach has some attractions where the assets comprise a large number of individual components of varying ages continually being 'rolled over' – since in this setting, the revenue is enough to provide the owner with the necessary incentive to maintain the composite facility, rather than running it down.

In many cases however, infrastructure costs may have been substantially recovered early in the life of the assets or may have been partially written off in times of demand uncertainty. The problem for the regulator coming in well through the life of the facility, is what base to choose for new price caps. The minimum requirement is that the regulated infrastructure firm is assured that it will be able to recover normal operating and maintenance costs *and* that it will be allowed to secure a reasonable return of and on any investment it is required to make to maintain (or expand, if necessary) the service capacity of the facility: then the firm will participate. The asset base will grow in line with the investments that come due.

Rather than start from a zero asset base, it is reasonable that the firm's shareholders be allowed to earn a return of and on the value of their initial investment in the enterprise, providing this was a prudent choice.

The advantages of the US rate base approach are that prices are kept low where possible and refurbishment investments that will increase prices will be carefully scrutinised by end users.

It will be interesting to see what the electricity sector inquiry team makes of the options. Is it worth going to the trouble and expense of regulating prices to entry levels, i.e. on the basis of ODRC, when any major over-stepping of the mark will lead to by-pass? The usual barrier to bypass (assuming prevailing prices are high) is the cost of assembling all the necessary easements. In those sectors where ODRC is seen as an acceptable rate base (presumably settings where replacement is a continuous process), perhaps rather than regulating, more consideration should be given to facilitating the creation of rights of way (avoiding hold-out).

¹ In fact, the changes in demand due to the price fluctuations we have experienced over the last 20 years is not usually *measurable* in New Zealand.

Incentives

Where there is thought to be a lot of value in providing incentives for greater efficiencies, price caps may be useful. However, regulation relies on the profit motive and may thus be less effective with community trust owner infrastructure.

Summary

Especially for New Zealand owned businesses, incentives for cost reductions are important but are hard to provide for non-profit-oriented owners.

If preventing cost-plus behaviour is acknowledged as being difficult, then more attention may be paid to price *per se* and it is questionable whether regulating prices to levels at which bypass is already a threat would be better than simply seeking to strengthen that threat.

The US-style rate base approach will, in many cases, produce lower prices without threatening the viability of the firms concerned, but like all regulation, is expensive to implement.

Author

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