

25<sup>th</sup> October 2013

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By email: [info@productivity.govt.nz](mailto:info@productivity.govt.nz)

Dear Steven

## Issues paper – regulatory institutions and practices

We appreciate the opportunity to comment on the issues paper *Regulatory Institutions and Practices*, published by the Productivity Commission (the Commission) on 27 August 2013.

We commend the Commission on a well-crafted consultation paper which, despite being broad in depth and scope, is easily digestible, logical in structure and insightful.

## Introducing Transpower

Transpower is a state owned enterprise with two main roles. The first is to plan, build, maintain and operate the national grid linking electricity generators to distribution companies and major industrial users. The grid extends from Kaikohe in the North to Bluff in the South. Our second role is as System Operator in which we manage the real-time operation of New Zealand's electricity system and operate the wholesale electricity market. In performing these roles we help secure the reliable supply of electricity and facilitate competition between generators and between retailers.

As well as general regulation Transpower is subject to sector and organisation specific regulation under Part 4 of the Commerce Act 1986 and the Electricity Industry Act 2010. Our business is materially affected by that regulation which encompasses our investment, revenues, shareholder return, quality of service and pricing, amongst other things. We naturally therefore have a direct interest in the quality of New Zealand's regulatory environment, the product of its institutions and their practices.

We also consider that those institutions and practices directly and indirectly affect the protections afforded to New Zealand citizens as well as the cost and competitiveness, and therefore productivity, of our domestic economy and our export sector. The quality of those institutions and practices therefore has a strong bearing on the wealth and wellbeing of New Zealanders generally. Our understanding of the basic objective of the inquiry is to assist the government in enhancing that wealth and wellbeing by improving the quality of regulatory outcomes, which is the product of our regulatory institutions and practices. We consider this to be a worth and achievable objective.

This letter submission contains our high level thoughts at this stage in the process. We respond to some of the Commission's questions at Appendix A. Appendix B contains further information on the evolution of electricity regulation for Transpower. No part of this submission is confidential. In addition to this submission we have met with the inquiry team.

### **The New Zealand context**

New Zealand has a small population and is geographically remote nation. On the one hand, being small and remote is an important part of how we identify ourselves and how we are identified abroad. On the other hand the twin tyrannies of distance and scale present genuine challenges for our economy and society. The long term wealth and wellbeing of our nation depends on conquering those challenges.

In the context of this inquiry our size and location mean, in our view, we are more reliant on the quality of our institutions and their decisions than our global competitors. That is because we have less margin for error to begin with, which means we have fewer shoulders to bear the direct and indirect costs of poor regulation, and because the quality of our regulatory institutions and their decisions has a direct impact on the competitiveness of our domestic economy and export sector.

We discuss below the challenges of getting regulation right. Our view is that quality regulatory outcomes are achievable and that 'world class regulatory institutions' is a worth and plausible aspiration. This does not necessarily involve fundamental change in the design or resourcing of our institutions.

### **Difficult...but not rocket-science**

It is not always recognised that policy making and regulation is hard. It involves defining new, and at times nuanced, problems and identifying creative solutions before making difficult trade-offs in aiming to align private behaviours with the public interest. That is before accounting for pressure, political and otherwise, to be seen as bold and decisive, and to be 'taking action'. In practice it is easy to make poor decisions, difficult to make good decisions and, unsurprisingly, very difficult to be world class.

That said the fundamentals of good regulatory policy lie in doing the basics right. The consultation captures the two basic ingredients in the regulatory mix, institutions and practices. To get regulation right, both need to operate well.

- The institutions: their establishment requires clarity of purpose and objectives at the formative stage and is the prerequisite for successful institutional design and governance models. The Commission identifies the sorts of issues that need to be considered when deciding on the institutional and governance models to facilitate achievement of the purpose and objectives.

Below that front end design are more practical issues involving capability, competency and balance of staff and directors. Appropriate resourcing requires a blend of the experience and capability of 'technical' experts (legal, economic, engineering etc.), coupled with experienced policy practitioners and balanced with commercial and real world experience.

- The practices: establishing early on the regulator's strategic direction, regulatory principles, policies, standards and the frameworks that staff and non-executives will adhere to is essential.

These are one of, if not the most important and first functions of the regulatory Board and underpin the effectiveness of the regulator and the ability of stakeholders to understand and engage with the regulator. The specific practices that individual regulators should exhibit will depend on its purpose and objectives. In general, we consider the following practices to be characteristic of effective regulatory institutions:

- adopting regulatory ‘principles’ to which the regulatory authority will hold itself and be willing be held accountable to by others (proportionate, consistent, transparent etc.)
- deploying ‘best practice’ regulatory policy development frameworks including to manage tensions between policy objectives, risk, uncertainty (and so on)
- a clearly articulated work plan that is demonstratively linked to the institutions purpose and policy objectives
- a commitment to transparency, even where this is difficult or uncomfortable for the regulator, and to properly assessing the impacts of its actions before intervening
- publishing decision papers containing the reasons for individual decisions
- reviewing established regulation to verify whether it has had the intended effect, and whether it should revise, retain or remove the regulation.

These practices and processes are formed by a regulator’s behaviours and ways of working. They must infuse the culture of the institutions, its staff and non-executives i.e. these are not boxes that, once ticked, can be put on a website and forgotten.

## **Evolution vs. revolution**

While it would be drawing a long bow to predict radical change to our existing regulatory institutions at this stage it is nevertheless possible that change will flow from the Commission’s recommendations. As an organisation and as part of an industry that has been on a journey of almost continual change for the last twenty years<sup>1</sup> we are acutely aware of the costs of changes.

We are cognisant that the sorts of practices outlined above, while beneficial, do impose some overhead on regulatory institutions. On balance we consider they result in a net reduction in resource requirements over time however an upfront investment is required to develop and implement the practices. Some institutions may lack the scale and capability to do this without external assistance. We consider that there could be value in establishing a ‘centre of excellence’, be that within Treasury, the Commission or elsewhere, to assist in this process.

## **Guidelines**

A set of guidelines that capture the sorts of things we reference above will be of great assistance to regulators as they go about their business. There is of course a risk that these guidelines will be paid lip-service to but not embraced – after all, like spinach and exercise, good regulatory practice is very beneficial but sometimes requires motivation and discipline.

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<sup>1</sup> See appendix B

More explicit accountability on the part of regulatory institutions would support the required motivation and discipline needed for good regulatory practice. Treasury guidance for good practice is aimed at central government and does not appear to extend to crown entities. State Services Commission guidelines limit the monitoring of independent crown entities to 'value for money' and 'output delivery' only (i.e. not good practice).

As Professor George Yarrow<sup>2</sup> points out, "*regulation itself is a monopolistic activity. It is, therefore, appropriately subject to checks and balances*".

## Concluding remarks

Having reflected on the consultation paper we have a few general observations which are unlikely to be revelatory to the Commission but are worth making nonetheless.

- It starts at the top: the genesis of most if not all regulation is central government. It is self-evident that regulatory policy making at this level needs to be robust and reflective of best practice.
- Stability and predictability are underrated: as humans we have a natural tendency to find solutions, sometimes to problems that don't exist or to the wrong problem. We consider that there should be an institutionalised bias against intervention (but fear the reverse is sometimes true).
- Quality regulation is worth the investment: the Commission's work is tremendously important – getting the foundations right and ensuring on-going commitment requires determination and discipline, but it is worth it.
- Since Regulators are monopolistic they need to be made accountable: whether through formal legal reviews, Treasury oversight, independent critique or other mechanisms, regulators must be accountable to those they regulate and those they are acting on behalf of.

Please contact me if you would like to discuss any of the points made in this submission. You can reach me on 04 590 7544 or [jeremycain@transpower.co.nz](mailto:jeremycain@transpower.co.nz).

Yours sincerely

A handwritten signature in black ink, consisting of a stylized 'J' followed by a long horizontal line that ends in a small hook.

Jeremy Cain  
**Chief Regulatory Advisor**

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<sup>2</sup> Professor George Yarrow, Director, Regulatory Policy Institute, UK. Keynote presentation (17<sup>th</sup> October 2013) at *Competition Matters* conference; hosted by the Commerce Commission.

## Appendix A – Transpower Responses to Consultation Questions

Question No.	Question	Response
1	What sort of institutional arrangements and regulatory practices should the Commission review?	<p>All the identified institutional arrangements and practices warrant review. If prioritising we consider the following to be of particular priority:</p> <ul style="list-style-type: none"> <li>○ Clarity of role, functions, duty</li> <li>○ Decision making structures, processes and approaches</li> <li>○ Decision review and appeal (and related to this accountability and transparency)</li> <li>○ Regulator workforce capabilities (including non-executives)</li> </ul>
2	The Commission has been asked to produce guidelines to assist in the design of regulatory regimes. What type of guidelines would be helpful?	Guidelines that assist central government policy makers at the institutional design stage (objectives / purpose; status, size, capability, non-exec make up etc.) and that can be used as a reference tool for regulators (principles, process e.g. how to develop policy, dos and don'ts, resources).
3	Does New Zealand have (or need) a unique 'regulatory style' as a result of our specific characteristics?	Yes. We have particular characteristics that mean what works for others may not always work for us. We should learn from the experience of our OECD peers, especially the 'how' they go about analysing problems and options but not necessarily 'what' they opt to do as the solution is more likely to be size or country specific.

Question No.	Question	Response
6	Can you provide examples of regulatory regimes with particularly clear or (conversely) unclear objectives? What have been the consequences of unclear regulatory objectives?	<p>We consider both the Commerce Act (Part 4 objectives for regulated suppliers) and the Electricity Industry Act (objectives for the Electricity Authority) have plain English clear objectives.</p> <p>However it is the interpretation of those objectives that frames how the agency will develop industry rules<sup>3</sup>. The interpretation process creates the risk that the a regulator could colour the interpretation which</p> <ul style="list-style-type: none"> <li>• introduces (perhaps unknowingly) a particular world view - in other words introduces regulatory bias and</li> <li>• creates divergence between Parliament's intent and the regulator's practice.</li> </ul> <p>There may be a role in the Parliamentary debate (and hence the public record through Hansard) to add greater guidance to the future interpretation of a new agencies objectives. There may also be a role in Ministerial departments submitting to a regulator's consultation of its objectives' interpretation.</p>
7	Where regulators are allocated multiple objectives, are there clear and transparent frameworks for managing trade-offs? What evidence is there that these frameworks are working well/poorly?	Specifically in relation to the Electricity Authority, we consider the guidance to be contained in the Electricity Industry Act (section 32), which states that Code amendments may promote any or all of the objectives. We consider this guidance to be clear.
8	Can you provide examples of where assigning a regulator multiple functions has improved or undermined the ability of the regulator to achieve the objectives of regulation?	We consider that the Commerce Commission has benefited from scale, pooling of resources and cross pollination of ideas between its Part 4, dairy and telecommunications and general competition functions.

<sup>3</sup> We comment more specifically on the interpretation in our submission to the Electricity Authority's Transmission Pricing CB A framework consultation paper, available at <http://www.ea.govt.nz/our-work/consultations/priority-projects/tpm-cba-working-paper/submissions/>

Question No.	Question	Response
10	Are there examples of where regulators have clearly defined policy functions? Conversely, are there examples of where the policy functions of a regulator are not well defined? What have been the consequences?	Commerce Commission – Information Disclosure regulation (purpose of the disclosure is to enable persons to assess whether the purpose of Part 4 is being met) and Price-Quality regulation (the pricing / quality frameworks that set either revenues or prices for regulated suppliers). Underneath these regulatory frameworks sit the Input Methodologies (IMs) which are the mechanical rules through which the regulation can be expressed e.g. asset valuation rules and rules on cost of capital are used to derive revenues.
11	Can you provide examples where two or more regulators have been assigned conflicting or overlapping functions? How, and how well, is this managed?	<p>There is potentially a blurring of roles and responsibilities between the Commerce Commission and the Electricity Authority vis-à-vis promoting efficient transmission investment decisions. This is not explicit but a function of one regulator overseeing investment, one overseeing pricing and both regulators pursuing efficiency objectives.</p> <p>There is also an overlap of requirements from the CC and the EA for information disclosure.</p> <p>This boundary is managed by legislative guidance in the Electricity Industry Act 2010:</p> <p><i>54V Impact of certain decisions made under Electricity Industry Act 2010</i></p> <p><i>“(1) The Electricity Authority must consult with the Commission before amending the Electricity Industry Participation Code (the Code) in a manner that will, or is likely to, affect the Commission in the performance of its functions or exercise of its powers under this Part</i></p>
12	Are there examples of where regulators are explicitly empowered or required to cooperate with other agencies where this will assist in meeting their common objective?	<p>See above.</p> <p>NB this type of overlap is relatively common in other jurisdictions. In the case of the UK media and communications regulator, Ofcom, competing objectives were <i>consciously</i> given to a single entity.</p>

Question No.	Question	Response
14	Are the dimensions of regulator independence discussed in Figure 4.3 helpful in thinking about New Zealand regulators?	Yes the dimensions for independence are helpful. However we note the view by Scott Hempling <sup>4</sup> <i>“literal independence is unachievable. No regulator is independent of court challenges, legislative overrides, financial markets, or public anger. These pressures constrain action but interject accountability...Effective independence means independent from forces that undermine regulation’s purpose – forces that block the regulator from aligning private behaviour with public interest...a regulator must be independent of arguments that are unverifiable”</i> .
15	Which of these dimensions of independence is most important to ensure a regulator is seen to be independent?	All of the dimensions of “more independence” are relevant, but that the stable environment is probably the most important.
16	Can you provide examples of where a lack of independence or too much independence according to one of these dimensions undermines the effectiveness of a regulatory regime?	We consider “too much independence” - where there is no accountability on a regulator - can undermine the effectiveness of a regime.
18	Do you agree with the list of features in Figure 4.3 which indicate a need for more or less regulatory independence? What other criteria are missing?	Scott Hempling <sup>5</sup> describes regulatory capture as “an extreme form of persuasion” and that being captured is to be in a constant state of being persuaded by the persuader based on their identity rather than the merits of their argument – what they want rather than what the public interest requires. <i>“Regulatory capture is a surplus of passivity and reactivity, and a deficit of curiosity and creativity”</i> .

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<sup>4</sup> Scott Hempling (2013), *Preside or Lead? The attributes and actions of effective regulators* (2<sup>nd</sup> Edition) Chapter 4.

<sup>5</sup> Scott Hempling (2013) *ibid* Page 89



Question No.	Question	Response
32	Which New Zealand regulators (or regulatory regimes) provide good examples of open and transparent funding arrangements? Can you provide examples where the transparency of funding needs to be improved?	CC / EA.
33	Can you provide examples where a regulator's funding arrangements support or undermine its independence?	We do not consider this the case for our regulatory agencies the Commerce Commission and the Electricity Authority.
34	What approaches are there to identifying, building, and maintaining workforce capability? How effective have they been?	Good practice dissemination, identify scale opportunities.
35	What restrains or enables a regulator to develop the capability they need in the New Zealand context?	Enabled by effective scrutiny e.g. providing a feedback loop from assessment to improved practice. Constraints are depth of pool and lack of near neighbours with comparable regimes to draw on.
37	What is the potential to improve capability through combining regulators with similar functions, compared with other alternative approaches?	There could be scope to achieve efficiencies and improve regulatory quality.
39	Can you provide examples of strengths and challenges in the way regulators monitor and enforce regulations? What are the consequences?	The CC appears to be thorough.

Question No.	Question	Response
40	Do New Zealand regulators have access to a sufficient range of enforcement tools? If not, what evidence is there to suggest that a broader range of tools would promote better regulatory outcomes?	Generally yes. However, at the Commerce Commission's recent (17 <sup>th</sup> / 18 <sup>th</sup> October 2013) conference we were interested to learn about the increased range of enforcement tools that the Australian Competition and Consumer Commission has for Consumer protection (e.g. misleading advertising and unfair contract terms) and how effective these were in providing timely remedy.
45	Can you provide examples of where regulatory regimes require too much or too little consultation or engagement? What are the consequences?	No examples but a comment that both the nature of the engagement and what is done with it is important – i.e. it should inform the decision making (it is not sufficient just to consult then ignore substantive submissions or to treat consultation as a test of whether there is majority support).
46	What are the characteristics that make some regulations more suited to prescriptive consultation requirements than others?	Technical regulations. Substantive new regulations that have value impacts, high costs and high risks.
47	What forms of engagement are appropriate for different types of regulatory regime? When do formal advisory boards work or not work well?	Advisory boards may work well where broader public consultation is not viable because of technical (specialist) nature of the material. They will not work well when impartiality is impractical due to fundamental commercial conflicts.
49	What elements of a regulatory regime's design have the biggest influence on culture? Why?	Concentration of power – rule maker and administrator – with little oversight.
50	How well do regulatory agencies ensure consistency of approach between or amongst regulatory staff, so that individual variations are minimised?	Making use of principles, adherence to clear frameworks, effective and transparent process, and a sense of oversight / scrutiny.

Question No.	Question	Response
54	Can you provide examples of regulators whose approach to their business is largely shaped by their reliance on a particular profession? How might that approach be different if it drew on a wider range of professions?	<p>The regulatory decision-making for the electricity industry relies on input from a range of disciplines e.g. economics, engineering and legal. We consider that at times a regulator's focus on a particular discipline can distort its decision-role e.g. EC (made own decisions on engineering solutions); EA (driven by pure economic efficiency arguments); and CC (bound by legal interpretations).</p> <p>Scott Hempling again (page 3) – posits that the regulatory decision for the 'public interest' is a trade-off between economic efficiency (benefit cost ratio), sympathetic gradualism (smoothing the edges of economic efficiency), and political accountability (not caving in to interest groups, educating by explaining).</p>
55	Can you provide examples of how accountability or transparency arrangements improve or undermine the effectiveness of a regulatory regime?	We consider transparency almost always improves quality and is necessary at all process steps.
56	What types of accountability or transparency arrangements are appropriate for different types of regulatory regimes?	We note that accountability for ICEs pertains only to output delivery and value for money (SSC guidelines, 2006) <sup>6</sup> . Guidance on quality regulatory decision-making and process (e.g. undertaking regulatory impact assessments) only applies to government departments, not their agencies.
60	Can you give examples of indicators or proxies that are effective as early warning signs of regulatory noncompliance or failure?	Indicators such as widespread disquiet and dispute, and process that is unclear and/or meandering.

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<sup>6</sup> <http://www.ssc.govt.nz/guidance-depts-crown-entities-may06>

## Appendix B – 20 years evolution of electricity governance<sup>7</sup>

Date	What	Governance
<b>1993</b> Electricity Market Administration The Electricity Market Company (M-co) was set up to support the electricity market framework for wholesale trading.	M-Co was responsible for (among other things) administration of the Metering and Reconciliation Information Agreement (MARIA). Transpower was National Reconciliation Manager and reconciled information against contracts and passed information for billing back to market participants.	M-Co was a private company, contracted by industry parties (not a statutory entity).
<b>July 1994</b> Transpower separated from ECNZ to become a stand-alone SOE.  Information Disclosure (ID) regime begins.	Separate audited financial statements for natural monopoly and potentially competitive businesses <ul style="list-style-type: none"> <li>• Prices and other main terms and conditions of contracts</li> <li>• Financial performance measures, based on standard asset values (ODV)</li> <li>• Efficiency and reliability performance measures</li> <li>• Costs and revenues by tariff category (and methodologies)</li> <li>• Line charges (and methodologies).</li> </ul>	Government Ministry administers Information Disclosure regime.
<b>1996</b> Wholesale Electricity Market created	Transpower is responsible for schedule and dispatch of energy.	Industry self-governance.
<b>April 1999</b> Revised Information Disclosure Regulations.	The Electricity (Information Disclosure) Regulations 1999 came into force, replacing the 1994 version of the regulation. Required line owners to disclose asset management plans and security standards, as recommended by the Ministerial Inquiry into the 1998 Auckland power failure.	Government Ministry administers Information Disclosure regime.
<b>August – November 1999</b> Electricity Industry self-Governance arrangements for grid security.	Industry participants sign up to a Multilateral Agreement on Common Quality Standards (MACQS).	MACQS was authorised by the Commerce Commission.

<sup>7</sup> Adapted from “Chronology of NZ electricity reform” available at <http://www.med.govt.nz/sectors-industries/energy/pdf-docs-library/electricity-market/electricity-industry/chronology-of-electricity-reform/Chronology%20of%20NZ%20electricity%20reform.pdf>

Date	What	Governance
<b>February - June 2000</b> Electricity Industry Inquiry and Report.	The Government announced a Ministerial Inquiry into the electricity industry on 3 February 2000.	
<b>December 2000</b> First Government Policy Statement (GPS) for Energy.	Energy Policy objective “to ensure the delivery of energy services to all classes of consumers in an efficient, fair, reliable and sustainable manner.”	GPS was transmitted to the CC under section 26 (Commission to have regard to economic policies of the Government)  The GPS required the electricity sector to establish a new electricity governance board.
<b>August 2001</b> Electricity Industry Bill.	The Commerce Commission: <ul style="list-style-type: none"> <li>• may control the price or revenue of electricity line businesses which breach thresholds</li> <li>• is responsible for administration of the electricity information disclosure regime.</li> </ul>	No Ministerial decision is involved in price regulation.  CC responsible for ID.  Electricity Governance Board provided for under Order In Council.
<b>July-September 2001 and March-June 2003</b> Supply shortages	Conservation campaigns – public urged to ‘save 10%’, and government ‘15%’.	Political.
<b>May 2003 – September 2003</b>	Government announced, and established, the Electricity Commission (EC). Costs recovered by levy.	The EC was created as a Crown Agent.
<b>2004</b> Transpower pricing methodology made legal.	The Electricity (Transpower's Pricing Methodology) Regulations 2004.	Order in Council.
<b>March 2004</b> Electricity Governance Rules (EGRs)	EGRs replaced the MARIA and MACQS.	Electricity Commission administered the EGRs.
<b>April 2004</b>	New regulatory framework for transmission investment and pricing.	Electricity Commission creates approval mechanism for new investment in capacity.
<b>October 2004</b> New GPS	GPS directed the EC to work with Transpower and grid users to facilitate priority investment in the grid.	Electricity Commission as Crown Agent can be directed (‘give effect’ to GPS).
<b>June 2006</b> Auckland blackout	Transpower’s substation at Otahuhu suffers D-shackle failure.	

Date	What	Governance
<b>October 2006</b> Updated GPS Revised section 26 statement	GPS: emphasise the strategic importance attached to timely investment in transmission infrastructure. Section 26: importance of regulated businesses such as Transpower and electricity lines businesses investing in new lines and other infrastructure.	Electricity Commission to 'give effect to' GPS. Commerce Commission to 'have regards to' section 26.
<b>July 2007</b>	Electricity Commission initiates approval process for new line to Auckland.	Electricity Commission gave approval in September 2009.
<b>August 2007</b>	Order in Council creates <i>Electricity Governance (Connection of Distributed Generation) Regulations</i> .	This regulation (secondary legislation) was later 'downgraded' by Ministry officials to become 'rules' (tertiary legislation) at the 'stroke of a pen'.
<b>April 2008</b> Transmission Pricing Methodology.	TPM was included as a schedule to the Electricity Governance Rules.	
<b>September 2008</b> Commerce Amendment Act.	This Act included a new provision for improved regulatory regimes for electricity lines businesses.  OECD countries already regulate these types of service Commerce Commissionable to develop rules, requirements and procedures (collectively called "input methodologies") for regulations.	Commerce Commission is legislatively redirected to deliver Price-Quality regulation and Information Disclosure regulation. Minister involved in regulation decision.  Clear purpose statements for objectives of the regulation (see section 52A and 53A respectively of the Commerce Act).  CC given policy functions for type of regulation and nature of rules and process to support it.
<b>April 2009 – December 2009</b> Ministerial review (under 2008 - elected National Government), via the Electricity Technical Advisory Group – ETAG.	Initiatives for effective governance included: • abolishing the Electricity Commission and replacing it with an Electricity Authority, with far fewer objectives and functions than the Commission; • establishing a Security and Reliability Council to monitor Transpower's performance and advise on security of supply; and • transferring responsibility for grid investment approvals to the Commerce Commission.	
<b>October 2010</b> Electricity Industry Act (EIA).	Establishment of the Electricity Authority.	The Electricity Authority is an Independent Crown Entity. It has clear objectives and guidance under the Act.

Date	What	Governance
<b>November 2010</b>	EGRs replaced with Electricity Industry Participation Code (EIPC).	EA administers Code (rule maker and changer). Chair of EA Board is the person who chaired ETAG.

