Regulation

Where are we going?

Prepared for the Institute of Directors (Wellington Branch)

Breakfast address: 11 October 2007

Lewis Evans

School of Economics and Finance, Victoria University
NZ Institute for the Study of Competition and Regulation
Outline

- General comment on regulation
- A quick stock take of New Zealand’s state of play
- Where to from here?
Regulation and Economic Planning

• Regulation seeks and enforces specific outcomes

• Heavy regulation beyond contract and competition law moves towards central planning

• The debate about de-centralised vs centralised administration of an economy
  – was over in the 1950/60s (most economists thought) and
  – evidence for the de-centralised approach were the revelations following Perestroika, and the performance of de-regulated “western” economies from the 1970s
**Competition is a major argument for a de-centralised economic system**

- Competitive tensions induce variety in new products and ways of doing things

- Competitive tensions arise in different markets
  - Goods and services market
  - Ownership market
  - Labour including managerial market, and
  - Debt market

- Enhances dynamic efficiency (real economic growth), providing the (legal) rules of the game
  - Permit property rights: leading to rewards and accountability, and
  - Have certainty attached to them
Reason to Regulate: *First Principles*

- externalities: e.g. issues to do with public goods and the environment
- getting better performance where firms have market power
- addressing hidden information problems

**OECD:** but only if regulation can improve performance
Reason to Regulate: Second Principles
The Supply and Demand of Regulation arising from the State’s ability to coerce

Regulators have their own interests
Ensure affected parties are “optimally disgruntled”

Political Interests
Special interest groups
Regulated Companies

Consumers/investors: where do they fit in?
OECD: regulatory arrangements - political independence
Third Principle
A neglected element of regulatory design

(less) Competence /
Corruption = M + D - A

Monopoly     Discretion     Accountability
How is New Zealand Regulating?

Differently from OECD Principles, the UK and Australia

• Regulation is typically not devolved to independent institutions (employment arrangements/political connection) e.g.
  – Telecommunications (period of appt.):
  – Electricity Commission (institutional location)

• The objective of institutions is not at all clear e.g.
  – Roading (Is a cost-benefit analysis OK for Transit analysis?)
  – Electricity Commission (both Regulator and Service Provider)
How is New Zealand Regulating?

• Limiting competition: e.g. health, insurance, education

• Extending regulation to activities that don’t “need” it: e.g. cooperative lines Co’s, state-owned entities without a profit max objective (Transpower)

• Extending the scope of regulation: e.g. the Commission extending Part IV of the Commerce Act beyond mimicking a competitive market by regulating for transfers even between firms

• Limiting the accountability of regulatory bodies vs the approach of Australia, UK and the USA that enable merit reviews.
How is New Zealand Regulating? Electricity Lines

• The Commission set price/quality thresholds that must be breached

• On breach, the Commission could choose to control: it has assessed price control for Unison, and Vector.

• In evaluating control it suggested that it would set prices according to ODV regulation. The idea is that the prices would be those of an efficient replacement firm (entrant).
Commission’s Evaluations of Regulation Have not Been Good Practice

• ODV is a hypothetical model and its prices were not checked for reality. Prices have failed the cash flow test.

• Issues (e.g. tax/asset purchases) inserted into its hypothetical model set prices below what any standalone efficient entrant could possibly charge

• In various of its analyses it has,
  – virtually ignored the risk that ODV regulation implies for the firm (some change in 2007):
  – Placed no weight on uncertainty in the estimates of ODV;
  – insisted on a wacc with errors;
  – would not evaluate forward-looking decisions using a proper, standard, investment tool;
  – confused discounting the future with compounding the past;
  – etc
How is New Zealand Regulating?

Lines Companies

• Unison and the Commission reached a settlement that was not the Commission’s suggested regulatory approach:

  • Vector settlement unknown?

Regulatory implementation Issues Arise Elsewhere

  e.g. in telecommunications
  in RMA decision-making
  in the presentation of data (OECD league tables)
How is New Zealand Regulating?
Investment has been affected

- Access, and *ex post*, regulation in telecommunications
- Transpower has (legitimately) complained of this effect of ODV regulation
- The *threat* of *takings* associated with scooping off “functional profits” is sufficient to reduce investment
  - Demonstrated in forestry
  - Demonstrated in cash flow analysis of lines companies
  - Demonstrated in cost-benefit analysis of gas regulation
Where To From Here?

• The review of part IV of the Commerce Act has been stimulated in large part by the interpretations and process of the Commission

• Some proposals for change lack recognition that the form of regulation and the inputs to regulation are jointly determined and cannot be assigned to separate layers of administration;

• Some officials seem to want “The Minister” involved in price setting;

• A limited merit review arrangement is a debated possibility.
More Generally

The (OECD) process for regulation on first principles seems in abeyance

Competition rather than central planning is desirable

Merit review processes for many regulatory institutions would be desirable