

TO: Alan Jenkins, Electricity Networks Association, and Kevin Ward, New Zealand Airports Association

FROM: Russell McVeagh (Craig Shrive and Catherine Marks)

DATE: 30 September 2014

SUBJECT: Review of Franks & Ogilvie advice dated 12 September 2014

Introduction

1. We have been asked by the Electricity Networks Association and the New Zealand Airports Association to review the legal opinion of Franks & Ogilvie dated 12 September 2014 ("**F & O advice**") commissioned by the Major Electricity Users Group Inc ("**MEUG**").
2. The F & O advice provides views on the Commerce Commission's ("**Commission**") proposed amendment to its weighted average cost of capital ("**WACC**") input methodology ("**IM**") determination.

Summary

3. The F & O advice concludes that:
 - (a) Any percentile above the mid-point estimate of the WACC is not consistent with outcomes produced in workably competitive markets and, accordingly, is contrary to the purpose statement of Part 4 of the Commerce Act 1986 ("**Act**") ("**Part 4 purpose**").
 - (b) In the alternative, the mid-point is the legal default position, with the "legislative parameters" requiring evidence in relation to investment behaviour, among other things, before a higher percentile can be adopted.
 - (c) The Commission is required under the Part 4 purpose to use a consumer welfare standard and would err in law if it used a total welfare standard.
4. In our view, these propositions are incorrect. They do not survive a closer consideration of the High Court's IM appeal judgment,¹ the subsequent judgment dismissing MEUG's application for leave to appeal,² the Part 4 purpose or the evidence before the Commission. Specifically:
 - (a) In the IM appeal proceedings, MEUG similarly argued that selecting a percentile above the mid-point was contrary to workably competitive market outcomes.³ The High Court did not accept that a percentile above the mid-point was contrary to Part 4, instead it:

¹ *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289 ("**IM appeal judgment**").

² *The Major Electricity Users' Group Inc v Commerce Commission & Others* [2014] NZHC 1765 ("**Leave judgment**"), at [52] and [53].

³ See, for example, IM appeal judgment at [1429](b).

- (i) confirmed the 75th percentile (a percentile higher than the mid-point was considered lawful); and
 - (ii) found that there was a lack of evidential support for MEUG's position (the mid-point was not accepted as the legal default position required under Part 4).
- (b) The High Court reiterated its position when it dismissed MEUG's application for leave to appeal, noting that MEUG had misconstrued the IM appeal judgment and that the issue was an evidential rather than a legal one.⁴
- (c) As the Commission sets out in its Draft Decision, the weight of the evidence provided in the current consultation process "provides substantial support" for a percentile significantly above the mid-point, rather than for MEUG's position.⁵
- (d) The position adopted in the F & O advice, as previously argued by MEUG, failed before the High Court because it misapplies the Part 4 purpose. Properly interpreted, the Part 4 purpose allows the Commission to choose a percentile above the mid-point as a means of balancing objectives in section 52A(1)(a) and (d) for the long-term benefit of consumers.
- (e) We note that the F & O advice relies on an assertion that anything above the mid-point provides for "indefinite long-term excess returns". This is an economic rather than a legal question. However, our understanding of the Commission's position and the relevant economic evidence is that:⁶
- (i) it is not known whether the mid-point WACC will be sufficient to allow normal returns; and
 - (ii) the purpose of the higher percentile is to reduce the probability of earning lower than normal returns (given risks of asymmetric social costs).
- (f) The Part 4 purpose does not set out a single welfare standard approach. To the extent that welfare standard approaches are relevant when applying the Part 4 purpose to the WACC percentile, it is not correct that only a consumer welfare standard can be lawfully considered. Rather, the Part 4 purpose was intended to (and does) promote the long-term benefit of consumers in the relevant regulated market by "including both efficiency and distributional objectives to provide for an appropriate balance between the protection of consumers and that of producers and investors".⁷

A percentile above the mid-point is consistent with Part 4

5. The F & O advice asserts that the Part 4 purpose invalidates any percentile above the mid-point of the WACC IM range. The reasons given are that:

⁴ Leave judgment at [52] and [53].

⁵ See Commerce Commission, *Proposed amendment to the WACC percentile for electricity lines services and gas pipeline services*, 22 July 2014, [**Draft Decision**] at paras X17 and X18.

⁶ See for example where the Commission's position is summarised in the Leave judgment at [13].

⁷ See Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007 para 87.

- (a) The Part 4 purpose requires workably competitive markets outcomes to be "replicated". Until this "base condition" is met the "descriptive and subsidiary criteria" (we assume objectives (a) to (d)) cannot be applied.⁸
- (b) F & O has been instructed that "indefinite or long-term expectations of above normal returns" are not consistent with workably competitive market outcomes.⁹
- (c) Accordingly, section 52A(1) does not allow a percentile above the mid-point to be chosen by the Commission.¹⁰

F & O advice repeats arguments not accepted by the High Court

- 6. The argument in the F & O advice, that allowing excess returns does not correspond with workably competitive market outcomes, was made by MEUG in the IM appeal proceedings.¹¹ However:
 - (a) The High Court did not accept that any percentile above the mid-point is unlawful per se, as it upheld the Commission's choice of the 75th percentile. The High Court found there was a lack of evidential support for MEUG's position, and accordingly, it could not be satisfied that the mid-point was materially better at meeting the Part 4 purpose.¹²
 - (b) The High Court did not dispute the Commission's approach of establishing a WACC range and then choosing a percentile within that range to balance objectives (a) and (d).¹³ However, as a matter of evaluative assessment, the High Court expressed concern about the lack of evidential support for a WACC substantially higher than the mid-point. The High Court went on to make a number of "tentative in-principle" comments about the choice of percentile but noted that these comments suffered from the same lack of empirical support as the Commission's approach, and that further analysis and experience may support the Commission's position.¹⁴
 - (c) In its application for leave to appeal, MEUG sought to construe the High Court's tentative reservations as findings that a percentile above the mid-point was inconsistent with Part 4. MEUG argued that, given these comments, the High Court erred in law by not directing the Commission to amend the WACC IM.¹⁵ The High Court dismissed this argument and rejected any suggestion that it had found in MEUG's favour on the lawfulness of the WACC percentile. Specifically, the High Court concluded:¹⁶

⁸ F & O advice, at paras 11 and 13.

⁹ Ibid, at para 11.

¹⁰ Ibid, at paras 11, 13 and 15.

¹¹ See IM appeal judgment at [1429], which summarise the arguments made by MEUG to the High Court.

¹² IM appeal judgment at [1483].

¹³ See for example, IM appeal judgment at [1482] where the High Court stated that the regulatory history should also be taken into account and that:

In the face of the Parliamentary recognition of the importance of incentives to invest, it is understandable that in establishing the new regulatory regime the Commission should not wish to run the risk of deterring investment by providing too low a rate of return.

¹⁴ IM appeal judgment at [1483].

¹⁵ Leave judgment at [39] to [41].

¹⁶ Leave judgment at [48] and [49]. See also [51] where the Court reiterated that it did not make a finding in MEUG's favour.

MEUG misconstrued the substance of our decision on its appeal against the EDBs' and Transpower's cost of capital IMs. In doing so, it seeks to create an error of law where, in our view, no point of law is involved.

...

MEUG's core proposition was that, because of the conclusions we had reached which, MEUG argued, showed we agreed with its propositions on appeal, we erred when we did not allow that appeal. By our assessment, that core proposition misconstrues our decision.

- (d) The High Court went on to reiterate that it had not found in MEUG's favour and that by declining MEUG's appeal it had confirmed the 75th percentile.¹⁷ Overall, the High Court concluded that the choice of percentile was a matter of "evaluative assessment", and not a point of law.¹⁸

7. MEUG's arguments failed, in our view, because they cannot be supported by the plain words of Part 4 and / or the policy underlying the Act:

- (a) The Commission is required to promote the long-term benefit of consumers by promoting outcomes consistent with workably competitive market outcomes such that suppliers have incentives to meet objectives (a) to (d). Parliament has determined objectives (a) to (d) as the specific outcomes the Commission is required to promote.¹⁹
- (b) Section 52A(1) does not require the Commission to meet a "base condition" of "workably competitive market outcomes" in isolation before (a) to (d) can be applied. Nor does this section require the Commission to precisely replicate workably competitive market conditions, which the F & O advice appears to acknowledge at paragraph 15. As noted above, (a) to (d) are the workably competitive market outcomes to be promoted by the Commission for the long-term benefit of consumers.
- (c) Where there is a trade off between incentives to invest and limiting the ability of regulated suppliers to earn excess profits, the over-arching objective is the long-term benefit of consumers.
- (d) The asymmetry of social costs associated with under-recovery was the policy reason for referring to limiting rather than eliminating excess profits in objective (d).²⁰
- (e) It is not unlawful to place greater emphasis on (a) in order to promote the long-term benefit of consumers. Indeed, many parties have argued that it would be unlawful not to place greater weight on (a) as, otherwise, consumers are at risk of being worse off in the long-term.

¹⁷ Leave judgment at [51] and [61].

¹⁸ Leave judgment at [52] and [53].

¹⁹ See, for example, IM appeal judgment at [10] which explains that the Part 4 purpose is concerned with:
 "... promoting outcomes that are consistent with outcomes produced in competitive markets, where "competition" is defined in s 3(1) as "workable or effective competition". The outcomes are those listed in s 52A(2)(a) to (d). All this is within the broader context of promoting the long-term benefit of consumers."

²⁰ See Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007 para 87.

- (f) The Commission's position has been that where there is a trade off between dynamic efficiency and allocative efficiency it would always favour outcomes that promoted dynamic efficiency.²¹
- (g) The High Court acknowledged that it was legitimate for the Commission to place greater weight on objective (a) when choosing the 75th percentile.²² While it recommended the Commission undertake further analysis in relation to its view on asymmetric social costs, it noted that this further analysis may support the Commission's original position.²³
- (h) The Commission has now tested the High Court's concerns. We read the Commission's Draft Decision as confirming that this further analysis and evidence supports its original position that the WACC should be significantly higher than the mid-point.²⁴
8. In summary, it is not unlawful for the Commission to choose a percentile above the mid-point as a means of balancing objectives (a) and (d).
9. The F & O advice argues in the alternative that the Commission must find evidence in relation to investment behaviour, among other things, before ever adopting a percentile above the mid-point. The legal argument appears to be that the Part 4 purpose requires the Commission to treat the 50th percentile as a default position. In our view, this argument must also fail for the reasons set out in paragraph 7 above. Specifically:
- (a) If the High Court agreed that the mid-point was legally required under Part 4 (absent evidence to the contrary) it could have adopted it to address its concerns about the lack of empirical evidence supporting the 75th percentile. This was not the position taken by the High Court.
- (b) In our view, the High Court's approach reflects the Part 4 purpose, which allows the Commission to balance objectives (a) to (d) in order to meet the long-term benefit of consumers (as discussed in paragraph 7 above). There is no requirement, as a matter of law, that the mid-point should be the default position.²⁵
- (c) Again, the alternative argument in the F & O advice is an evidential rather than a legal one, where the weight of the evidence now before the Commission appears to confirm a WACC percentile significantly higher than the mid-point.

Further observations

10. It also appears to us that the legal positions adopted in the F & O advice largely depend on the NZIER reports for MEUG reflecting the correct economic position.²⁶ Our review of the evidence is that other economists take a different view to NZIER. The F & O advice's assessment of the evidence is also based on the incorrect assumption that no

²¹ For example, see where this is discussed in the Leave judgment at [14].

²² IM appeal judgment at [1482].

²³ IM appeal judgment [1486].

²⁴ See, for example, the Draft Decision at para X18, where the Commission concludes that the available provides substantial support using a WACC above the mid-point.

²⁵ To the contrary, as we explain at paragraphs 22 to 24 below, the current IM should provide the starting point where evidence is required before an amendment is made.

²⁶ See for example the F & O advice at paras 3, 25, and 35. See also para 14 where the F & O advice incorrectly states that, among other things, suppliers have not provided any empirical evidence of under-investment adversely affecting consumers.

evidence is required in support of the mid-point because it is the required default position under Part 4 (a position soundly rejected by the High Court, as discussed above).

11. We do not further consider the differences between the expert evidence for the purposes of this legal advice. We expect any areas of difference in the economic evidence will be fully analysed in submissions and expert analyses provided by interested parties. However, we make the following observations regarding some assertions made in the F&O advice:
 - (a) The F & O advice appears to conclude that a higher percentile will allow "indefinite long-term excess returns" and "a permanent extraction of excess profits". We note that the prospect of earning above normal returns is not prohibited by the Part 4 purpose (as noted at paragraph 7(d) above, the phrase "limited in their ability to extract excessive profits" was carefully chosen). However, that is not the reason for choosing a percentile above the mid-point. From reviewing the Commission's reasoning and various reports by economists, we understand that the reason for considering a percentile choice within a range is that it is not known whether the mid-point WACC will be sufficient to allow normal returns.²⁷
 - (b) As noted above, the Commission's position throughout the development of the IMs has consistently been that, when faced with a trade off, the Commission should err on the side of risking over compensation given the asymmetric social costs to consumers of under compensation over the long-term. However, whatever percentile is chosen, it will not in fact be known whether it allows under or over recovery. As noted in paragraph 6(b) above, the High Court did not dispute the legality of the Commission's approach.

Total welfare and consumer welfare approach

12. The F & O advice is based on the premise that submitters have argued the Commission should only apply a total welfare standard when selecting a percentile within the WACC range. Our understanding is that the Commission considers that both consumer welfare and total welfare standards are relevant under the Part 4 purpose, and that submitters largely agree with that approach. It appears to us that the debate is more about what each standard means, and what weight should be given to each.²⁸
13. Although it is not entirely clear what the "consumer welfare standard" supported by the F & O advice entails (other than placing a full value on wealth transfers), if it precludes giving weight to overall efficiency and / or producer welfare, then in our view it is the incorrect standard under the Part 4 purpose.
14. As noted above, the Part 4 purpose requires that the Commission promotes the long-term benefit of consumers by promoting outcomes such that objectives (a) to (d) are

²⁷ In this context, we note that there are various methods available to regulators to set a WACC. The Commission made numerous choices regarding the choice of model and parameters within the model. Among other things, the High Court suggested that the Commission should further consider whether to retain the simplified Brennan-Lally CAPM. Accordingly, at a conceptual level, we struggle with the assertion advanced by the F & O advice that the mid-point of the range produced by the Commission's WACC IM is "the" WACC that replicates workably competitive markets.

²⁸ The F & O advice states that Sapere was critical of the Commission for adopting both consumer welfare and total welfare approaches (at para 23). Our understanding is that Sapere did not argue against the use of both approaches but was concerned about the Commission's failure to set out how it weighted these approaches with reference to the Part 4 purpose. The F & O advice appears to acknowledge this at footnote 6.

met. The consumers in question are consumers in the relevant regulated market rather than all consumers in New Zealand's wider economy.²⁹

15. The new section 52A purpose built on the previous section 57E and sought to include both efficiency and distributional objectives. As explained in the Parliamentary materials, the new Part 4 purpose:³⁰

...includes both efficiency and distributional objectives to provide for an appropriate balance between the protection of consumers and that of producers and investors.
16. That is, achieving an appropriate balance between the protection of consumers and the protection of producers and investors was considered the appropriate means for promoting the long-term benefit of consumers in the relevant regulated markets, including by promoting incentives for suppliers to invest and innovate.
17. We understand from reviewing the economic evidence that both consumer welfare and total welfare standards are relevant to achieving these objectives. We have also noted advice from economists that a consumer welfare standard only could result in under-recovery (contrary to objective (a) and the overall long-term benefit of consumers).³¹
18. In our view, a consumer welfare standard cannot be the only consideration if it will not promote objectives (a) to (d) for the long-term benefit of consumers. The Commission must be able to demonstrate that it is balancing efficiency and distributional objectives in the way intended by Parliament.
19. The F & O advice cites the Court of Appeal case *Powerco v Commerce Commission* ("**Powerco**") to support its position that only a consumer welfare standard should be applied under the Part 4 purpose.³² *Powerco* was concerned with arguments regarding the applicability of net public benefit and net acquirer benefit tests under the previous Part 4 legal test for when control could be imposed. As noted above, the current Part 4 purpose was intended to, and does, embrace both efficiency and distributional objectives.
20. The F & O advice argues that the High Court stated that the *Powerco* case was still relevant and that Parliament had chosen not to adopt the net public benefit test when enacting Part 4.³³ However, neither the passages referred to in the judgment, nor the Parliamentary materials, support a consumer welfare standard only. In particular, in the passages cited from the IM appeal judgment, the High Court:
 - (a) In relation to the Part 4 purpose, cites the relevant parliamentary material for the proposition that the Part 4 purpose was intended to include both efficiency and distributional objectives to provide an appropriate balance between the protection of consumers and the protection of producers and investors.³⁴

²⁹ As defined in section 52C of the Commerce Act 1986.

³⁰ The Regulatory Impact Statement, Commerce Amendment Bill 2008 (201-1), at 20.

³¹ See for example Professor Dobbs, *Proposed amendment to the WACC percentile for the allowed rate of return: Comments on the application of the Dobb [2011] model*, 17 September 2014, at para 20, which explains the issues with using a consumer welfare standard. See also Sapare, *WACC percentile - cross submission*, 12 September 2014 at para 20.

³² *Powerco Ltd v Commerce Commission* [2008] NZCA 289.

³³ F & O advice at para 21.

³⁴ IM appeal judgment at [663].

- (b) Discusses the *Powerco* case only in the context of the history of the Part 4 purpose statement.³⁵ There, the Court of Appeal concluded that the purpose of the Act (section 1A which requires an overall efficiency-based analysis) was not appropriate for the previous section 52 test for determining control (which was concerned with acquirers). While there was separate purpose for electricity lines businesses (section 57E),³⁶ the lack of a purpose for imposing control was considered an issue.
- (c) At paragraph [222], only confirms that Part 4 is concerned with consumers in markets where this is little or no competition and, using the words of the *Powerco* case, refers to these as acquirers of goods and services in relevant markets rather than as participants in New Zealand's wider economy. As set out in (a) above, the High Court goes on to explain that Part 4 intended the long-term benefit of these consumers to be met by achieving the appropriate balance between consumers and producers and investors.

21. In summary, a consumer welfare standard only (as advocated in the F & O advice) was not endorsed by the High Court or by Parliament, and would not be consistent with achieving the balance between producer and consumer interests intended by the Part 4 purpose.

Certainty

- 22. In the context of correcting previous advice, the F & O advice argues that a potential change to the WACC IM at the next IM review negates whatever incentives to invest might lie in a higher percentile and, accordingly, the mid-point is now the most prudent choice because the evidence best supports this approach.
- 23. Again, this is an evidential rather than a legal issue. The Commission's assessment of the evidence is that it supports a percentile above the mid-point in order to reduce the risk of the WACC being set too low, given the asymmetric social costs of under-recovery (contrary to what the F& O advice suggests).
- 24. In relation to the argument that that the prospect of a further review creates uncertainty that undermines any incentives to invest, we note as follows:
 - (a) The legislative framework requires that the over-arching purpose of IMs is to promote certainty by setting out the rules that apply to regulation and, it follows, this certainty must be promoted notwithstanding the statutory power to amend and / or review an IM. As is clear from the legislative history, this certainty was intended to better promote incentives to invest.
 - (b) In our view, this requires that the IMs are consistently applied and only amended, or changed on review, where there is clear evidential support for that change. Otherwise it is difficult to see how the IMs can achieve their statutory purpose.
 - (c) To amend the current 75th percentile and adopt the mid-point against the weight of evidence accepted by the Commission would establish a precedent that the IMs may be subject to change at any time, contrary to the Part 4 purpose and the purpose of IMs.

³⁵ IM appeal judgment at [662] - [666].

³⁶ At the time, there was a separate purpose for electricity lines businesses (Part 4A), but not for imposing control.

- (d) In our view, the better position as a matter of law is that the existing percentile choice carries more weight than the mid-point, such that evidence must positively support any change.

Russell McVeagh
30 September 2014