

Agenda

Advancing economics in business

Out of the dark: the role of information disclosure regulation in New Zealand

New Zealand was among the first countries to implement wide-ranging microeconomic reforms to improve the performance of infrastructure-intensive industries, and light-handed regulation was chosen as the preferred regulatory tool. Although other forms of economic regulation now exist, light-handed regulation is still important. Tobias Maugg, economist at the Commerce Commission, New Zealand’s main economic regulator and competition agency, explains how this form of regulation is used in airports and electricity distribution networks

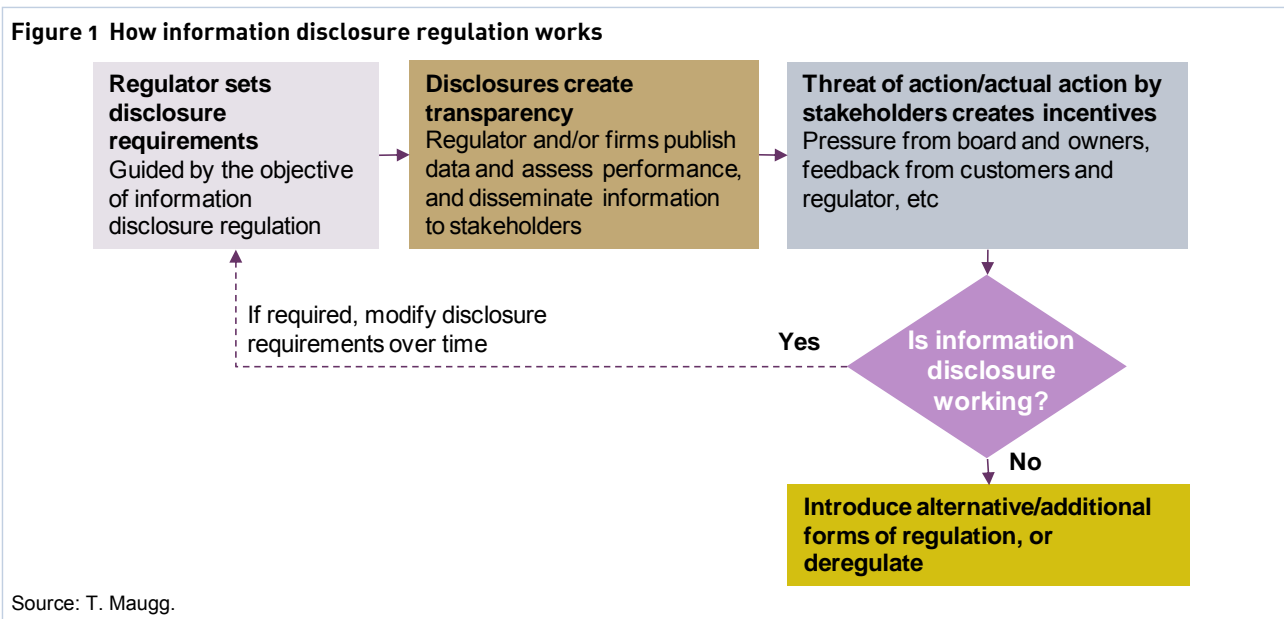
Louis Brandeis’s statement ‘sunlight is said to be the best of disinfectants’ captures the essence of public disclosure of information.¹ Under freedom of information legislation, public bodies are required to publish data in order to promote transparency and accountability. Governments run open data projects to disseminate information, expecting (among other benefits) that public scrutiny will incentivise better performance.²

Similarly, the core of information disclosure regulation (also often described as light-handed regulation) is the public disclosure of firms’ information that can be used to assess their performance, which in turn has flow-on effects through various mechanisms on the actual

performance of regulated firms. The figure below illustrates how information disclosure regulation works.

Stakeholders (owners, boards, the regulator, customers, investors, etc) use the disclosed information in their various roles to influence the performance of the regulated firm. There are many mechanisms through which information disclosure may incentivise a firm to improve its performance, including the following.

- Revealed poor or undesirable performance may damage the reputation of the firm, resulting in the loss of customer goodwill in other markets in which the firm operates, for example.



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- In situations where customers are also shareholders of the firm, the firm's incentives may already be broadly aligned with its owners' incentives. Some additional transparency may be all that is needed to ensure that the firm acts in the interests of its customers.
- The requirement to develop systems and information for regulatory purposes may address a lack of data that a firm needs to manage its assets effectively. Overcoming information asymmetry is often considered the key issue in regulation. However, more fundamentally, in the absence of competitive pressure, firms might not produce all relevant data, and the regulator may have to deal with a lack of information first.

Views on what 'good performance' looks like can vary between stakeholders, such as between shareholders and customers. Regulators typically provide structure to the performance discussion by publishing comparisons with relevant benchmarks.

The wider context for a light-handed regulatory regime will also influence performance, including in the following ways.

- The threat of further regulation will affect a firm's behaviour, as it is likely that a firm will prefer light-handed regulation to more intrusive and costly forms of regulation. The incentive strength depends on factors such as the credibility of the threat, and how costly the firm expects the additional regulation to be compared with the benefit of temporarily keeping the gains from using its market power.³
- Generic competition law applies to all firms in the economy. Firms that are subject to information disclosure are also likely to have market power. They are likely to be aware of the competition law, which may act as a deterrent to overstepping boundaries. The extent to which this occurs depends on the specifics of the law and its ability to deal with the issues that may arise in a sector.
- Other forms of regulation are likely to interact with the light-handed regime (eg, safety regulation/standards, or self-regulation through industry bodies).

Light-handed regulation is used in a number of jurisdictions. Before I turn to how information disclosure applies to electricity distribution and airports in New Zealand, I will give three examples to illustrate how light-handed regulatory regimes may or may not work.

The light-handed regulation of German electricity networks was considered unsuccessful.⁴ When the German electricity sector was liberalised in 1998,

the vertically integrated distribution and transmission networks (and generation and retail) were subject to light-handed regulation, involving self-imposed rules agreed between industry participants, and ex post interventions by the Cartel Office if third-party network access issues arose. Ex ante incentive regulation of price and quality was introduced in 2009.

Light-handed regulation in the Dutch drinking water sector appears to be working effectively. The publicly owned drinking water companies in the Netherlands have been subject to light-handed regulation since 1997. The regime requires the companies to participate in a performance benchmarking exercise, with public scrutiny of the results. A 2010 study assessed the performance of the Dutch water sector, and concluded that, in the right political and institutional context, 'sunshine regulation' can be an effective tool to ensure that public services are efficient and profitable.⁵

Recent assessments of Australian airports have revealed different views on whether light-handed regulation works. Most of the major Australian airports are subject only to light-handed regulation (mainly price and quality monitoring). As part of an inquiry by the Australian Productivity Commission, the regulator submitted that 'facilitation of commercial negotiations' should be introduced to deal with the exercise of market power in the sector.⁶ In its final report, the Productivity Commission concluded that the light-handed regime appeared to be working, and noted that nobody had requested a return to regulatory price-setting (given past experience with the costs of price regulation that applied up to 2002).⁷

From early microeconomic reforms to regulation under Part 4

In the 1980s and 1990s, New Zealand policy-makers were among the first to embrace neo-liberalism, resulting in liberalisation and ownership reforms in a number of sectors.⁸ Light-handed regulation was the preferred regulatory tool for those sectors that became subject to economic regulation (energy distribution and transmission, telecommunications, and airports). This preference was the result of concerns that more heavy-handed forms of regulation would be too costly in a small country with a relatively large number of firms.

Regulation under the Commerce Act was overhauled in 2008 with amendments to Part 4 of the Act, which provides for a range of regulatory tools. In addition to light-handed regulation, price-quality regulation and negotiate/arbitrate regulation can be applied. Factors that contributed to the shift in policy away from relying on only light-handed regulation were the perceived ineffectiveness of the regime and the regulatory uncertainty that the previous regime created.

Economic regulation under the Commerce Act, Part 4

The main aim of Part 4 is for businesses to:

- innovate and undertake the right level of investment, at the right time;
- use resources efficiently;
- earn reasonable returns;
- provide goods and services that consumers want, at the quality they demand.

These broad, interlinked objectives are reflected in the Part 4 purpose statement.⁹

Part 4 addresses various concerns in the New Zealand regulatory policy environment, including:

- the cost of price-quality regulation, which is addressed by ‘default/customised’ price paths. By ‘default’, businesses are under a price cap with an industry-wide X factor, similar in spirit to yardstick competition. Businesses that find that a default price path does not suit them can apply for a ‘customised’ price path. The regime is intended to keep the overall cost of regulation down (compared with price controls common in other jurisdictions that involve detailed proposals and assessments for every firm);
- regulatory certainty, which is addressed by ‘input methodologies’—ie, certain rules and processes (asset valuation, cost of capital and cost allocation) that the Commission has to set upfront, and which it and the businesses have to apply under the different forms of regulation;
- processes and criteria for deciding whether new services should be subject to regulation under the Commerce Act. Any sector is potentially subject to economic regulation, but the threshold for introducing regulation is high. After a Commission inquiry that includes assessing the expected net benefit of regulation, the relevant Minister makes a decision on whether to regulate.

Of the 29 regional electricity distribution services, 17 are subject to both information disclosure and price-quality regulation, as are the national electricity transmission service, the five regional gas distribution services and the two gas transmission services.¹⁰ The three major international airports and 12 consumer-owned electricity distribution services are subject to information disclosure regulation only. Although economic regulation under Part 4 began only in 2008, these sectors were subject to some form of regulation before then. (Electricity networks had been under information disclosure regulation since 1994, and airports and gas pipeline services since 1997. After 2005, some gas pipelines were also price-controlled.)

Information disclosure regulation under Part 4

The purpose of information disclosure is directly linked to the Part 4 purpose—ie, it ensures that sufficient information is readily available to stakeholders to assess whether the purpose of Part 4 is being met.

The role of information disclosure regulation is twofold:

- information disclosure is recognised as a form of regulation in its own right (similar to the figure above). Information disclosure regulation works partly by just making data available for stakeholders, which they can use in assessments relevant to them. There is also an important role for the Commission in undertaking and publishing summary assessments, which makes the information more accessible to stakeholders;¹¹
- information disclosure complements other forms of regulation (where it applies). It provides a set of standardised regulatory accounts and non-financial information that the Commission can use as part of price-quality regulation. The information also allows the Commission to evaluate the effectiveness of the regime, which helps in assessing whether further regulation may be required (as seen in the discussion on airports below) and to refine the approach to regulation over time.

The input methodologies provide a standard set of rules and processes that apply under both information disclosure and price-quality regulation. This reduces the cost of regulation, as it limits the duplication of resources by businesses and the Commission.

Businesses that are subject to information disclosure regulation only do not have to use input methodologies in determining their revenue requirements, but they have to apply them in preparing their annual regulatory accounts. If a business uses assumptions that differ from those in the input methodologies, it has to explain the reasons for this in its annual disclosure.

Different regulation due to different ownership structures

There are 29 electricity distributors, 12 of which are subject only to information disclosure regulation (ie, they are ‘exempt’ from price-quality regulation). Two-thirds of customers are served by the five largest distributors, and the distributors are very diverse (eg, the smallest business has fewer than 5,000 customers, and the largest over 500,000). Electricity distributors use a range of ownership and governance models, including community trusts, community co-operatives, private ownership (some businesses are listed), public ownership by local government, and combinations of different models.

The 12 exempt distributors are not subject to price-quality regulation because the government considered that, given their ownership structure, the interests of businesses and owners were likely to be aligned. Together, they serve around 20% of the 2m New Zealand electricity users. The exemption was based on five criteria, including ownership (the business has to be a consumer or community trust) and size (it needs to have fewer than 150,000 customers). An exempt distributor can also lose its exempt status, for example if consumers ask the Commission to put it under price-quality regulation.¹²

Future debates are likely to focus on whether there are some ownership models that serve customers better than others. The industry provides for an interesting natural experiment: only 12 of the 17 community/consumer trust-owned businesses are exempt from price-quality regulation. It will be interesting to assess whether the five businesses that are also under price-quality regulation will perform differently from those subject to information disclosure regulation only.

Information disclosure regulation for airports

The three international airports regulated under Part 4 are Auckland, Wellington and Christchurch. In 2011, Auckland had 12.9m, Christchurch 5.8m and Wellington 5.1m passenger movements. As they operate under a dual-till system, only their aeronautical services are subject to regulation. The non-aeronautical services provided by airports (eg, duty free, catering and car parking) are subject to generic competition law, although there are provisions in the legislation to extend the scope of services subject to regulation.¹³

When setting their prices, which typically occurs every five years, airports have to consult their major customers (ie, the major airlines), but ultimately they can set service terms and prices as they see fit (as set out in the Airports Authorities Act 1966). Airlines may have some negotiation power and the aeronautical and non-aeronautical services are complementary in demand—so, as higher landing or take-off charges reduce the number of passengers, demand for and revenue from other services such as car parking will fall. It is therefore possible that an airport's ability and incentive to exercise its market power would be more limited and constrained than with other sectors.¹⁴

The threat of further regulation, or the possibility of deregulation, is written into the legislation. After an airport sets new prices for its regulated services (in or after 2012), the Commission has to advise the Ministers of Commerce and Transport as to how

effectively information disclosure regulation is promoting the purpose of Part 4.

Wellington Airport was the first to set its prices, in early 2012. The Commission has started the consultation process for its report to the Ministers, who will decide whether further (or no) regulation is needed.¹⁵

As the regime has been operating only since 2011, comparisons between actual performance before and after introducing regulation under Part 4 would be relatively limited. The analysis is likely to focus on the process used in developing the pricing assumptions, and on assessing forecasts used to develop revenue requirements.

The future of information disclosure regulation in New Zealand

Light-handed regulation is no longer the only tool in the New Zealand regulatory toolkit. However, information disclosure regulation remains important, both in its own right and together with other forms of economic regulation.

There are other current examples of information disclosure regulation in New Zealand.

- As of 2012, the Commission is responsible for monitoring the farm-gate milk price in the dairy sector. New Zealand is one of the largest milk exporters in the world. Fonterra Limited New Zealand, a cooperative owned by 10,500 farmer shareholders, buys and processes about 90% of the New Zealand raw milk supply. Fonterra must provide access to 600m litres (around 4% of its milk production) to independent milk processors in New Zealand.
- The government is investing NZ\$1.35 billion over the next ten years to build an ultrafast broadband fibre network in New Zealand.¹⁶ The Commission collects and monitors certain financial and non-financial information from the infrastructure providers.¹⁷
- As part of its recent investigation into international freight services, the New Zealand Productivity Commission identified the importance of information for making better decisions. It recommended that ports should regularly publish economic value-added analyses for their operations, and the Ministry of Transport should regularly publish comparative assessments of performance.

The Part 4 regulatory regime is still relatively young and not all the rules and processes of the regime have been fully settled. Businesses are currently challenging

in court some of the Commission's decisions (for example, some of the input methodologies).

The regulatory regime now has to be allowed to bed down and mature to promote the purpose of economic regulation under Part 4. The information that the

Commission is collecting and publishing will play a key role in understanding whether the regime is achieving its objectives.

Tobias Maugg

¹ Brandeis, L.D. (1914), *Other People's Money: and How The Bankers Use It*, chapter 5: 'What Publicity Can Do'.

² Examples of open data projects are those run by the UK (www.data.gov.uk) and US (www.data.gov) governments.

³ Glazer, A. and McMillan, H. (1992), 'Pricing by the Firm under Regulatory Threat', *The Quarterly Journal of Economics*, **107**:3, pp. 1089–99.

⁴ Kuhlmann, A. and Vogelsang, I. (2005), 'The German Electricity Sector – Finally on the Move?', CESifo DICE Report, Ifo Institute for Economic Research at the University of Munich, **3**:2, pp. 30–9.

⁵ De Witte, K. and Saal, D. (2010), 'Is a Little Sunshine All We Need? On the Impact of Sunshine Regulation on Profits, Productivity and Prices in the Dutch Drinking Water Sector', *Journal of Regulatory Economics*, **37**:3, June, pp. 219–42.

⁶ Australian Competition and Consumer Commission (2011), 'Submission to the Productivity Commission's Inquiry into the Economic Regulation of Airport Services', October.

⁷ Australian Government Productivity Commission (2011), 'Economic Regulation of Airport Services: Productivity Commission Inquiry Report', December 14th.

⁸ See chapter 3 of Commerce Commission (2008), 'Regulatory Provisions of the Commerce Act 1986', December 19th. See also Ministry of Economic Development (2012), 'Chronology of New Zealand Electricity Reform', June.

⁹ Part 4 of the New Zealand Commerce Act 1986, Section 52A(1)(a)–(d). For an economic discussion of the interpretation of the Part 4 purpose, see Commerce Commission (2010), 'Input Methodologies (Electricity Distribution and Gas Pipeline Services)', Reasons Paper, December.

¹⁰ Electricity distribution and transmission are mostly unbundled. There is some common ownership in gas distribution and transmission.

¹¹ A feature of regulation under Part 4 is that, as part of default price-quality regulation, the Commission is not allowed to use comparative benchmarking. This prohibition is the result of concerns that regulated businesses raised about benchmarking done under the previous light-handed regulatory regime. The comparative efficiency of businesses can be revealed only through assessments done as part of information disclosure regulation (or when a business applies for a customised path). The Commission has started developing its approach to efficiency—see the material under Commerce Commission, 'Information Disclosure Emerging Views Briefing – 7 October 2011', available at www.comcom.govt.nz/part-4-review-of-electricity-information-disclosure-requirements/.

¹² The criteria for exemption from price-quality regulation are set out at: www.comcom.govt.nz/treatment-of-consumer-owned-electricity-distribution-businesses/.

¹³ Commerce Commission (2010), 'Information Disclosure (Airport Services)', Reasons Paper, December 22nd.

¹⁴ On some issues, such as cost allocation, there appeared to be limited disagreements on the approach taken between airports and its customers; in other areas, such as asset valuation and cost of capital, significant disagreements exist. See Commerce Commission (2010), 'Input Methodologies (Airport Services) Reasons Paper', December 22nd 2010.

¹⁵ See www.comcom.govt.nz/section-56g-reports/.

¹⁶ For further information, refer to the Ministry of Business, Innovation and Employment website at www.med.govt.nz/sectors-industries/technology-communication/fast-broadband.

¹⁷ Telecommunications services are regulated under the Telecommunications Act 2001. Commerce Commission (2012), 'LFC Information Disclosure 2012', Reasons Paper, June 28th.

¹⁸ New Zealand Productivity Commission (2012), 'International Freight Transport Services Inquiry', April.

If you have any questions regarding the issues raised in this article, please contact the editor, Dr Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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