

Electricity: Commerce Commission Notches up a Supreme Court Win

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Electricity lines company, Unison, lost its appeal to the Supreme Court against the Commission's decision setting the thresholds to be met to avoid imposition of price and other controls.

Summary

Electricity lines businesses are subject to a regime which gives them a safe harbour if they comply with thresholds set by the Commission. If they don't comply, the Commission can then review whether to impose price and quality controls on the particular business.

The Commission set the thresholds using a model based on price movements referenced predominantly to the industry as whole rather than individual businesses. It chose this approach from an array of options.

Unison, a lines business in Hawke's Bay, Taupo and Rotorua, sought judicial review of the thresholds, alleging they were unlawfully set. The Supreme Court has accepted that the thresholds used were within the Commission's powers. The Commission's choice was acceptable.

This was not a review of the merits of the Commission's decision (and that raises the question of merits reviews). It was a more limited judicial review.

The ultimate outcome was that control was not imposed on Unison. Instead, the Commission accepted an administrative settlement by which Unison adjusted prices (and rebalanced them between its service regions) and agreed to keep within the thresholds going forward.

Introduction

New Zealand has 29 large electricity lines businesses. They carry electricity from the grid to the end user. There are five main components in the electricity industry: generation, wholesaling, transmission

(predominantly Transpower), distribution (Unison in this instance) and retailing.

These lines companies are natural monopolies. A review concluded that normal Commerce Act remedies - such as the Part 4 control regime - were not sufficiently strong. So Part 4A was introduced in 2001 to establish a tighter regime. This is designed to impose price and quality controls, etc, but only on those lines businesses which require control.

The initial step under Part 4A is for the Commission to set thresholds. If the business does not breach those thresholds, it avoids the risk of being controlled.

If it breaches them, the Commission investigates the particular lines business to decide whether to declare control in respect of that business. In other words, merely breaching the thresholds does not necessarily mean that ultimately the lines business has a problem.

The purpose of the regime

Driving the relevant aspect of Part 4A is the section 57E purpose statement. The purpose of the regime is to promote the efficient operation of the relevant markets through targeted control of consumers. It is to do this by ensuring that suppliers:

"(a) are limited in their ability to extract excessive profits; and

(b) face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

(c) share the benefits of efficiency gains with consumers, including through lower prices.”

While guided by this purpose statement, the legislation does not specifically set out what the thresholds should be.

What the Commission did

The Commerce Commission had a number of options to choose from when setting the thresholds, which raised some challenging issues. After consultation and other steps, the Commission opted for an approach focused on the industry as a whole (but with some variations depending on the particular business)¹. It did this instead of taking an approach which would have been targeted more closely to individual businesses, and would have covered a number of possible metrics which might have more comprehensively covered the points quoted at (a) to (c) above.

One reason for the approach was the complexity, cost and delay in a more targeted approach, when the aim of thresholds is to act as a filter.

The Supreme Court judgment sets out the detail of some of these options. The Commission opted for a form of the CPI – X model.

The CPI – X model

The CPI – X approach is based on setting an initial price, and then limiting price changes over a period to:

- the rate of inflation as determined by an appropriate index (in this instance, CPI); adjusted by
- a percentage factor characterised as X, to reflect anticipated efficiency gains, typically over 5 years

This approach potentially involves using differing information and methodologies.

¹ It did this in two steps by setting thresholds on two occasions: the second time it set thresholds, it took an approach more targeted on the individual businesses, but the overall approach was industry-wide focused.

The CPI – X used by the Commission migrated to an approach by which the X percentage was calculated by using a sub-formula: $B + C$.

B was a positive figure, representing the Commission's assessment of expected improvements in efficiency, industry-wide. This figure would apply to all businesses.

Each business would be assigned a different value as its C factor, which in turn was made up of two components: relative productivity (cost efficiency) of each business and relative profitability. This would enable those businesses that had been maintaining low prices, relative to others, to increase their prices by more, relative to others, while remaining within the required price path to meet the threshold. In this way, the threshold was targeted, to a degree, to the particular business.

Judicial review application by Unison

Unison sought judicial review of the way in which the thresholds were set, claiming they were unlawful. Unison said that the Commission had not set the thresholds in accordance with the statutory purpose (promoting the efficient operation of electricity distribution markets, applying the factors (a) to (c) listed above).

It said that the thresholds did not comply with the requirements for setting thresholds in the statutory scheme. Unison claimed that the thresholds screened businesses on a basis that is irrelevant to whether those in breach of them should be made subject to price control (and in fact might miss those that should be subject to control).

It is important to recognise that this was a judicial review and not a broader appeal on the merits of the Commission's decision. The scope of the judicial review was limited to whether or not what the Commission did was lawful, that is, whether it was permitted by the legislation.

The Court could not go into the **merits** of the Commission's choice between the various models available to it and the specifics of implementation, beyond whether the choice and approach was lawful.

Merits review?

This raises again the question of whether or not particular decisions of the Commerce Commission should be a subject of merits review (where merits review is not currently available). Whether justified or not in this case, Unison's request by the Court to review the Commission's decision was decidedly hamstrung. It couldn't get into the detail of the approach adopted by the Commission. Should it have had the ability to seek a review on the merits by a tribunal which included expertise in economics (of which one option is the existing regime by which a lay member sits with a High Court Judge on certain Commerce Act appeals)?

On this threshold issue, there might be arguments both ways. Given this is a threshold question, and not one as to ultimate control of the business, arguably merits review should not apply to it. This also reflects the approach taken by the Commission (but effectively criticised by Unison) of taking a more rudimentary and quicker approach to thresholds: merits review would, it could be argued, elevate the threshold issue beyond what it should be doing: acting as a relatively straightforward filter.

What Did Unison do at the same time?

As well as mounting its judicial review application, Unison went ahead and increased its prices so that the threshold was breached. That in itself doesn't mean that its business would be controlled. As part of the regime, that is a subsequent step that the Commission would consider. Based on Unison's own specific circumstances, the Commission may have decided that controls should not be imposed.

What Did the Supreme Court Say?

The Supreme Court disagreed with Unison and decided that the Commission had exercised its powers in accordance with requirements of Part 4A of the Commerce Act.

The Commerce Commission has a broadly expressed power, designed to achieve economic objectives which are themselves extensively expressed. The legislation contemplates that wide policy considerations will be taken into account in the exercise of the expert body's powers. The Courts in those circumstances are unlikely to intervene unless the body exercising the power has

acted in bad faith, has materially misapplied the law, or has exercised the power in a way which cannot rationally be regarded as coming within the statutory purpose.

The Court accepted Unison's argument that price changes by themselves can convey no information about the ultimate objective (the efficiency of the business). It also accepted that a threshold price path, which is breached whenever a business increases its prices, is not capable of screening particular businesses for inefficiency or excess profitability concerns.

Despite this problem, the Court noted that the threshold setting power is broadly worded and does not explicitly stipulate any necessary attributes for the thresholds. The Commission could legitimately have elected to go for a threshold regime which focused more on individual businesses, or more on industry-wide factors. It was within its power to do the latter.

It is only at the final stage of the process (when examining a particular business which has breached its thresholds to decide whether it should be controlled) that the Commission is obliged to take into account all aspects of the statutory purpose of promoting efficiency (including the three factors listed above as (a)-(c)).

Conclusion

Whether one's view is that the Commission's decision on the approach to thresholds is right or wrong, one thing seems clear. The ability of an affected party to get a review of a Commission decision, such as this, by the Courts, is relatively limited. If we don't have a merits review regime, this puts a heavy responsibility on the Commission – in our view – to get decisions like this right in the first instance. That's not to say the decision was wrong here!

Postscript: Did the Commission impose control on Unison?

Unison breached the Commission's thresholds in 2003-2006. So, the Commission considered whether to take the intrusive, and costly, option of imposing control.

It also ended up looking at the pragmatic option of entering an administrative settlement with Unison, to agree pricing and quality levels over a 5 year period. Often, commercial

resolution is preferable to the blunt-edged imposition of regulation.

Unison is owned 100% by the Hawke's Bay Power Consumers Trust (which represents Hawke's Bay consumers). It supplies electricity consumers in Hawke's Bay, Taupo and Rotorua. Its charges are around 20 to 40% of the average power bill. So, distribution (from the national grid to end user premises) is a hefty chunk of the end-users' bills.

The Commission came to the preliminary view that Unison was earning significant excess profits, with the greatest impact on the consumers outside its home territory (that is,

the position was worse in Taupo and Rotorua).

All this led to an administrative settlement by which Unison re-balanced pricing between Hawke's Bay, Rotorua and Taupo, and got back onto the Commission's existing price path thresholds. Imposing control wasn't needed, the Commission decided.

We welcome your feedback on this article and any enquiries in relation to its contents. This article is intended to provide a summary of the material covered and does not constitute legal advice. We can provide specialist legal advice on the full range of matters contained in this article.

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