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New Zealand's 'Light-Handed' Approach to Utility Regulation

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AFTER enjoying considerable prosperity in the early post-war decades, based on high commodity prices and favourable access to the British market, New Zealand suffered major economic reversals in the 1970s. Britain's entry into the European Community, and massive increases in oil prices, undermined the country's competitive advantage. Its traditional reliance on a narrow range of commodity exports and a single overseas market cost it dearly. Rather than adjusting to these international changes, successive governments opted to continue with policies, originally conceived in the Depression years of the 1930s, designed to insulate New Zealand industry from its competitors. These interventionist policies culminated in heavy government borrowing to finance the 'Think Big' energy projects of the 1980s. During this period New Zealand's relative standard of living dropped markedly. In 1950, its GDP per capita was 26 per cent above the OECD average; 40 years later it had dropped to 27 per cent below the average.

Economic Liberalisation in the 1980s

Although hesitant and piecemeal reforms were initiated in the late 1970s, New Zealand was ripe for a more radical approach. This came with the new Labour government in July 1984 which, in the short space of three years, introduced a series of far-reaching reforms affecting commerce, government, and the relationship between the two. These reforms continued at a slower rate under subsequent governments.

Several factors influenced the economic liberalisation policies adopted and the way they were implemented. First, it was widely agreed that a change in the business environment was essential to improve economic performance, even though it was recognised that this could be costly in terms of business failures and lost jobs. Second, government economic advisers, particularly those in the Treasury, had formulated a coherent view about the way to carry out reform. This view incorporated theories relating to contestable markets, principal-agent relationships, the economic role of government, and the regulation of industry (The Treasury, 1984). Third, the cohesive political structure in New Zealand, and in particular a very strong ex-

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ecutive government, allowed a relatively small number of political leaders to carry through the reform process relatively unimpeded.

As a result, the economic reforms were consistent, wide-ranging, and introduced very quickly. The majority of those reforms which impinged on the business sector were implemented in the period 1984-89 — a very short period by international standards, although some reforms, such as import liberalisation, were phased in gradually. Apart from this, little attention was paid to minimising transition costs; to sorting out sequencing issues (though reforms within some sectors reveal a sequenced series of decisions, as for example in the corporatisation and privatisation of government trading departments); or to compensating the losers from the reforms. This 'big bang' approach was seen as the only way to carry through the reforms within an acceptable time: it avoided possible constraints imposed by the three-year electoral cycle, and undercut opposition from special interest groups by introducing changes that affected all areas.

The basic thrust of the reform program was to free the market mechanism so that resource allocation would be guided by price and profit signals which were not distorted by controls and subsidies. The emphasis was on allowing the forces of enterprise and self-interest to generate efficiency and economic growth; concern about distributional equity was correspondingly reduced. Government intervention in the economy was rolled back by putting its trading activities (including utilities) on a commercial footing, exposing them to competition, and in some cases privatising them.

The pace of reform was constrained only by the rate at which officials could formulate the necessary policies. Few sectors were left untouched. An early focus was the financial sector. Interest-rate controls and nearly all regulations on banks and other financial institutions were removed, as were foreign-exchange controls. Monetary policy was to have the single aim of lowering inflation (a goal later enshrined in the Reserve Bank Act 1989), and the fiscal deficit was to be reduced, implying a redirection of stabilisation policy away from the immediate goal of full employment. The floating of the dollar in March 1985 led it to appreciate under the influence of high interest rates (caused by the budget deficit and a tight monetary policy), which initially hurt the profitability of exporting industries. The pace of import liberalisation was accelerated: licences were phased out in favour of tariffs, which were reduced according to a timetable. The faster implementation of Closer Economic Relations with Australia added to import competition. The extensive system of subsidies to the agricultural sector was abolished almost overnight in 1984, and price controls were eliminated (except for three items) by 1987. Plans were established for the deregulation of many industries, ranging from eggs to cement and real-estate services, and the lifting of controls on road and rail freight was completed.

To underpin the newly deregulated economy, a heavily amended and more strongly competition-focused Commerce Act was enacted in 1986. But significant labour market reform had to wait for a change of government. The Employment

Contracts Act 1991 introduced a more flexible, decentralised approach to labour relations and reduced the role of trade unions in wage bargaining.[1]

In addition to promoting private-sector reform, the government itself restructured the core departments of the public service. This, together with tight control of labour costs, resulted ultimately in a significant reduction in expenditure. On the revenue side, the tax base was broadened with the introduction of the goods and services tax and the closure of loopholes, allowing the top rate of income tax to be halved. When economic growth resumed in mid-1992, rising income combined with tight control of expenditure produced the first budget surpluses in many years. The Fiscal Responsibility Act 1994 now requires the government to focus on debt reduction by running surpluses (Scott, 1995).

Competition Policy

The strengthening of competition policy through the Commerce Act 1986 was seen as an integral part of these reforms. The Act is closely modelled on Australia's Trade Practices Act 1974, which draws heavily on United States anti-trust concepts and principles, and the Commerce Commission has a similar role, and similar objectives and powers, to the Australia's Trade Practices Commission. Both Acts are designed to promote competition on three fronts: by ensuring that competition is not artificially constrained through restrictive practices; by screening mergers and takeovers to prevent the acquisition or strengthening of an undesirable degree of market power; and to deter firms in a dominant position in a market from using that position to lessen competition. In New Zealand the Act was seen as necessary to deter the possible spread of restrictive practices and mergers by firms wishing to reduce competition in the newly deregulated marketplace, and to provide the basis of the 'light-handed' regulation of corporatised and privatised utilities with market power.

However, the New Zealand regulatory regime departs from the Australian in eight principal ways:

1. The Commerce Act has *wide and general application*; almost no trading activity (whether private or public) is exempted. New Zealand has no equivalent of the Australian States, and hence avoids the constitutional questions raised by State versus federal jurisdiction.

2. *All public sector activity*, whether conducted by central or local government, falls within the scope of the Commerce Act to the extent that the bodies concerned are 'in trade'. There are no significant exemptions other than the labour market and offshore activities, such as shipping.

[1] For an early appraisal of the rationale for, and the impact of, the reforms see Bollard & Buckle (1987).

3. The Commerce Act is *broad spectrum*, covering all industries in the same way. There are no major industry-specific regulators such as Austel, and only a very few remaining areas of statutory monopoly, such as New Zealand Post in letters and some of the export-marketing boards.

4. *Specific trade practices*, such as price discrimination, secondary boycotts and exclusive dealing arrangements, are not generally singled out for particular prohibition. Rather, most are dealt with on the basis of their ultimate competitive effects.

5. The Commerce Act has *a higher threshold of anti-competitiveness* in assessing mergers or takeovers, namely, whether a dominant position will be acquired or strengthened. The current Australian test is a 'substantial lessening of competition'.

6. There is a reliance (under a 1990 amendment) on voluntary notification of mergers, rather than mandatory pre-notification.

7. The Commerce Act ensures a clear separation between the Commerce Commission and the political and executive arms of government, allowing it independence in its competition-enforcement activities.

8. The Commerce Act relies on court-based dispute resolution of competition issues, and incorporates private rights of action and appeal.

As legal standards have evolved, the Act (in authorisation cases) focuses attention on efficiency issues (Pickford, 1993). In *Tru Tone Ltd v Festival Records*[2] the Court of Appeal stated that the Act 'is based on the premise that society's resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources'. Early concerns with distributional matters have faded. It has been accepted after much vigorous debate in court cases, Ministry of Commerce discussion papers, and elsewhere, that the Act adopts no distributional standard: it does not specifically favour the rights of any particular group of people, such as consumers disadvantaged by monopoly pricing. This stance presumably rests on the assumption that distributional goals are more effectively achieved through efficiently targeted welfare policies.

Reform of Public Sector Enterprises

In the early 1980s the Treasury estimated that public sector enterprises in New Zealand accounted for about 12 per cent of GDP, and for some 20 per cent of investment in the economy. Since they often produced inputs used by firms in the private sector, their efficiency, price-setting and investment behaviour had a major

[2] 2 NZLR [1988] 352-64.

impact on the economy. However, their performance was judged to have been poor for several reasons: a lack of clear, non-conflicting objectives; an operating environment free of competition; inadequate monitoring of performance; lack of accountability; and political interference. From 1985 government policy aimed to improve efficiency by putting the operations of state trading operations on a commercial basis through corporatisation, privatisation and the introduction of competition.

Under the State-Owned Enterprises Act 1986 the major government trading departments were corporatised on 1 April 1987, from which time they were required to operate as profitable and successful businesses, comparable with their private sector counterparts. Goods and services were to be marketed on a user-pays basis unless an explicit subsidy was provided to finance non-commercial activities. Regulatory barriers were dismantled, thereby exposing the new corporations to private sector competition, and other forms of special assistance, such as subsidised government loans, were removed. Taxes and dividends had to be paid to the government. In short, 'competitive neutrality' was to apply. Monitoring of performance was enhanced by the establishment of measurable targets based on profitability (although asset values were hard to assess) as set out in corporate plans, and backed by new information systems. Departmental organisation was replaced by a company (limited liability) structure, with the government as sole shareholder. Managers were given greater independence in decision-making, but were accountable to boards of directors appointed from the private sector, and ultimately to Parliament through the Minister of Finance and the responsible minister. Decision-making in state-owned enterprises (SOEs) was thus removed from direct political interference.

Although these reforms represented major progress, it was argued that certain problems remained with the SOE model (New Zealand Business Roundtable, 1988). Since the ownership rights in SOEs are diverse and cannot be transferred (ownership being vested in the Crown), managers lack the incentives to perform normally provided through the share market. They face no threat of takeover, and the monitoring of performance by shareholders and investment analysts is attenuated (the free-rider problem). In addition, the incentives provided by the possibility of bankruptcy are regarded as minimal because of an implicit government guarantee. By reducing risk, this may distort the cost of capital in a downwards direction. Finally, some claim that SOE decision-making is subject to residual government interference since the directors are political appointees and an annual statement of 'corporate intent' has to be approved by the government. Moreover, interest groups may pressure the government to hold inquiries into particular management decisions, as happened with the pricing of the Electricity Corporation (ECNZ) and New Zealand Post's rural mail charges in the early 1990s. Such considerations provide the justification for privatising the SOEs, as has happened in several cases, including Telecom and New Zealand Rail.[3] Competition and other concerns have

[3] However, SOEs are typically large and complex organisations, which would tend to make them more resistant to takeover and bankruptcy, and more difficult for the capital market to monitor because of

hindered moves to privatise other major utilities such as ECNZ, CoalCorp and Television New Zealand.

The radical changes in the role of the New Zealand government in trading activities in the economy are summarised in Figure 1.

Figure 1

The changing role of government in trading activities in New Zealand

	Provision of funds	Ownership	Provision of services	Regulation
Pre-1984	Direct funding by Parliamentary vote	Widespread public ownership	Widespread public provision with little or no private involvement	Many statutory monopolies; price, import, and entry controls
Post-1984	Only for public-goods areas and social obligations	Corporatisation under state ownership; some privatisation	User charges, contracting out, private sector crowd-in	Commerce Act, information disclosure, competition

A Regulatory Framework for Utilities

Regulation of utilities (primarily found in communications, energy and transport) poses more complex problems than the regulation either of non-utility SOEs or (generally) of private sector firms through competition policy. This is because utilities, particularly those in the energy sector, have intrinsic features that, by resulting in small numbers of industry participants and by raising significant barriers to entry and exit, serve to attenuate competition. These features include: substantial economies of scale, sometimes to the point of natural monopoly (e.g. high voltage electricity transmission lines, local telephone loops); economies of scope (e.g. in the provision of different telecommunication services); and large, lumpy, immobile investments in sunk assets (e.g. natural-gas production facilities and distribution pipelines; railway networks). Further regulatory problems are raised by the fact that networks and plants (e.g. hydro-electric dams) typically have low marginal costs of

information asymmetries and possible managerial opportunism. Thus privatisation may not be able to solve all of the incentive problems posed by large, complex SOEs. For an agency-cost analysis, see Farrar & McCabe (1995).

expanding output up to full capacity, but high fixed costs associated with that capacity; by the potential for substantial externalities, especially environmental (e.g. coal mining, power stations); and, in some cases, by inelastic demand curves (e.g. for electricity because of appliance ownership), which raise the gains from the exercise of market power.

Left to themselves, such industries may generate significant resource misallocation and inefficiency from their monopoly pricing and other behaviour. At the other extreme, direct regulation imposed by a regulatory commission is likely to bring its own inefficiencies. These include: the costs of the regulatory body; the 'paper burden' or information supply costs imposed on the regulated firm, and the scope for it to engage in 'opportunistic' behaviour; the compliance costs arising from imperfect regulation; the losses associated with the possible corruption of the system through 'regulatory capture'; and dynamic losses associated with the control by regulators of industry structure and conduct, which may inhibit new entry, competition, and innovation. The design of a regulatory regime must therefore weigh up the potential costs and benefits involved.

New Zealand's approach to utility regulation, which charts a middle course, has been more innovative than most. Dubbed 'light-handed' regulation, it comprises a mix of the following eight elements, not all of which are used in any particular industry:

1. A reduction or elimination of statutory barriers to entry, so as to encourage the entry of new competitors, as has happened in the case of telecommunications, television broadcasting, and domestic airlines. All of these industries were formerly state-owned statutory monopolies.

2. A separation of the core natural-monopoly network from the more contestable parts of the industry, and the encouragement of competition in the latter. This is happening in electricity generation, where the transmission network has been hived off as a separate business in public ownership.

3. In cases where there has been no such separation,[4] incumbents who refuse to provide access to natural-monopoly facilities on reasonable terms risk breaching s.36 of the Commerce Act (based on s.46 of Australia's Trade Practices Act), which can carry with it punitive damages.

4. The imposition of information disclosure regimes on operators of natural monopolies in telecommunications, electricity, and postal services (and soon gas) in order to facilitate private (including capital market) monitoring of behaviour, and hence action under the Commerce Act (Ministry of Commerce, 1995).

[4] Examples include the major gas and telecommunication utilities, which were sold complete with networks. While there may be efficiency reasons for this integration, it has complicated the entry conditions for potential new competitors (see below).

Such regimes could also improve the bargaining position of new entrants in contestable markets and allow public pressure to be placed on poorly performing monopolists. In the same vein, full accounting ring-fencing is required of electricity distributors who also operate as retailers (the same is soon to be required of gas distributors).

5. The encouragement of competition from substitute goods or from new technologies. Industries that historically have been the preserve of regulated monopolists, such as long-distance transport (New Zealand Rail) and parcel post (New Zealand Post), have experienced intense competition from road freight and courier services respectively. In telecommunications, technological advances in cellular, radio and satellite-based technologies are undermining the advantages of network ownership, while in electricity retailing the sharp fall in the price of metering is expected to increase the number of electricity users having the option of switching between retailers.

6. Some of the privatised companies, including Air New Zealand, Telecom, and electricity supply companies have certain, well-defined, operating obligations (e.g. safety requirements) imposed upon them. Others are required to meet social obligations agreed with the government. For example, New Zealand Post's obligations include six-day delivery and a universal service requirement, for which it is compensated by the imposition of a price floor of 80 cents on the carriage of ordinary letters (under 200 grams) by rival firms, which are not then able to compete with Post's lower price. In some cases the government has retained a 'Kiwi share' to prevent changes to the Articles of Association (e.g. to maintain a 65 per cent domestic ownership of Air New Zealand to allow the government to negotiate international bilateral access agreements).

7. A recent development (announced in June 1995) is the breaking up of the state-owned ECNZ, which is dominant in the electricity generation market, into two separate generating companies, which are expected to begin trading in February 1996. Although this should promote competition, it might threaten the savings achieved through the coordination of generation from ECNZ's 39 hydro and thermal power plants.

8. If all else fails, there is the threat of direct intervention to induce firms with natural-monopoly characteristics to act within competitive bounds. The Commerce Commission can recommend to the government that it impose price control. In addition, there have been specific warnings of direct regulation for particular industries. However, the government has shown no desire to reintroduce such controls in the newly deregulated environment.

These elements of regulation have been widely applied to utilities throughout the communications, energy and transport sectors (including the ports and airports).

Although the emphasis is on admitting and encouraging competition wherever possible, New Zealand's policy of light-handed regulation clearly does not mean zero regulation, as has sometimes been asserted.

Regulatory Issues to Date

The utilities, whether privatised or not, are subject to the same constraints on behaviour under the Commerce Act as other businesses. So far the Commerce Commission has had to resolve three main competition issues involving utilities: mergers and takeovers; the price and other terms of access to facilities; and complaints of monopoly pricing. As an example, in the local markets for the supply and distribution of electricity, the Commission has received a number of complaints alleging inability by one company to gain access to another's network, usually because of onerous terms and conditions in the 'use of system' agreements. These include: refusal to negotiate; the demanding of unreasonable reconciliation costs; and the locking in of large customers through high line charges coupled with low unit energy charges. The Commission has taken the view that such difficulties can often be resolved by negotiation and by further refinement to access agreements during the 'shakedown' period of industry adjustment to developing competition, but that persistently anti-competitive behaviour (whether by a network owner towards an entrant seeking access or by arrangements between an incumbent supplier and downstream buyers) may have to be taken to court.

The Commission's general approach has been:

- To give industries a breathing space after deregulation to sort out their own approach to appropriate industry structure and conduct, rather than to try to impose any 'optimal' arrangement upon them; and in the meantime to 'educate' participants on the reach of the Act.

- To monitor merger activity, and give clearance to those mergers that do not raise competitive concerns, in terms of s.66(3)(a) of the Commerce Act. Where dominance is acquired or strengthened in a market, the merger may be authorised under s.67(3)(b) only where the detriments from loss of competition are outweighed by public benefits (such as efficiency gains).

- To monitor closely the contractual arrangements for access being negotiated between would-be users and the owners of telecommunications, electricity and gas networks and other natural-monopoly facilities, and to consider guidelines for what might constitute predatory behaviour in this area.

- To undertake active investigations in markets where competition has been slow to emerge or where anti-competitive behaviour appears to be a problem.

- To take court action where it sees anti-competitive agreements among firms or the misuse of a dominant position.

Competition disputes arising either from the enforcement activities of the Commission or from grievances of private parties are resolved in the courts. Three types of legal approach have recently been used in New Zealand courts, depending upon whether the dominant firm faces rivals (e.g. Telecom, electricity supply companies) or not (e.g. operators of ports and airports). Recent litigation involving the latter has revolved around judicial review and the principle of prime necessity. Judicial review has also been used where the monopolist derives its power to operate a facility from statute. The doctrine of prime necessity imposes upon a monopolist who owns an essential facility a common-law duty to supply at a reasonable price. For example, New Zealand Rail used the doctrine as an argument against the Port of Marlborough company examining its revenue as a means of fixing the port's charges.

Finally, s.36 of the Commerce Act may be employed against a dominant firm, but only when there is a *purpose* to restrict competition. Section 36 prohibits dominant firms from using a dominant position for the purpose of restricting entry into a market, preventing competitive conduct in a market, or eliminating a firm from a market. However, this does not prohibit the dominant firm from using its market power for purposes other than anti-competitive ones. For instance, the charging of a 'monopoly' price in itself is not prohibited, although the inference is that monopoly profits should be competed away where entry is possible.

Access, particularly in telecommunications, has attracted the most attention, and may become the benchmark by which the light-handed policy is judged. The Baumol-Willig rule (Baumol & Sidak, 1994), which states that monopolists are entitled to provide services to new competitors at the price which they would charge themselves, has been sanctioned by the Privy Council (1994).[5] But as the rule is likely to preserve any monopoly profits that might be earned by the incumbent, pricing performance may not be immediately improved, unless there is scope for the entrant to bypass the incumbent's network. Moreover, the price that the entrant can charge for its part of the service provided is limited, because of competition, to the variable costs saved by the incumbent through not providing that element. No scope is left for the entrant to recoup its own overhead costs, unless it is more efficient. While hindering competition, this is a necessary requirement for the promotion of static production efficiency in the industry as a whole.

In other words, the encouragement of competition from new entry may itself be distortionary in circumstances where a single, natural-monopoly supplier producing efficiently would minimise the cost of producing the output. For example, efficient bypass in electricity distribution may be viable only where the incumbent sets a line charge that is inflated by over-valued assets or inefficiencies (or contains an element of monopoly rent). In some cases the exposure of incumbents to the threat of competition could make them improve their efficiency (and reduce monopoly

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[5] There have been numerous reviews of the litigation between Telecom and Clear Communications (the entrant) concerning the latter's efforts to gain access to Telecom's network. See, for example, Ross (1995) and van Roy (1995).

prices), without actual entry taking place. Increasing the contestability of markets would then have served its purpose. Alternatively, the promotion of inefficient entry through the adoption of other pricing rules could conceivably still be socially beneficial overall if the resulting inefficiencies were more than offset by dynamic gains from the introduction of competition in the market.

Summary and Evaluation

In New Zealand the corporatisation of government trading activities (including utilities) into state-owned enterprises had the goal of putting their operations into a corporate framework with commercial objectives, and in the same competitive environment as that faced by companies in the private sector. Statutory entry barriers were dismantled, information disclosure was introduced, access to networks was required, competition was encouraged, and the new enterprises were subject to the prohibitions of the Commerce Act. Key features of New Zealand's competition law are the narrow focus on a single, well-defined objective — the promotion of competition as a means of increasing efficiency, with efficiency over-riding competition where the two conflict — and a broad scope, which extends to almost all 'in-trade' activities (this contrasts with the Australian predilection for special industry treatment, as noted in the CER Services Accord of 1988). Consistent application of the Act across industries is encouraged by having a single body responsible for enforcement. This also reduces the likelihood of the regulator becoming captured by a specific industry, allows policy in one industry to be informed by experience in another, and is much cheaper.

The success of light-handed regulation has to be gauged against the probability that natural monopoly is more widespread in New Zealand, where markets are typically small, than in larger countries. Nonetheless, the policy has made inroads into areas of monopoly power in a relatively short time, and from a former status quo of government ownership and heavy regulation. For example, New Zealand Rail's freight rates reportedly fell by 50 per cent in real terms between 1983 and 1991 (Duncan & Bollard, 1992:129), while over the period 1987-94 Telecom reduced the price in real terms of a basket of residential telephone services by 45 per cent (Kerr, 1994). However, three general issues continue to cause concern: monopoly pricing; discriminatory and anti-competitive pricing; and the terms and conditions of access to natural monopoly facilities. Light-handed regulation clearly has not eliminated — and is not likely to eliminate — all monopoly distortions in the economy. Time is required for the approach to show its worth, and the costs and benefits associated with it have to be compared with those of other regulatory options available, rather than with 'first-best' outcomes in an ideal world.

Critics have argued that the law is too comfortable for incumbents and too challenging for new entrants. An incumbent monopolist has an incentive to delay entry in order to preserve profits, and little to lose save the consequences of a renewal of direct regulation, which it could always circumvent by a last-minute change of heart. On the other hand, a potential entrant may have an incentive to refuse reasonable offers while continuing to play the role of disadvantaged underdog, in

the hope of securing more favourable terms through direct government intervention. A number of interests, both potential entrants and customers of incumbents, have intensified lobbying for stronger s.36 penalties and for legally binding arbitration in disputes between owners of networks and potential entrants. Arbitration proposals have been criticised as likely to distort investment decisions since investors may not know in advance whether, and under what terms, they may be required to share the use of their assets with others.

New Zealand's policy is an innovative one and has attracted much international attention. But the policy is relatively new. The reality of market entry, technical change and the development of new contractual arrangements between firms suggests dynamic markets with unpredictable long-term outcomes. Hence, the success of the policy may be judged only by a comparison with alternatives on a long-term basis.

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