A policy framework for regulatory uncertainty

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Regulatory uncertainty

Regulatory uncertainty is a difficult concept, being employed (often indiscriminately) in different contexts to describe distinct but related situations. It is commonly misused. A framework for understanding regulatory uncertainty assists with identifying where the term is being misused and where genuine issues of regulatory uncertainty arise.

Regulatory uncertainty is not the same as the uncertainty associated with Parliament's exercise of its legislative function. The (theoretically unlimited) potential for Parliament to enact or amend legislation that affects regulated industries may create uncertainty, and indeed may result in costs similar to those created by regulatory uncertainty. But the appropriate exercise of the legislative function represents a broader range of issues, including Parliamentary sovereignty, the rule of law and the role of legislation in a liberal democracy. These issues are not particular to regulation, nor are they particularly 'regulatory' in character.

Regulatory uncertainty is also confused with business uncertainty, particularly if that business uncertainty can be (indirectly) traced back to regulatory processes or outcomes. There may, for example, be an unacceptable and costly level of uncertainty in the market following the implementation of a new regulatory regime but that does not mean that the regulatory regime itself has been implemented in uncertain terms. In these circumstances, an appreciable increase in regulatory certainty alone is unlikely to impact on the level of uncertainty in the market overall.

Policy-makers should, of course, account for both business uncertainty and regulatory uncertainty when considering the costs and benefits of a particular regulatory intervention, but it would be a mistake to confuse the two concepts.

Finally, it is important that regulatory uncertainty is not confused with industry or an individual business' dissatisfaction with substantive regulatory outcomes. The variety of meanings attributed to 'regulatory uncertainty', and the wide-spread misuse of the term, mean that it is regularly used in this way. This is both unfortunate and costly, as it relies on an empty statement that fails to identify let alone resolve the underlying issues with a particular regulatory regime.

Regulatory discretion

Even where regulatory uncertainty is correctly identified, a common misconception persists that regulatory uncertainty is an intrinsic evil that ought to be eliminated completely. For that reason it is worth emphasising that regulatory uncertainty is, to an extent, a necessary and desirable feature of all principled regulatory processes and regulatory regimes. It is excessive or unnecessary uncertainty that represents a genuine economic policy issue and which ought to be mitigated.

Regulatory uncertainty is the result of regulatory discretion and, within certain limits, regulatory discretion is desirable. Regulatory discretion promotes flexible regulation that is more responsive to the dynamic commercial and political context in which regulation is required to function. However, the trade-off for increased regulatory discretion is greater potential for regulatory uncertainty, which (as discussed below) carries costs.

A balance needs to be struck to ensure the benefits of regulatory discretion are not outweighed by the costs of regulatory uncertainty. In this sense, the two phenomena represent different sides of the same coin. In striking this balance, two aspects of the discretion-uncertainty relationship need to be considered:

- First, regulatory uncertainty is likely to exist where the bounds of regulatory discretion are not clear. The scope of legitimate regulatory discretion is a product of the regulator's governing legislation and the margin of appreciation afforded to the regulator by the courts on review, which is never unlimited but may be significant.[1] Undue regulatory uncertainty is likely to result if answers to questions of jurisdiction and the scope of discretion are not self-evident.

- Second, the exercise of the regulator's discretion may generate regulatory uncertainty, even where that exercise is clearly within the formal limits of the regulator's jurisdiction. If the regulator exercises its discretion in unpredictable or unjustifiable ways — for example, acting inconsistently with accepted principles or established precedent and without articulating credible reasons for that inconsistency — then uncertainty results.

In summary, both the scope of regulatory discretion and the manner in which that discretion is exercised may create excessive or unnecessary uncertainty for regulated businesses. Together these two aspects comprise regulatory uncertainty, properly understood.

The costs of regulatory uncertainty

Regulatory discretion has certain benefits, but these benefits must be considered in light of the costs of uncertainty. Regulatory uncertainty has the potential to be highly inefficient and therefore raise costs to regulated firms, their customers and society at large. This is a particular concern in a regulatory environment such as that which applies to network industries that is aimed at promoting economic efficiency.[2]

The potential for inefficiency is twofold:

- First, regulatory uncertainty has the potential to raise the costs of investment in regulated sectors to inefficient levels. Firms and investors react to uncertainty of any kind in the investment environment by reflecting, in the required return on any investment, an assessment of the risks. Rational investors will require a higher return on invested funds to compensate for the additional uncertainty. All other factors being equal, investment in a sector facing regulatory uncertainty will attract a premium (which raises costs) compared to investment in an unregulated sector.

- Second, a regulated firm may misprice the risks associated with regulatory uncertainty, even if attempts have been made by the regulator to ensure that uncertainty has been mitigated to the optimal level. Anecdotally, it appears that some firms have difficulty understanding regulatory risk, even where such firms have experience in dealing with other forms of uncertainty. As a result, the firm and its investors may either under- or over-price the risk of regulatory intervention, leading to an inefficient level of investment.

Each situation is cause for concern. In the first case, the firm is likely to be unduly exposed if the risk of regulation is realised and, in the second, the overall level of investment (if it proceeds at all) may be less than optimal.

Both sources of inefficiency have detrimental consequences for society. The additional costs of investment in industries characterised by regulatory uncertainty may lead to reduced investment, meaning that new services are not available to consumers. Alternatively, investment may be delayed until after the socially-optimum time. If investment does proceed, then the cost to consumers of accessing services are likely to be disproportionately high, reflecting the increased investment costs. In each case, it is the end-consumer that loses.

Objective and subjective uncertainty

Comparing these two sources of potential inefficiency serves to highlight an often overlooked distinction between what might sensibly be characterised as "objective uncertainty" and "subjective uncertainty".[3]

Objective uncertainty is uncertainty that would be recognised by the rational, reasonable investor and manifests on an industry-wide (or even economy-wide) basis. Regulators and policy makers ought to take full responsibility for objective uncertainty, as it is solely a product of the regulatory environment.

Subjective uncertainty is different: it represents the uncertainty that results from the idiosyncratic views of particular firms and investors. The uncertainty that results from the mispricing of regulatory risk is an example of subjective uncertainty. This insight is important because regulators and policy makers alone are unlikely to be able to mitigate subjective uncertainty effectively. Investors and firms must take some responsibility for understanding the processes and consequences of regulatory initiatives. This does not mean that regulators and policy makers have no role to play. A sound and transparent regulatory process is a necessary, although not a sufficient, condition for mitigating subjective uncertainty, as these processes provide the required insight into the regulatory process necessary to improve the level of regulatory competence in the industry as a whole.

Regulators therefore have an indirect but important — and perhaps underappreciated — role in helping businesses price regulatory risk effectively, which therefore mitigates subjective regulatory uncertainty.

Conditional predictability

This analysis suggests that the policy challenge is to eliminate or reduce unnecessary or undue uncertainty in the scope and exercise of regulatory discretion. This requires that regulatory decision making be reasonably predictable, particularly with regard to the substantive aspects of any regulatory decision. This approach does not seek to unduly inhibit flexibility in regulatory approach, but it does require clear reasons for any change that align with the accepted principles underpinning the regulatory regime.

Perhaps the best statement of the issue in New Zealand has been provided by regulatory economist George Yarrow:[4]

> *What is required is ... conditional predictability in relation to things that really matter. Regulators need to be able to adjust and adapt when the economic environment changes, but should change and adapt in ways that are predictable to market participants conditional on available information about the changes in the economic environment to which the regulator is responding. That is, it should be possible to predict how a regulator will react to changing circumstances.*
>
> *In this way, although the future evolution of markets is inherently uncertain—and businesses routinely deal with such uncertainties as part of what they do — the regulatory system will not materially add to uncertainty. This is pretty much the best we can hope for ...*

Orthodox legal principles governing regulatory decision-making tend to support the concept of "conditional predictability" as described above, but regulators are likely to need to go further than simply meeting their legal obligations to ensure that conditional predictability is achieved in practice. A balance between flexibility to seek the appropriate response to individual circumstances and consistency with previous decisions, for example, is clearly provided for under administrative law. As a matter of law, neither the Commerce Commission nor the Electricity Authority is strictly bound by their previous decisions.[5] But there is, of course, a clear duty on these decision makers to act consistently with previous decisions in the absence of good reasons to justify departure.[6] The law therefore provides for the dynamic relationship between regulatory discretion and uncertainty, while promoting reasonably predictable outcomes.

Conditional predictability, however, is only achieved where a regulator avoids arbitrary or unjustified decision making. A decision may be considered arbitrary or unjustified as a matter of law where the evidence does not support the decision, or is inconsistent with the decision, or one where the only tenable conclusion is contrary to the substance of the decision.[7] In regulatory best practice, the same legal principles apply but the evidence supporting the decision, and any substantive conclusions drawn, must also account fully for the microeconomic policy context.

A policy framework for addressing regulatory uncertainty

Given the important implications of regulatory uncertainty, there should be express consideration of it as part of regulatory decision making. Likewise, policy makers should consciously address issues of regulatory uncertainty. The analysis in this discussion paper suggests that these issues include:

- distinguishing the potential for regulatory uncertainty from other forms of uncertainty;
- the need for (and value in) regulatory discretion;
- the historical evidence of the regulator's exercise of discretion;
- the scope of discretion afforded to the regulator by the courts and legislation;
- the regulator's ability to minimise objective uncertainty;
- the ability of business to contribute to the minimisation of subjective regulatory uncertainty; and
- whether the law promotes 'conditional predictability'.

Taken together, these issues provide a framework for understanding and addressing regulatory uncertainty in a principled way that can materially improve regulatory design and practice

Endnotes

1 See *Unison Networks Ltd v Commerce Commission* [2007] NZSC 74 at [55].
2 See, for example, Telecommunications Act 2001, s 18(1); Electricity Industry Act 2010, s 15.
3 Frances J Milliken "Three Types of Perceived Uncertainty About the Environment: State, Effect, and Response Uncertainty" (1987) 12 Academy of Management Review 133 at 134.
4 Yarrow et al *Review of Submissions on Asset Valuation in Workably Competitive Markets* (Commerce Commission, Wellington, November 2010) at [2.6]–[2.7].
5 *Telecom New Zealand Ltd v Commerce Commission* HC Wellington CIV-2004-485-2118, 17 August 2005 at [24]; *Bay of Plenty Energy Ltd v Electricity Authority* at [118].
6 *Pharmaceutical Management Agency Ltd v Roussel Uclaf Australia Pty Ltd* [1998] NZAR 58 (CA) at 72.
7 *Edwards v Bairstow* [1956] AC 14 (HL).

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