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By email

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Decision of majority of Commission not to backdate the FPP prices it sets for Chorus's UCLL and UBA

(A) Summary of our advice[1]

1. You have sought our advice on the draft determinations by a majority of the Commerce Commission ("the Commission"), being Commissioners Gale and Welson (Commissioner Duignan dissenting), that the final prices to be set under the final pricing principle ("FPP") processes for Chorus's UCLL and UBA services should not be backdated to apply from 1 December 2014 (i.e. the date the initial pricing principle ("IPP") prices for Chorus's UCLL and UBA services came into effect).[2]

2. Chorus has argued in its 13 August 2015 submission in response to the July 2015 draft pricing review determinations that the majority view incorrectly interprets and applies the Court of Appeal's 2006 decision in the *Telecom* case.[3] The purpose of our opinion is to respond to the arguments Chorus advances and, in doing so, to explain why we consider that the decision of the Commission, by majority, that the FPP prices should not be backdated to apply from 1 December 2014, is a reasonable and tenable decision, open to the Commission at law and on the evidence before it.

3. In summary, it is our view that:

   (a) While the Court of Appeal's 2006 decision in *Telecom* - that the Commission has a power under the Telecommunications Act 2001 ("the 2001 Act") to backdate FPP price - was expressed broadly, the facts and circumstances here and the economic analysis that is now available is such that, while the Commission is entitled to follow that decision, there are grounds to say that it need not do so.

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1 This advice has been prepared together with Matthew Smith, barrister.

2 See Further Draft UBA Determination of 2 July 2015 ("Further Draft UBA Determination"), at §711; Further Draft UCLL Determination of 2 July 2015 ("Further Draft UCLL Determination"), at §846, 883.

3 *Telecom v Commerce Commission & Ors* CA75/05, 25 May 2006 ("*Telecom* (NZCA)").

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(b) Applying the Court of Appeal's 2006 *Telecom* decision, while the Commission has a power to backdate the FPP prices in issue, it is not required as a matter of law to do that. Instead, the Commission has a discretion as to whether to backdate.

(c) We have reviewed the reasoning of the Commission in its draft determinations for the FPP prices in issue and in our opinion the conclusion by the majority of the Commissioners that the FPP prices should not be backdated to apply from 1 December 2014, or earlier, is a reasonable and tenable decision, clearly open to the Commission at law and on the evidence before it.

(B) Structure of our analysis

4. In the sections that follow, we have set out the analysis which sits behind the advice that we have summarised in **Section A**. It is structured as follows:

(a) **Section C** addresses whether the Commission has a statutory power to backdate the (lower) FPP prices it is setting for access to Chorus' UCLL and UBA services.

(b) **Section D** assesses whether the decision of the Commission, by majority, that the FPP prices should not be backdated to apply from 1 December 2014, is a reasonable and tenable decision, open to the Commission at law and on the evidence before it.

(C) The Commission's power to backdate FPP prices

5. The first question is whether the Commission has a statutory power to backdate the FPP prices it sets for retail service providers ("RSPs") like Vodafone to gain access to Chorus's UCLL and UBA services. It is only if the Commission has such a power that the issue arises of how it should be exercised.

6. To answer the first question, the starting point is that the Commission, as a statutory body, has only those powers which have been given to it expressly or by necessary implication by Parliament.

7. We must therefore look to the relevant telecommunications legislation to determine whether the Commission's statutory powers include the power to backdate FPP prices.

8. The relevant telecommunications legislation is the 2001 Act and the Telecommunications (TSO, Broadband, and Other Matters) Amendment Act 2011 ("the 2011 Amendment Act").

9. These statutes envisage a two-stage process for the Commission's determination of the prices payable for access to Chorus's UCLL and UBA services:

(a) First, a determination on the basis of the IPP.

(b) Secondly, in the event of an application being made under s 78 of the 2011 Amendment Act for a review of the IPP price, a determination on the basis of the FPP.

10. Where, as here, applications have been made for a review of an IPP price, s 42(2) of the 2001 Act provides that the IPP determination "*continues to have effect and is enforceable pending the making of a pricing review determination*". In other words, the IPP price applies pending the FPP price being determined by the Commission. The final FPP determination must include, according to s 52 of the 2001 Act:[4]

> (a) the price payable for the designated access service, which, in the opinion of the Commission, is determined in accordance with—
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> (i) the applicable final pricing principle (as affected, if at all, by clause 2 or clause 3 of Schedule 1); and
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> (ii) any regulations that relate to the applicable final pricing principle or, if there are no regulations, any requirements of the Commission; and
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> (b) if the Commission has considered any matters that relate to the price payable for the designated access service under section 48(b) and has made a determination in respect of those matters, that determination; and
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> (c) the reasons for the pricing review determination and the determination referred to in paragraph (b) (if any); and
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> (d) the terms and conditions (if any) on which the pricing review determination and the determination referred to in paragraph (b) (if any) is made; and
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> (e) the actions (if any) that a party to the determination must do or refrain from doing; and
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> (f) the expiry date of the determination.

11. The Court of Appeal in its 2006 *Telecom* decision referred to s 52(d) of the 2001 Act as a provision which "*may well authorise the Commission to*" backdate prices.[5] In the High Court, Harrison J had identified ss 51(2)[6] and 52(b) as potentially providing the power to backdate FPP prices.[7]

12. The fact that the High Court and the Court of Appeal did not agree conclusively on the statutory provision which authorised the backdating of FPP prices is not insignificant. It indicates that the question of whether the Commission has the power to backdate does not permit a simple answer.

13. A number of considerations suggest a negative answer to that question:[8]

    (a) Parliament has not conferred on the Commission any express power to backdate FPP prices.

    (b) Parliament's use of the future tense "*price payable*" in s 52(a) of the 2001 Act, suggests that an FPP price is to operate prospectively, that is to say only in respect of future periods.

    (c) The directions in s 42(2) of the 2001 Act that an IPP price "*continues to have effect and [be] enforceable pending the making of a pricing review determination*" and in s 51(2) of the 2001 Act that an IPP price "*continues to have effect and [be] enforceable to the extent that it has not been altered by a pricing review determination*", also suggest that FPP prices are to be prospective.

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4 The same requirements apply in relation to the draft FPP determinations which the Commission must prepare and consult on under the 2001 Act; see s 49 of the 2001 Act.

5 *Telecom* (NZCA), at §39.

6 Section 51(2) provides that "To avoid doubt, a determination made under section 27 continues to have effect and is enforceable to the extent that it has not been altered by a pricing review determination".

7 See *Telecom v Commerce Commission & Ors* HC Auckland CIV-2004-404-5417, 8 April 2005 ("*Telecom* (NZHC)"), at §27, 37 and 51.

8 Note too the further arguments supporting a negative answer to the question which are discussed in *Telecom* (NZCA), at §33-44.

(d) That conclusion finds further support in the nature of the Commission's price-setting exercise, which is that regulated prices are being set by the Commission to reflect current conditions; they are not designed to pay back past excessive profits or to recoup past operating losses.

(e) Where Parliament intends to confer a backdating power, it tends to do so explicitly – as in s 30R(3) of the 2001 Act, or in the claw-back provisions in Part 4 of the Commerce Act 1986.

(f) Parliament has shown that, where a power to backdate is intended, and it has been conferred expressly by statute, the power tends to be accompanied by further statutory guidance to ensure it is exercised in the manner Parliament intended. For instance, where the Commission exercises its claw-back powers under the Commerce Act 1986, Parliament requires it to "*spread over time*" any over- or under-recovery of revenue "*to minimise undue financial hardship to the supplier*" or "*to minimise price shocks to consumers*" (as the case may be).[9]

(g) Without such ancillary guidance from Parliament, there is *ex ante* uncertainty not only as to whether backdating will occur, but as to the date to which prices will be backdated, the sum, the terms and conditions (including as to payment of interest, and if so at what rate);[10] and as to whether all affected parties will be treated the same or whether some should be differentiated to see that they are not impacted disproportionately by backdating.[11] The silence of Parliament on important variables like these means that to read a power to backdate prices into the 2001 Act requires the Commission to make a number of significant and policy laden decisions on the machinery of backdating, without any clear guidance for them.

(h) For Parliament to be imputed with an intention to confer such significant and policy-laden discretion, one would expect backdating to be a mechanism so obvious and non-contentious, from an economic/policy perspective, that it would 'go without saying' that it must be amongst the powers conferred on the Commission.[12] Such reasoning is evident in the Court of Appeal's 2006 *Telecom* decision.[13] But leaving to one side the response that if Parliament had intended to confer a backdating power it would have said so, it does not make indisputable "common" or "commercial" sense for the Commission to backdate. Instead, and as DotEcon explains in its August 2015 report, backdating is, for good economic reasons, the exception rather than the rule overseas in the context of regulatory price setting determinations similar to this one.[14]

(i) Drawing on overseas experience, DotEcon's August 2015 report criticises the Court of Appeal's reasoning in the 2006 *Telecom* decision from an economic perspective. Its criticism includes this point:[15]

> It is worth emphasising that the Court of Appeal in *Telecom v ComCom* (CA75/05, 25 May 2006) does not appear to have considered that benefits from applying a 'better' price from an earlier date must be linked to the

9 See s 52D of the Commerce Act 1986.

10 See Further Draft UCLL Determination, §867, 927-934, 939, 1758-1801.

11 See Further Draft UCLL Determination, §935-936.

12 Or, put differently, that if we asked Parliament whether it intended the Commission to be able to backdate FPP prices, Parliament invariably would have answered "of course".

13 See e.g. *Telecom* (NZCA), at §25; and also *Telecom* (NZHC), at §30.

14 See DotEcon report, August 2015, at pages iii, 9-10, 19.

15 See DotEcon report, August 2015, at page 7 (fn 13).

> expectation that such backdating will occur, and that these benefits are therefore contingent on the conditions set out [in the bullet points at page 6 of the DotEcon report]. It is unclear whether the Court has implicitly assumed that all of these conditions hold, but as a matter of economic logic, the presumption that applying prices that arise from a further review or from using a cost modelling framework instead of a benchmarking approach with retroactive effect must be beneficial because these prices are 'better' is unjustified.

(j) In the same report, DotEcon identifies the fact that, where powers to backdate do exist overseas, they tend to be conferred expressly (as in s 190(2)(d) of the Communications Act 2003 (UK), and Article 68 of the Electronic Communications Law (Portugal)) and, further, that overseas Courts are reluctant to infer such powers by necessary implication (illustrated by *Vodafone Ltd & Ors v British Telecommunications Plc & Anor* [2010] 3 All ER 1028 (CA), §[36]-[46]).

14. In our view, these considerations provide good grounds to conclude, as a matter of statutory interpretation, that in circumstances where a backdating power has not been conferred expressly by Parliament on the Commission, it is not appropriate to read that power into the 2001 Act.

15. We recognise that our conclusion is contrary to the Court of Appeal's decision in the 2006 *Telecom* case. However, we have the benefit, through the lens of the particular facts and circumstances here and through the benefit of economic analysis not previously undertaken, to consider the point more fully than was possible through the declaratory judgment process in the 2006 *Telecom* case.[16] Those facts and circumstances and the economic considerations to which they give rise (either way) when considering whether or not to backdate were not before the Court of Appeal in 2006. They are so material to the analysis that the Commission would be entitled to say that the entry-level analysis in 2006 is no longer current, that the landscape is now considerably better defined and that, as a result, there are good grounds to doubt the correctness of the Court of Appeal's decision.

16. In these circumstances, we conclude that, as the law currently stands, the Commission is entitled to, but it need not, conclude that it has a statutory power under the 2001 Act to backdate FPP prices.

17. The proviso we have underlined in paragraph 16 above is important for two reasons. First, it recognises the reasonable likelihood that a Court will take a different view to that which the (three judge) Court of Appeal took on backdating in the 2006 *Telecom* decision. Secondly, it recognises that the absence of any express requirement to backdate in the 2001 Act (see further below) means that the Commission has a discretion as to whether to backdate FPP prices.

(D) Legality of the majority's decision not to backdate

18. Our conclusion that, as the law currently stands, the Commission is entitled to, but need not, conclude that it has a statutory power to backdate FPP prices, leaves open the question of whether the Commission in its discretion should backdate the FPP prices in the particular circumstances.

19. Consistent with the *Telecom* decision (the correctness of which is assumed for the purposes of the analysis which follows), the Commission has accepted provisionally that it has a discretion as to whether to backdate, and that that discretion is to be exercised in accordance with the relevant legislation.[17]

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16 The limits to the (economic) evidence before the Court of Appeal in its 2006 *Telecom* decision are recorded in that decision; see *Telecom* (NZCA), e.g. at §16.

17 Further Draft UBA Determination, at §713; Further Draft UCLL Determination, at §848, also 889-890.

20. The Commission has identified the following criteria to be relevant in the exercise of that discretion:[18]

    (a) The purpose provision in s 18 of the 2001 Act.

    (b) Whether backdating will be "*demonstrably efficient*".

    (c) Whether backdating will "*demonstrably promote competition in a way that is likely to directly benefit end-users*".

21. If there is a power under the 2001 Act to backdate FPP prices, then we agree with the Commisison that it has a discretion as to whether or not to do that.

22. We agree also with the criteria that the Commission has identified as relevant to the exercise of that discretion. All three criteria are referable to the s 18 purpose provision, which (as the Court of Appeal recognised in the 2006 *Telecom* decision[19]) informs any backdating exercise. That now follows from s 19 of the 2001 Act, in addition to the more general administrative law principle that statutory discretion is to be exercised consistently with the policy and objects of the Act.[20]

23. Using an error of law framework, it is our opinion that the Commission's majority decision not to backdate the final prices to be set under the FPP to apply from 1 December 2014, or earlier, was clearly open to the Commission at law and on the evidence before it.

24. While we have disputed particular aspects of the Court of Appeal's 2006 *Telecom* decision, its reasoning can be considered now in the context of the current set of facts.

25. In this exercise, a helpful starting point is the Court of Appeal's statement at §37:

> A restitutionary remedy would be available on the basis that it would be unjust for a party to retain the benefit of a superseded determination. In any event, the Act itself allows the final determination to be enforced according to its tenor. Where the tenor indicates that a party has obtained a benefit to which it is ultimately adjudged not to be entitled to, the enforcement remedy will relate to the value of the differential.

26. This raises the question: Are the RSPs entitled to the benefit of/the application of the IPP while it is in place, or should Chorus be regarded as entitled to the benefit of the FPP during that period?

27. As the Commission said at §850.4 of its Further Draft UCLL Determination, any decision about the relevant start date for the regulatory period needs to be considered in its specific factual and statutory context and against the s 18 purpose.

28. The approach the Commission has taken (in §865 and following of its Further Draft UCLL Determination) is that the start date for the FPP needs to align with the point in time at which market participants can actually base decisions on determined prices that are sufficiently certain.

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18 Further Draft UCLL Determination, at §854-855.

19 See *Telecom* (NZCA), e.g. at §41.

20 See e.g. *NZ Milk Corp Ltd v McDonald* [1993] 2 NZLR 543 (CA), at pages 546, 549.

29. Going back to the Court of Appeal's words, if it is not sufficiently certain that there will be a future FPP price at a particular level then there cannot be a benefit obtained in operating in the market under the IPP pricing regime to which a party is not entitled.

30. The IPP regime has been designed carefully to be a valid proxy. It must, therefore, provide a valid basis under which RSPs can make investment decisions and operate in a market while it is in place. If the Commission can backdate over the top of it in circumstances such as this, it would deprive the IPP of meaning; of relevance.

31. We do not overlook that the Court of Appeal recognised in the 2006 *Telecom* decision that an FPP price does not supplant an IPP price because the latter is wrong but because the former must be regarded as more efficient by reason of it's more sufficient methodology.[21] This logic was seen by the Court of Appeal to tell in favour of backdating an FPP price on efficiency grounds.[22] However, in economic terms, that was a questionable conclusion to draw; see paragraphs 13 (g)-(i) above.

32. Moreover, the statutory and evidential context, on the present facts, is different to *Telecom*.[23]

33. If backdating is available, then in our opinion it should only be contemplated to correct unwarranted gains, for example where a party has used delaying tactics (being the apparent basis for the 2007 ACCC guidelines[24] (see §3.2.1, at page 12)), or where there has been a serious regulatory failure (of the type given in examples on pages 16-17 of DotEcon's August 2015 report).

34. No unwarranted gains are evident in the process, or proposed outcomes, in issue.

35. Instead, the position on the present facts is this:

    (a) The prices fixed through the IPP processes are certain, while the prices that might be fixed under the FPP processes are not at all certain during the tenure of the IPP. Quoting from §44 of Professor Hausman's report for Chorus, there is "inherent uncertainty" in TSLRIC "cost estimation"; a point which is accepted by the Commission also.[25]

    (b) Investment by RSPs is, as the Commission said in §868 of its Further Draft UCLL Determination, important for the continued evolution of competition in retail broadband provision and an earlier start date may potentially impact on RSP investment incentives.

    (c) Moreover, the spectre of UCLL and UBA backdating uncertainty, both as to quantum and timing, has operated to dis-incentivise existing RSPs and prospective new ones from UCLL and UBA-related investments, frustrating the secondary purpose in s 18(2A) of the 2001 Act.[26]

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21 *Telecom* (NZCA), at §15.

22 *Telecom* (NZCA), at §34-35, 41-44.

23 See Further Draft UCLL Determination, at §889-890.

24 ACCC *Guidelines relating to deferral of arbitrations and backdating of determinations under Part IIIA of the Trade Practices Act 1974* (March 2007).

25 See Further Draft UCLL Determination, at §887.1.

26 See Commission Consultation Paper of 19 December 2014, at §22.

(d) Section 18 of the 2001 Act is focused on consumer welfare; a point supported in Professor Hausman's report for Chorus, at §6(iii), 16 and 17.

(e) RSP/end user contracts, coupled with strong competition in the retail market,[27] operate to prevent FPP price adjustments from being passed on retrospectively to end users.

(f) There is also an 'inter-generational' consumer equity point. Backdating will impose on the current consumers of RSPs shortfalls incurred by previous generations, creating inequities or improper subsidisations as between past and present consumers, who may not be the same.[28]

(g) Accordingly, backdating would cause an unwarranted windfall loss.[29] Price would be below TSLRIC (as it is later determined) for a period and then, if backdating is applied, above TSLRIC for a period. That would create a very lumpy market that would not provide an investment environment that would benefit end users.

(h) As the Commission has said, a previous "distortion" (through the operation of IPP prices) cannot be undone and any forward looking increase would only introduce a different distortion.[30]

(i) And as the Commission went on to say in §891 of its Further Draft UCLL Determination, while it could be said that an FPP price is more 'accurate' than an IPP price, that accuracy reflects forward looking incentives only and is not an accurate reflection of Chorus' actual network costs,[31] so the efficiency benefit of backdating is less clear to the Commission than it was to the Court of Appeal in the 2006 *Telecom* decision.[32]

36. Returning to the Court of Appeal's reasoning in 2006:

> Has a party obtained a benefit to which it is ultimately adjudged not to be entitled to?

37. As the DotEcon analysis shows, backdating is commonly used in the case of dispute resolution to discourage regulatory gaming and to provide compensation for those who have suffered losses as a result of wrongdoing or, in the case of standard regulatory determinations, to address serious regulatory failures or, in certain situations, pursuant to an express backdating power. (Although in the Australian case, the rationale for backdating is almost entirely based upon any need to "remove an incentive to delay the negotiate/arbitrate process" (§3.2.2 on page 12 of the 2007 ACCC Guidelines and reinforced again in §3.2.3 on page 13)). In the absence of factors such as these, and in the absence of certainty over the conditions under which backdating will take place, to backdate would only increase the volatility of revenues and costs and would be likely to discourage investment.

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27 See Further Draft UCLL Determination, at §886.1.

28 See by analogy *Atco Gas Pipelines Ltd v Alberta (Utilities Commission)* [2014] ABCA 28, at §51; *Calgary (City) v Alberta (Energy and Utilities Board)* [2010] ABCA 132, at §48-50.

29 Further Draft UCLL Determination, at §886.1.

30 Further Draft UBA Determination, at §715.1; Further Draft UCLL Determination, at §886.3, also §853, 865.

31 Further Draft UCLL Determination, at §886.6-886.7, 891.

32 See similarly Further Draft UBA Determination, at §715.2.

38. Chorus has said in §312 of its 13 August 2015 submission in response to the July 2015 draft pricing review determinations, based upon the Sapere report, that:

> … reasonable RSPs will derive an understanding of appropriate retail prices in the period prior to the final pricing determination by reference to the potential for the final determination to alter the initial price.

39. It referred in §287.9 to the risk of an adjustment to the prices determined under the IPP being well known to all parties and, in §310, to Sapere's hypothesis being that the FPP process provides everyone with a "reassurance" that prices will be set through a more sophisticated process. That may be so, but knowledge of the potential for the final determination to alter the price is too uncertain and, again, increases volatility and discourages investment.

40. Factors such as these underlie the Commission's reasoning in §885-894 of its Further Draft UCLL Determination. When supplemented with the evidence that reinforces these points in Vodafone's submission on the further draft pricing review determination, in the DotEcon report and in related evidence that is presently before the Commission, there are in our view good grounds (and at the very least sufficient grounds) for the Commission to maintain the position expressed in those paragraphs.

41. It follows, in our opinion, that the conclusion by the majority of the Commissioners that the FPP prices should not be backdated to apply from 1 December 2014, or earlier, is a reasonable and tenable decision, clearly open to the Commission at law and on the evidence before it.

(E) Conclusion

42. We have summarised our advice in **Section A** above.

43. Thank you for your instructions. Please contact us if it would be helpful to discuss further anything we have raised.

Yours sincerely

Paul Radich QC