21 March 2014

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By email

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Dear Allan

COMMERCE COMMISSION OBLIGATIONS REGARDING WACC IMs REVIEW

Introduction

1. We have been asked by Vector to review the legal opinion of Franks & Ogilvie dated 13 March 2014 ("**Franks advice**") commissioned by the Major Electricity Users Group Inc ("**MEUG**"). The Franks advice has been provided by MEUG to the Commerce Commission ("**Commission**") in response to the Commission's paper *Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies* ("**Consultation paper**"), dated 20 February 2014.

Overview

2. The Franks advice concludes that, given the circumstances outlined in the Commission's Consultation paper, a court in judicial review proceedings would "more likely than not" compel the Commission to initiate a consultation process on the WACC input methodologies ("**IMs**") "forthwith".

3. We consider this conclusion is not supported by case law, the statutory scheme or the facts. In summary, in our view:

   (a) As a starting point, and as the Franks advice accepts, the Commission has an implied and broad discretion whether or not to amend an IM in-between required IM reviews.

   (b) Contrary to the position outlined in the Franks advice, case law demonstrates that, in judicial review proceedings, courts will be reluctant to intervene where an expert body such as the Commission exercises broad judgment such as in this case (unless the decision is irrational or there was fraud, corruption, or bad faith). Indeed, the limitations of judicial review in this regard were one of the reasons merits review of IMs was introduced under Part 4 of the Commerce Act 1986 ("**Act**").

   (c) The Franks advice relies on a case where the exercise of a discretion was compelled by a court because otherwise the object and intent of the relevant enactment would have been frustrated. However, the present

statutory scheme and circumstances are clearly distinguishable from that case. Here, a decision to review the WACC IMs as part of the upcoming wider IM review is unlikely to be viewed by a court as frustrating the objects of the Act (such that the Commission would be compelled by a court to issue a notice of intention to amend the WACC IMs forthwith). Nor is there an evidential or factual basis for the position in the Frank advice that the Commission is "on notice" that the WACC IMs run counter to the purposes in the Act.

(d) Overall, there is no basis for reaching a conclusion that it would be unlawful for the Commission not to conduct an immediate review of the WACC IMs; not to do so simply is not unreasonable or irrational nor would it frustrate the purposes of the Act (such that the court would compel the Commission to start an amendment process now).

Background

4. The Consultation paper was released following comments made by the High Court in its judgment on the merits review appeals of IMs (in relation to the WACC IMs) and because some consumer groups have requested an urgent review. This is in circumstances where the High Court:

   (a) rejected the MEUG appeal and upheld the Commission's WACC IMs on the basis there was no evidence to support a lower percentile as a materially better alternative;[1]

   (b) made the following *obiter* remarks in relation to the 75th percentile:

      (i) noted that there was a lack of empirical evidence in support of the 75th percentile;[2]

      (ii) put forward a number of arguments (framed as "tentative and in principle") questioning the Commission's reasoning in support of the 75th percentile, noting that these arguments suffered from the same lack of empirical support as the Commission's approach;[3] and

      (iii) expected these issues would be addressed at the next IM review, acknowledging that further analysis may or may not support the Commission's position;[4] and

   (c) raised questions in relation to other aspects of the WACC IMs, again to be addressed at the next review.

5. The Consultation paper seeks views on whether the Commission should:

   (a) address the High Court comments when the IMs are next reviewed (option 1);

   (b) bring forward the review of the WACC IMs (no end date specified) (option 2); or

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1 *Wellington International Airport Limited v Commerce Commission* [2013] NZHC 3289 ("**MR Judgment**"), at [1483].

2 MR Judgment, at [1462].

3 MR Judgment, at [1471] - [1486].

4 MR Judgment, at [1486].

(c) consult only on the appropriate WACC percentile in order to complete the work prior to November 2014 (option 3).

The action or inaction potentially subject to judicial review

6. Currently, there has been no exercise or failure to exercise a statutory power by the Commission that could be subject to judicial review. Nor is this a situation where the Commission is failing to take any action in relation to the comments made in the High Court judgment. Rather, the Commission has initiated a consultation process to consider whether or not it should bring forward review of the WACC IMs in whole or in part. At the very least, the issues raised by the High Court will be addressed when the Commission reviews the IMs (prior to 2017).

7. We also note that the Franks advice does not support MEUG's preference for completing consultation on one aspect of the WACC IMs before November 2014. It concludes only that the Commission would likely be compelled to issue a notice of intention to amend the WACC IMs forthwith. There is no suggestion that the Commission would be compelled to undertake a shortened process within a set timeframe or consult only on one aspect of the WACC IMs.

Statutory context

8. Subpart 3 of Part 4 of the Act sets out a framework for the determination and review of IMs where the Commission must, among other things:

(a) set the first IMs for services regulated under subparts 9 to 11 of the Act by December 2010 (in relation to the relevant matters set out in s 52T) following a prescribed consultation process;[5] and

(b) review each IM no later than 7 years after the publication date.

9. There is no express power to amend an IM between reviews. This power is, however, implicitly recognised in s 52X, which provides that if the Commission proposes to amend an IM by making a material change it must follow the consultation process in s 52V.

10. The Commission's discretion to amend IMs (or to not amend IMs) is both implied and broad, the only constraints on that discretion being the purposes of Part 4 and the IMs.[6] The Act does not prescribe any conditions precedent for the exercise of its discretion to amend IMs.

11. Further, the overall scheme of the Act does not, in our view, envisage frequent or urgent change to the IMs between the required reviews. For instance:

(a) as noted above, when reviewing (or materially amending) IMs, the Commission must follow consultation requirements which, practically, mean that the timeframes for amending or reviewing an IM can be extensive;

(b) the IMs must be published and are then subject to merits review appeal (and possibly further appeal);[7]

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5 Section 52U. The regulated services being electricity distribution services, Transpower, gas pipeline services and airports.

6 Sections 52A and 52R.

7 Section 52Z.

(c) the Commission is required only to review IMs every seven years;[8]

(d) a price-quality path cannot be reopened because IMs are amended or reviewed (notwithstanding the Commission may have been satisfied that the amended IM better met the Part 4 purpose and / or that the previous IM did not meet the Part 4 purpose);[9] and

(e) more generally, constant change to the IMs would appear to run contrary to the statutory scheme and the certainty objective in s 52R.

12. We note that the courts have considered certainty in the context of the Part 4 scheme, finding that IMs are not the only mechanism for achieving certainty under the Act and that certainty is intended to develop over time.[10] These comments appear to suggest that a decision to review the WACC IMs as part of the IMs review (and to consider any new information at that time) would not necessarily be viewed by a court as frustrating the purposes or scheme of Part 4.

Case law demonstrates that courts are reluctant to review the exercise of a discretion by an expert body

13. The decision whether or not to review or amend the WACC IMs is an exercise of discretion by the Commission and involves the exercise of judgement by what is an expert body. Case law demonstrates that courts are reluctant in judicial review proceedings to intervene in such circumstances. Indeed, this was a key reason for introducing merits review in Part 4.[11]

14. The Supreme Court's decision in *Unison Networks* provides a relevant example of the courts' likely approach. In that case, Unison challenged regulatory threshold decisions made by the Commerce Commission in relation to electricity distribution companies under the old Part 4A of the Act. Unison argued that the Commission had failed to exercise its power to set thresholds in accordance with the purpose and requirements of the Act. The Supreme Court noted:[12]

> Often, as in this case, a public body, with expertise in the subject matter, is given a broadly expressed power that is designed to achieve economic objectives which are themselves expansively expressed. In such instances Parliament generally 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.

15. The decision whether or not to amend or review the WACC IMs is a regulatory decision made by a public body with expertise in the matter, under a broad

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8 Section 52Y.

9 Section 53ZB(1).

10 *Commerce Commission v Vector Ltd* [2012] 2 NZLR 525 (CA), at [60].

11 As noted in the Explanatory Note to the Commerce Amendment Bill (201-1), one of the problems with Part 4A was the that the accountability regime for the Commission (primarily judicial review) was limited (at p 3); also see Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007, at [46] - [48].

12 *Unison Networks Limited v Commerce Commission* [2008] 1 NZLR 42 (SC), at [55].

power designed to achieve expansive economic objectives. In these circumstances, and applying *Unison Networks*, the courts will not intervene unless the Commission shows bad faith, materially misapplies the law, or breaches the statutory purpose.

16. These restricted review grounds reflect the courts' long-held position that the greater the policy content of a decision, the less disposed the court will be to entertain an application for judicial review.[13]

Case law relied on in Franks advice does not support position

17. The Franks advice states that, while the Commission is not under any a duty or obligation to initiate an amendment process, there is a "body of precedent" which empowers the courts to enforce the application of statutory powers "in a manner consistent with the purpose of the empowering Act".

18. On the basis of this "body of precedent", the Franks advice opines:

    (a) "there are strong arguments that the Commission is duty bound to issue a notice of intention to amend or review the cost of capital IMs forthwith;"[14]

    (b) "a court would not accept a situation in which the Commission failed to do all that is reasonably practical to remedy a misdirected methodology after it is effectively 'on notice' of provisions that run counter to a purpose of the Act;"[15] and

    (c) given the statutory purposes and circumstances it is "more likely than not that a court would hold the Commission to be under a compelling duty to use the prescribed processes of consultation with a view to amendment."[16]

19. In our view, the position set out in the Franks advice misstates the relevant case law, statutory framework and factual circumstances. At best, and as explained below, where there is a broad statutory discretion, the courts would only imply a duty to act where the failure to act would frustrate the objects of the Act.

20. Given the statutory scheme in Part 4 and the relevant facts, the current circumstances fall well short of meeting this high threshold. Further, as stated above, in judicial review proceedings a court will be reluctant to intervene with the exercise of judgement by an expert body.

21. The Franks advice relies on the case of *Padfield* in support of its conclusions.[17] However, this case is clearly distinguishable from the current situation. *Padfield* concerned a detailed statutory complaints process and the failure by a Minister to refer a complaint for investigation. While the relevant Minister had a discretion whether to refer a complaint to an investigatory committee, the failure to refer a genuine and substantial complaint was viewed as frustrating the very intent and purpose of the complaints procedure.

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13 *CREEDNZ Inc v Governor-General* [1981] 1 NZLR 172 (CA), at 197 and 198.
14 Franks advice, at para 3.
15 Franks advice, at para 15.
16 Franks advice, at para 2.
17 Franks advice, paras 9 and 10, citing *Padfield v Minister of Agriculture, Fisheries and Food* [1968] AC 997 (HL).

22. Here, and in contrast to the position in *Padfield*, a decision to amend an IM as part of the wider and upcoming review is unlikely to be viewed by a court as defeating the scheme or objects of the Act (such that the Commission would be compelled to take action). To the contrary, as explained in paragraph 11 above, the statutory framework envisages that the IMs will not be reviewed frequently and / or on an urgent basis.

23. Turning to the factual circumstances in this case, in our view:

    (a) The remarks by the High Court do not put the Commission on notice that the WACC IMs are contrary to the Part 4 purpose such that immediate action is required. Rather, as noted above, questions were raised by the Court on a tentative basis, the expectation being that these issues would be fully and properly considered at the next IM review.

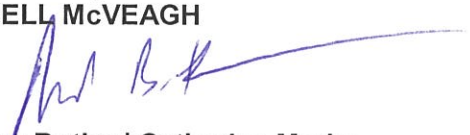
    (b) The comments in the Franks advice in relation to increased uncertainty do not appear to be supported by evidence, nor do they reflect the intent of statutory scheme (as explained above). We also note that a number of submitters are of the view that a short or selective consultation on the WACC IM would increase uncertainty.

24. Finally, we note that the cases (other than *Padfield*) referred to in the Franks advice appear to support a position that a court would not compel the Commission to initiate a consultation process immediately.[18] Further, the barriers to a court granting relief cited in the Franks advice (as not applying) do in fact apply in these circumstances.[19]

Conclusion

25. In our view, the Franks advice conclusion - that a court would be more likely than not to compel the Commission to start an amendment process now - is not supported by the case law, statutory scheme or circumstances. In our view a review of the WACC IMs, other than immediately, is unlikely to be viewed by a court as unreasonable or irrational or as frustrating the purposes of the Act such that a court in judicial review proceedings would intervene.

Yours faithfully
RUSSELL McVEAGH



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[18] For example, *Julius v Lord Bishop of Oxford* [1880] UKHL 1 (23 March 1880) states that, for the Court to require a public power to be exercised, there must be legislative definition of the conditions upon which that power ought to be exercised. The power in question here has no conditions outlining when it is to be exercised.

[19] See Franks advice, at para 17. For example: (i) to the extent any "duty" exists, here it is clearly permissive and not mandatory; (ii) another legal remedy (merits review) would arguably equally address MEUG's underlying complaint - indeed, MEUG is currently using this alternative process.