Application of Cost-Benefit Analysis Under Competition Law: the gas enquiry

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Overview

1. Cost Benefit Analysis
2. The Issue Posed
3. The Characteristics of Gas in NZ
4. Approach: The Draft
5. Approach: Final
6. Matters Arising
7. Is Regulation Debatable?
Preliminaries

Cost benefit analysis is a decision aid: in evaluating the merits of a policy/decision, quantification complements qualitative analysis.

Objective of social cost benefit analysis is to weigh up costs and benefits using the common metric:

- Total (consumer plus producer) surplus valued at social costs/prices
- It is the efficiencies test
- Different weightings of gainers and losers may apply if incidence can be identified and if germane, particularly in the absence of tax/social welfare/direct provision programmes
- In competition law and regulation under the Commerce Act total surplus is a justifiable criterion
Static efficiency CBA is present value of total (consumer plus producer) surplus ignoring investment, and usually risk management, processes.

Dynamic efficiency CBA: the present value of total surplus recognising investment and risk management processes.

Static is abstract and normative: dynamic seeks to be more positive and about process.

CBA for decision-making is forward looking: goal is to estimate the expected net benefit (efficiency) of a decision at the time the decision is taken.

- The past is only informative to the extent it allows future outcomes and behaviour to be estimated.
- Uncertainty is a key element: CBA should economically deal with risk and inform on risk of potential outcomes and ramifications.
CBA has a long history on public policy analysis

Commerce Commission has generally

- sought to calculate the benefits of a “factual” (e.g. regulation, or merged entity) relative to a “counterfactual” (less regulation, or no merger)
- Used total surplus CBA in investigations of mergers and contracts
- In regulation it has sought to evaluate “control” (or more regulation) versus “no control” (status quo) in its inquiries, and employed a different criterion: counting transfers as a benefit.

CBA

- Requires precise specification the factual and counterfactual: factors that are the same under both the factual and counterfactual play a minor role in the analysis
Overview of Commerce Commission Approach to Regulation

Basic framework applied to Airports, Gas Pipelines and (potentially) Electricity Lines Businesses

Factual: price control (in gas pipelines two, five year price paths)

Counterfactual: status quo of light-handed regulation + information disclosure

Commission’s benefits of control (relative to counterfactual):

• Reduced excess profits and dead-weight-losses
• Reduced productive inefficiency
• Reduced dynamic inefficiency

Commission’s costs of control:

• Failure to achieve benefits of control (excess profit and deadweight-loss reduction)
• Reduced productive efficiency
• Reduced dynamic efficiency
The Question(s) Posed In the Gas Inquiry

1. The terms of reference required the Commission to consider whether gas transmission and/or gas distribution systems should be controlled, i.e., assess
   – Whether competition is limited or likely to be lessened
   – Control is necessary or desirable in the interests of persons who acquire or supply the goods or services in the affected market or markets.

2. The Minister also requested the Commission’s advice on ‘the methodology that the Commission considers appropriate for valuation of pipeline assets’, ‘the net benefits to the public of control’ and ‘any other matter that the Commission may think relevant to a decision on whether control should be introduced’.
Commerce Act Part 4 Inquiry

• “Is it necessary or desirable in the interests of acquirers, consumers or producers, for control to be imposed?

• The overarching purpose of the Act the “long term benefit of consumers” suggests that dynamic rather than static approach is relevant, even for the “benefits to acquirers”

• *The Commission’s interpretation:* the transfer of ‘excess profits’ from producers to acquirers is a benefit – under a public benefits test the transfer is welfare neutral and produces no benefit (except where these are ‘functionless’ profits that flow to foreigners)
  – general approach to competition law has been the Public Benefits Test
  – general approach to regulation has been to factor in Net Public Benefits to Acquirers

• *The interpretation* cannot be justified by assessment of incidence, by guidance of criteria in the Act, and given the Commission’s calculation of excess profits it cannot be justified by dynamic performance, or by mimicking a competitive market

• The Act is consistent with seeking to mimic a competitive market: ie allow rents to function
Background: Relevant Characteristics of Gas Pipelines in NZ

• The demand for gas pipelines is derived from the demand (and supply) for gas: anything that affects the supply/demand for gas affects the demand for pipelines.

• Demand by households
  – is very small in NZ relative to, gas used in industry, and situation in other countries
  – Is subject to electricity competition

• There is no actual or implied statutory requirement to supply: i.e. to supply is a commercial decision

• Pipeline businesses are: capital intensive, have sunk long lived capital, face considerable uncertainty

• The NZ gas market is tiny by any yardstick, has great uncertainty about future supplies, has no spot market in gas, and prospects for a thick spot market are remote.
The Approach: the Draft Decision

• Little weight was placed on interfuel competition and so advancement to the next step of price control appraisal

• The benefits and cost of control were then considered by checking out
  – benefits to acquirers, and
  – public net benefits test

• By
  – estimating net benefits by comparing a “factual” of price control to a counterfactual of no price control
Desirable Approach

1. The net benefit analysis should compare the factual (price control under the Commission’s nomenclature) and the counterfactual

2. The costs and benefits of price control should be assessed looking forward from the date of price control implementation 2005:

3. The (unadjusted) past cannot tell us about the factual vs counterfactual because behaviour is different between the alternative regimes. “Excess” profits should only be assessed in the context of the factual vs the counterfactual

4. Assess risk and expected outcomes by using
   i) historical information on variability in such factors as operating costs, demand and customer numbers,
   ii) anticipated structural changes in the economic environment,
   iii) assumptions on behavioural effects of regulation - estimate the range of potential outcomes

5. Calculate the range and likelihood of net benefits arising from price control.
The Draft Decision

- The price control used in the factual was different from that proposed as policy by the Commission.
- Focused heavily on static “excess” profits at the expense of assessing the investment effects on net benefits.
- Did not seriously incorporate risk (including regulatory) or variability.
- Made limited behavioural and regulatory cost adjustments between the factual and counterfactual.
- Made a certain mistakes in the implementation of the conceptual approach advocated in calculating “excess” profits: e.g. treatment of acquisitions.
Risk Not Treated

Capacity Determined by Historical Maximum Throughput
Implies (partial) Costly Stranding Almost Surely

NGC Gate Station Gas Flows
Importance of the Right Regulatory Process I
Stranding is Normal for Most Networks

- The ODV/ODRC regulatory scheme benchmark
- ODV/ORC
  - is wise after the event
    - looking backwards in time almost always less than actual capital is “needed”, and
    - “needed” capital can be very different from efficient capital.
  - Some allowance for unused but potentially useable capital must be made if a firm is to breakeven on participation in the regulatory scheme
  - typically understates capital unless an adjustment is made to the rate of return
  - Does not allow for (economies of scale in investment) investment in advance

- Studies such as this (and other profit studies that say NPV looking back should = 0) ignore the stranding issue and thus understate capital/the rate of return required and thereby overstate excess profits and ignore company responses
Importance of the Right Regulatory Process II

Competition with Electricity: Small Gas Consumers

• Background: ODV/ODRC regulatory scheme, all houses have electricity

• The rate base to which the regulatory rate of return is applied is

\[ ODV = \min (ODRC, EV) \]

where \( EV \) = (present) value of the cost-saving in delivering energy because the pipeline network is in place and where the alternative need not actually be in place.

• This implies that if there is actual or (potential) cheaper cost in delivering energy by an electricity network: the pipes will be excluded from the rate base

• Thus for a given spark gap a) where there is excess capacity in the electricity network local pipes have no value, and b) where electricity network expansion is cheaper, or occurs for other reasons, investment in pipes can be stranded

• Conclusion: investment in pipes to small demanders must be severely curtailed and stranding enhanced by this form of regulation
Importance of the Right Regulatory Process III
Tax Calculation

- The conceptual approach of the draft was to set up pipeline businesses with capital given by ODV and prices such that expected net present value of these businesses was zero on a post tax basis.

- In implementation, tax was based upon acquisition values of assets acquired, not the regulatory ODV values.

- This had the effect of setting lower prices than the Commission had conceptually argued were appropriate for assessing excess profits.

- The effect was to bias upwards the assessment of excess profits and thereby the bias upwards the transfers attributed to regulation that were ultimately taken as a benefit.
Tests Applied in the Draft I

• In implementing the *public benefits* test the rule was invoked that
  • transfers among NZ public did not produce net benefits: only increases in the size of the pie were net benefits, but
  • Transfers from (to) foreign owners were benefits (costs) and reached the view that foreign-owned firms should be regulated more tightly than domestically held firms

• On the basis of this outcome the Commission concluded that the public benefits test was not appropriate and so chose as its criterion benefits to acquirers

• There was no detailed analysis presented of the legal or economic basis of the tests applied
Tests Applied in the Draft II

- Do not mimic a competitive market or sit easily with the High Court (in the Amps A Decision).

- Do not place weight on the role of expected profits for investment, efficiency gains and market participation.

- Would under the (draft) public benefit test consistently imply foreign firm discrimination in competition law and by extension contract law.
Draft Conclusion

• *Positive Acquirer’s Benefit from Control*
  NGC (transmission and distribution), Powerco, Wanganui Gas and Vector

• *Positive Net Public Benefit from Control*
  NGC transmission and distribution (because it was foreign owned)

• *Negative Net Public Benefit from Control*
  Vector, Powerco and Wanganui Gas

The Commission considered that if companies under price control reduced investment that other firms would fill the gap: implying it acceptable for regulation to *substantially lessen* competition
Cost Benefit Analysis can take some Account of Volatility, Risk and Investment

- Charles River Associates (CRA) developed a simple dynamic model (based upon standard methodology) that
  - enabled a forward-looking cost-benefit analysis from 2005
  - incorporated risk (and so provided a range of outcomes and their likelihood)
  - permitted the correct regulatory factual to be analysed
  - enabled investment effects to be incorporated explicitly
  - Did not incorporate the stranding problem

- CRA Applied the Model to NGC Distribution
  - Assumed that the Commission’s (largest) WACC (1% lower than NGC’s publicly stated hurdle rate) would lower investment by 50%
  - Found
    - 80% likelihood that Economic Profit would be negative
    - 98% likelihood that Net Acquirer’s Benefit would be negative (average -$2.1m)
    - 100% likelihood that Net Public Benefits would be negative (average -$3.7m)
The Final Report

• **Made a Number of Changes**
  – Changed its present value calculation
  – No longer treated transfers from foreigners as a benefit to the public

• **Retained**
  – A different regulatory factual from that posed as possible
  – Did not consider risk in any detail: either that faced by the companies or regulatory risk
  – A very low WACC (outcome hugely affected by WACC)
  – A low investment cost of regulation although changed from a one-off 0.5% reduction in (2004) quantity to a 0.25% per annum reduction
  – Tax using acquisition values

• **Introduced**
  A measure: the net public benefit lost per $ transferred
The Final Report Concluded

• Positive Net Acquirer’s Benefit of regulating all pipeline providers

• Negative Net Public Benefit of regulating all pipeline providers

• The efficiency costs of regulating NGC and Wanganui Gas were too high to warrant imposing control relative to the transfers that consumers would get (>30c per $1 transferred)

• The efficiency costs of regulating Powerco and Vector were worth imposing control relative to the transfers that consumers would get (only 17 and 9c per $1 transferred respectively)

Bottom Line the Commission argued that a (thresholds) regulatory regime should be considered for all pipeline businesses. The thresholds regime is a significant step in regulation
Matters Arising

• A net-benefit analysis of a regulatory scheme that mimics the proposed regulatory scheme was not done

• No evidence of incidence of transfers were provided and no evidence of any social benefit in its benefits to acquirers test were provided.

• It was found that imposing price control, even on its assumptions of negligible quality and investment effects, would reduce net public benefits (e.g. reduce economic growth)

• Price control was recommended
Process

- A regulatory body was chosen to do the analysis
- It posed price control as the null hypothesis
- It went beyond (on its own analysis) mimicking a competitive market creating stiff hurdles for the alternative hypothesis
- Dynamic economic performance (growth) received low ranking in the analysis and recommendations
Monopolisation: Evolving Trends

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Presented at the Conference on Recent Issues in Competition Law and Regulation Wellington, March 2006
Section 36, Commerce Act 1986

No person with a **substantial degree of market power** may **take advantage of** that power (in that or any other market) for the **purpose of** --

- Restricting entry
- Preventing or deterring competition
- Eliminating a competitor
Outline

1. The nature of rules (and what history may tell us)

2. Five approaches to monopoly
   - Counterfactual analysis
   - The purpose exception
   - Conduct which is materially facilitated by market power
   - Predatory pricing
   - Business justification
The Nature of Rules (and what the History of Antitrust may tell us)

General Rules

Grinnell Corp

Two elements to unlawful monopolisation under section 2, Sherman Act:

1. Possession of monopoly power; and

2. Willful acquisition or maintenance of that power as distinguished from growth or development of a superior product, business acumen or historic accident
Specific Rules
Two key examples

Predatory Pricing: Brooke Group
1. Prices below a relevant measure of cost of production; and
2. Reasonable prospect (or dangerous probability) of recoupment of investment in below cost prices.

Essential Facilities: MCI
1. Control by a monopolist of an essential facility;
2. Competitor is unable practically or reasonably to duplicate the facility;
3. Unjustified denial of access to the facility; and
4. Grant of access is feasible
Five Possible Approaches in New Zealand Setting

1. Counterfactual analysis
2. Purpose exception
3. Conduct materially facilitated by market power
4. Price predation
5. Business justification
Sources of Law

“Take advantage” and “use” elements did not come into alignment until 2001

No real difference:
Queensland Wire
Melway
Cf: Commentary to the Commerce Bill 2001
Boral

NZ legal developments have followed Australian precedent. In particular:
Telecom/Clear - influence of Queensland Wire
Carter Holt Harvey - influence of Boral
The Counterfactual Question

Has the monopolist acted in the same way that it would have, had the market been (hypothetically) competitive?
Approach to the Counterfactual Discussion

1. Problems with counterfactuals

2. Three case studies

3. The would/could aside
Problems with Counterfactuals

Cogency

*Port Nelson*

*Melway*

Formulation

*NT Power* (FCAFC)

Cf other counterfactual assumptions (sections 27 and 47)
Three Case Studies

1. Queensland Wire

2. Melway

3. NT Power
Melway

- Automotive parts
- Bookshop
- Service stations
- Office stationery

Wholesale

Retail

Automotive parts
Bookshop
Service stations
Office stationery
## NT Power

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The Would/Could Aside

**Would**
Queensland Wire (Mason CJ and Wilson J)
Telecom/Clear
Melway
Carter Holt Harvey
NT Power
Safeway

**Could**
Queensland Wire (Dawson J)
Melway
Rural Press
“Would” = Prevalent NZ Position

Telecom/Clear and Carter Holt Harvey

Does the Difference Matter?

“Could” may be narrower

But a rational conduct inquiry is likely to apply the same way under both approaches
The Purpose Exception

Foundation Case
Queensland Wire (Deane J)

Alternate Recognition
NT Power

Dangers with Purpose
Telecom/Clear
Melway
Boral
Carter Holt Harvey

Narrow Rule
Confined to circumstances where the competitor will be totally deprived from competing?
Conduct Materially Facilitated by Market Power

The conclusion in Queensland Wire that BHP’s refusal to supply Y-bar was made possible by the absence of competitive conditions:

“does not exclude the possibility that, in a given case, it may be proper to conclude that a firm is taking advantage of market power where it does something that is materially facilitated by the existence of the power, even though it may not have been absolutely impossible without the power.”
Subsequent Cases

*Safeway*

*Rural Press*

Problems and Application

Unclear formulation and uncertain open-endedness

Consistency with application of counterfactual analysis

Likely prevalence of counterfactual analysis
Predatory Pricing

Specific rule; general rule; or a mixture?

*Boral*

*Carter Holt Harvey*
Business Justification

Alternative Use of Justifications

1. Purpose (*Queensland Wire* and *Melway*)
2. Defence (*Telecom/Clear* and *Melway* (FCAFC))
3. Element of counterfactual (*Carter Holt Harvey*)

Defence application unlikely

Subset of counterfactual analysis means it is not a stand-alone test
Concluding Position

In reality there are likely to be just three (and not five) approaches to the characterization question:

Material facilitation and business justification are unlikely to result in stand-alone formulations
Concluding Position cont

Three key propositions emerge

1. Counterfactual analysis will operate as an all-purpose general rule

2. Purpose exception may emerge as a stand-alone rule in exceptional cases - but even then it is likely to be subservient to the counterfactual rule

3. Price predation is the one specific rule formulation to emerge (but it is coupled with counterfactual analysis).
Institutional Arrangements for Welfare-Enhancing Anti-trust and Price Regulation

Prepared for a Conference on Recent Issues in Competition Law and Regulation: ISCR 31 March 2006

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Outline

• Goals and criteria for assessment
• Institutional structures for regulatory agencies
• Costs and benefits of the integrated agency model
• Role of judicial review
• The practice of Regulatory conferences
• Summary of problems and solutions
• Conclusion.
The Goal

• Processes for assessing anti-trust and regulatory issues that result in the highest probability of decisions that facilitate social welfare enhancement and do not result in reductions in social welfare.

• Combination of structure, process and incentives
Normative Criteria

Normative criteria for evaluating anti-trust and regulatory institutions:
• independence—accountability
• expertise—detachment
• transparency—confidentiality
• administrative efficiency—due process
• predictability—flexibility

(Trebilcock and Iacobucci 2002)
Agency Models

• **Bifurcated agency model.** Specialized enforcement agencies must bring formal complaints before separate, specialized adjudicative agencies.

• **Bifurcated judicial model.** Specialized and separate investigative and enforcement authorities must bring formal complaints before the courts and seek remedial relief therefrom.

• **Integrated agency model.** A single agency undertakes investigative, enforcement, and adjudicative functions.
Integrated Agency Model

• A single agency undertakes investigative, enforcement, and adjudicative functions.

• Examples:
  • FTC in the US.
  • Competition Directorate-General of the EU.
  • Securities Commissions
  • NZ Commerce Commission
Integrated Agency Model

• Claimed advantages
  • Higher levels of expertise since agency staff and commissioners work day-to-day in all aspects of competition law (under bifurcated agency model, adjudicators may see few cases).
  • With multi-member commissions, there is more accountability, consistency, and continuity of decision-making.
  • Faster decisions at lower resource cost
Integrated Agency Model

- Disadvantages
  - Procedural presumption for the case put by the Agency, and thus lack of independence in decision-making
  - The power of the agency to determine outcomes without the scrutiny of an adversarial process
  - Importance depends on the presence or absence of a right of appeal.
Procedural Rules and Credibility

• Procedural requirements reflect the pursuit of credibility.
• Credibility is critical if regulation is to be welfare enhancing:
  – In the absence of credible regulation, private investors require higher rates of return, and will favour investment in generic rather than specific assets.
Requirements for regulatory credibility

• Credibility is enhanced where
  – Process provides for scrutiny of the views of all interested parties, including a rigorous analysis of the views of the Commission staff,
  – The decision-makers are independent of the parties, and
  – The decision-makers are not easily influenced by the legislators
Requirements for regulatory credibility #2

• Credibility is also enhanced by strong incentives for regulators to make quality decisions
  – Loss of professional integrity with poor decisions (people with substantial reputational capital make the best regulators)
  – Impairment of future career prospects with poor decisions, and
  – Right of appeal on “merit” as well as on “law”
Regulatory Conferences

- Conferences are designed to provide a forum for stakeholders to participate and to increase the credibility of regulation.
- Regulated firms, entrants and interest groups play two important roles:
  - Provide regulator with information about the state of the world
  - Provide regulator with information about interest groups’ preferences
Conferences: The theory

• Conferences are not adversarial – no cross examination.
• Representatives of interested parties may be heard at the conference.
• The conference discusses the draft determination or issues paper of the Commission.
• Commissioners use the information from the conference to inform their decision.
Consultation not Examination

• Conferences are consultation processes that start with a presumption for the case put by the Commission.
• The conferences discuss the submissions of the parties but provide no direct examination of the Draft Determination.
  – The process is designed to find weaknesses in (reasons to dismiss) the submissions, not to provide a rigorous assessment of the Draft Determination.
Problems with Consultation Process

• Information flow is one-way and neither the Commissioners nor the parties can ask questions of the authors of the Draft Determination.

• The Commissioners are asked to assess their own work. Can they?
Decision Making

“It is too much to expect men of ordinary character and competence to be able to judge impartially in cases that they are responsible for having instituted in the first place.”

Judge Richard Posner
Decision Making

“It strains credibility to believe that Commissioners, who have authorized the prosecution of a case that may cost the agency (and hence taxpayers) substantial sums, will at the end of the process conclude that a mistake was made and that the respondent committed no wrong.”

Terry Calvani, former FTC Commissioner
Absence of Cross-Examination

• Designed to reduce the time and expense associated with conferences?

• In the absence of cross-examination is it possible for the conference to
  – Elicit all relevant information needed to make the welfare-maximising decision? and
  – Provide incentives to make the welfare-maximising decision?
Example

• Boyle, Evans and Guthrie (2006) raise questions about many aspects of the work on which the Commission has relied for recent decisions about the cost of capital for firms in industries subject to regulation.
  – These concerns seem sufficient to warrant consideration of an appeal against Commission decisions, if there were an appeal process.
Asymmetric Cross-Examination

- Conference proceedings are adversarial: cross-examination is in fact allowed.
  - Commission experts and staff undertake extensive cross-examination of parties.
  - Normally do so without reference to the constraints that would apply to cross-examination in a court.

- This asymmetry in rights of cross-examination serves to limit the influence of stakeholders.
  - Consistent with consultation rather than examination.
Independent Experts

• Commission views independent experts as speaking on behalf of parties.
  – No consideration of the qualifications of individuals to act as an expert.
  – Views experts as having less weight than non-expert testimony provided by third parties.

• Consistent with a process designed to consult stakeholders rather than a process designed to maximise scrutiny of the draft determination.
Judicial Review

• Legislation requires substantial interpretation
  – Regulators have wide discretion
• Legislative review will rarely be case-specific, so legislative review is rare.
  – Leaves regulators with wide discretion on individual cases.
• Judicial review puts substantial limits on the discretion available to the regulator in individual cases (Spiller 1997).
Judicial Review

• In New Zealand: “merit” and “law” for the Commerce Act (except electricity and price control provisions) but not for decisions under industry specific regulation:
  – Appeals under the Telecommunications Act and under Electricity Industry price controls are provided only on matters of law.

• In the US: merit and law for decisions of all administrative and regulatory agencies (Spiller 1997).
Judicial Review

• Where the threat of judicial review is largely absent, regulatory credibility requires that much greater emphasis be placed on the process, especially the quality of governance and the transparency and independence of decision processes.

• Judicial review improves credibility even where the Commissioners are independent
  – Tests the quality of the Commissioners’ analysis.
Judicial Review

• Governance = the design of institutions that induce or force management to internalize the welfare of stakeholders (Tirole 2001)
  – A right of appeal to the courts is an effective means of providing governance without costly multiple layers of regulators.
Summary of the Problems #1

- Commission processes amount to consultation rather than examination.
- This:
  Imposes a very high standard of proof on any party opposed to a draft determination.
  Results in too little direct scrutiny of the Commission’s case and its experts.
Summary of the Problems #2

- In the absence of judicial review, the Commission lacks incentives to set appropriate standards of proof for its own case.

- There is under current processes, too high a probability of false positive determinations or recommendations to regulate.
Normative Criteria Again

- Independence: Y - accountability: N
- Expertise: Y - detachment: N
- Transparency: Y - confidentiality: Y
- Administrative efficiency: Y
- Due process: N
- Predictability: Y - flexibility: Y
Two Possible Solutions

• Bifurcated agency model
  • Staff present and defend their report
  • Commissioners write the decision themselves.

• Appeal to the High Court on merit as well as law.
Costs and Benefits

• Some resource cost associated with these solutions.
  – But what is the cost of making decisions that are not optimal?

• Appeals are costly,
  – But because they are costly and since their primary role is to create incentives they are rarely used (as practice in Canada, Australia and EU demonstrates).
Conclusion

Overall, appeals to the High Court may be the most cost effective solution:

• Avoids costly changes to current Commission structure and aligns regulation with anti-trust processes.

• Provides incentives that may remove the need for appeal in most cases.
  – Might also lead to changes in Commission processes at regulatory hearings without making these significantly more costly.

• Reduces the chance of false positive recommendations to regulate.
Notes

1. Disclosure of potential conflicts: Neil Quigley has appeared at a number of regulatory conferences as an expert for Telecom NZ, and has engaged with the Commerce Commission as an expert adviser to several other parties.

2. I thank several participants in the ISCR Workshop on Regulatory Theory and Practice 22 March 2005 and others for helpful comments on an earlier draft. To avoid damage to any of their careers, I have agreed not to name them individually.
Notes and references

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