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Inquiry into Regulatory Institutions and Practices
New Zealand Productivity Commission
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Via email: info@productivity.govt.nz

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Productivity Commission Inquiry into Regulatory Institutions and Practices

Mighty River Power welcomes the Productivity Commission's review and supports the frameworks put forward in the discussion paper for evaluating regulatory institutions and practices.

The quality of regulatory frameworks is important to sectors like electricity with long asset lives and the need to attract both domestic and international capital for future large scale investments. Regulatory risks are often the most significant and uncertain risks many sectors face and can have substantial wealth redistribution and shareholder value impacts.

The essential service characteristics of electricity coupled with hydro-dominance creates a high degree of risk of policy change in order to deliver desired price and security of supply outcomes. Increasing environmental concerns have also resulted in a greater focus on enabling renewable generation and ensuring water is managed sustainably.

These drivers have seen the electricity sector subject to a significant number of reviews and changes in regulation, but progressively there has been move toward increasing competition for the long term benefit of consumers and improving the independence of the regulatory frameworks.

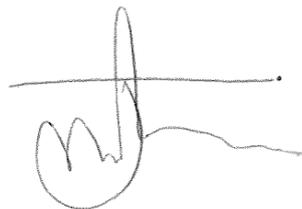
Despite positive progress, the unique features of the New Zealand political system means the sector is still subject to risk of significant changes in policy direction.

Key principles from Mighty River Power perspective that we would like to see included in the Productivity Commission's review is that regulation should be stable and the general quality and direction (rather than outcome) is predictable. Options for reform should be subject to high thresholds for change and proceed according to robust and best practice regulatory impact assessment processes. Any changes should be subject to long lead times and involve appropriate grandfathering arrangements where there are significant wealth transfers.

Our formal submission is included as an attachment to this letter. As Mighty River Power has previously responded to the Productivity Commission's review of local government regulation, this submission focuses largely on electricity market regulation.

Please direct any queries on this submission to myself on nick.wilson@mightyriver.co.nz or 09 580 3623.

Yours sincerely,

A handwritten signature in black ink, consisting of a horizontal line with a vertical stroke crossing it, and a series of loops and flourishes below.

Nick Wilson

Senior Market Regulatory Advisor

Submission by Mighty River Power to the Productivity Commission’s Review into Regulatory Institutions and Practices

1 CLARITY OF ROLE, FUNCTIONS AND DUTIES

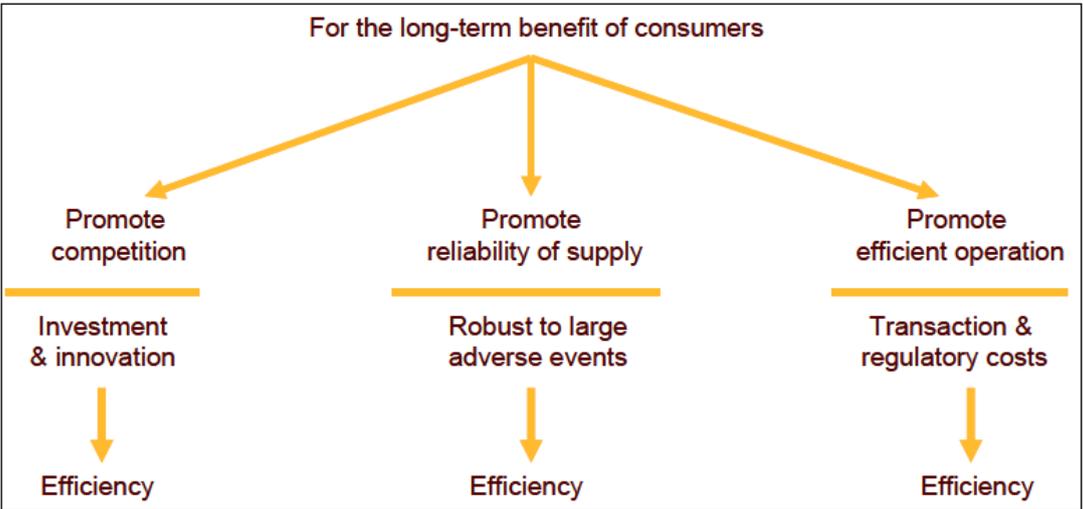
The statutory objective of the Electricity Authority is defined under Section 15 of the Electricity Industry Act 2010:

‘To promote competition in, reliable supply by, and the efficient operation of the electricity industry for the long-term benefit of consumers’

This definition was developed to simplify the Electricity Commission’s¹ statutory objective which required it to deliver a range of sometimes conflicting government policy statements. This made the assessment of its progress problematic².

While the Authority’s revised objective has improved in clarity, aligning its objectives with wider economic efficiency and consumer benefits objectives, interpreting the objective is not without its challenges. Setting multi-tiered objectives still requires the exercise of significant judgment around appropriate trade-offs which some commentators considered may be asking regulatory bodies to achieve the impossible³.

The Authority’s has issued an interpretation of its statutory objective summarised below:



¹ The Electricity Commission was the predecessor to the Electricity Authority and was replaced in 2010.
² As outlined in Office of Controller and Auditor General (2009) “Electricity Commission: Review of the first five years”. Available from <http://www.oag.govt.nz/2009/electricity-commission>
³ See for example the presentation by Prof. Stephen King at the Australian Competition and Consumer Commission conference 2012 <http://www.accc.gov.au/about-us/conferences-events/accc/aer-regulatory-conference/accc/aer-regulatory-conference-2012>

The main limitation of this approach is that it reduces the valid considerations of the various limbs of the Authority's statutory objective and reduces the transparency of the trade-offs that need to be considered in developing regulatory policy options. An example to illustrate this point is provided in Box One below.

Box One: Statutory interpretation and the Transmission Pricing Methodology

Refer to Appendix A for background on the TPM.

In undertaking its recent review of transmission pricing, the Electricity Authority took the view that that: "the TPM should focus on overall efficiency of the electricity sector for the long-term benefit electricity consumers"⁴. This definition enabled the Authority to then argue that overall efficiency would best be served by creating incentives for more efficient participation in transmission planning which would in turn reduce the scope for challenge over the TPM and improve regulatory certainty.

As a result, the Authority's interpretation of its statutory objective lead to the selection of a single option for TPM reform. Following consultation, stakeholders raised a number of concerns with that the Authority approach, particularly that insufficient analysis had been undertaken on the impact to consumers.

Submitters highlighted areas where a more detailed consideration of the Authority's statutory objective could be enhanced; particularly around reducing the proposals complexity (which was seen to act as a barrier to competition) and reducing the incentives in the proposal which could lead to distortions in the efficiency of wholesale market dispatch⁵. Subsequently the Authority has had to expand its consideration of such impacts.

The above highlights that allowing leeway for the interpretation of statutory objectives can undermine the process necessary to reach a robust and enduring regulatory decision. This in turn can increase the potential for dispute and legal challenge. Within the electricity sector, the Authority's interpretation of its statutory objective has yet to be tested.

This raises the question as to whether regulatory objectives should be more tightly defined in statute, particularly where there may be multiple competing objectives, such that there is less scope for interpretation.

Government policy makers also need to be cognisant of the significant challenges associated with multi-tiered statutory objectives and the assessment of what constitutes the long term interest of consumers. As noted by the Chair of the Authority, Dr Brent Layton⁶, regulators

⁴ Electricity Authority, Transmission Pricing Methodology: issues and proposal. Consultation Paper, (10 October 2012), [3.2.2].

⁵ See Footnote 20 below for further detail on stakeholder feedback prepared by PriceWaterhouseCoopers.

⁶ See "Economics Of Electricity" section 63. Available from <http://www.ea.govt.nz/dmsdocument/15066>

will always be able to implement large wealth transfers but need to consider the longer term dynamic responses, particularly regarding incentives for future investment, which will undermine consumer welfare.

As an isolated country, New Zealand is heavily reliant on international capital markets to support future large scale infrastructure investment. The long run costs of capital intensive electricity sector assets fluctuate according to providers' assessment of regulatory risk. Regulatory stability is therefore highly important in reducing long term costs to consumers.

The challenge facing regulators is to measure objectively and communicate such potential short and long term trade-offs to consumers and strike an appropriate balance in regulatory decisions. This is not an easy task, particularly where rising near term consumer costs may increase pressure for policy reform and where long term benefits may appear uncertain.

Given that regulating in the long term interests of consumers is a common objective across a number of regulators, there would be merit in the Productivity Commission considering whether any generic principles or guidance could be developed to assist regulators. This could take the form, for example, of a consumer charter to which all regulators could subscribe.

There would also be merit in the Productivity Commission review considering whether a sole focus on long-run benefit of consumers is an appropriate regulatory objective and whether a more nuanced definition could be advocated. As noted above, the preservation of shareholder value will have positive impacts on the long run costs of capital for infrastructure investment and reduce the future costs to consumers.

1.1 Separation of Policy-making and Regulation

The Electricity Authority has responsibility for proposing code amendments that it considers would promote its statutory objective as well as the enforcement of electricity sector regulations. This contrasts with jurisdictions such as Australia where a deliberate decision was taken to separate these functions.

The Electricity Authority was formed in 2010 with a mandate to progress a number of priority reform projects in the electricity sector (so-called Section 42 matters) within a relatively protracted timeframe.

The integrated structure of the Authority allowed it greater flexibility to expedite the implementation of the Section 42 reforms. However, as discussed further in the following sections, it has also led to a particular style and process of decision making.

Mighty River Power considers there could be merit in the Productivity Commission considering whether there could be efficiencies in concentrating industry specific regulator functions in an umbrella regulator like the Commerce Commission. We discuss this further in section 7.

2 OVERLAPPING AND CONSISTENT REGULATORY REGIMES

With the exception of recent experiences in transmission pricing as outlined in Box Two below, Mighty River Power is not aware of any material overlaps or inconsistencies in the regulatory regimes under which it operates.

Box Two: Overlapping Regulatory Regimes – Commerce Commission and the Electricity Authority

Refer to Appendix A for further background.

Since 2010, the Commerce Commission (and prior the Electricity Authority's predecessor the Electricity Commission) has had responsibility for approving capital expenditure proposals from Transpower on major transmission investments.

The Electricity Authority administers the Transmission Pricing Methodology (TPM) which determines how Transpower's annual revenue (circa \$800m in 2012/13) should be recovered from designated transmission customers.

Many submissions to the recent TPM consultation highlighted that the Authority's intention to reallocate the costs of all transmission investment since 2004 over \$2m created regulatory overlap with the Commerce Commission.

This was due to the fact that the Authority's proposal attempted to reallocate costs of transmission investments to a different set of beneficiaries than envisaged under the Grid Investment Test (GIT) administered by the Commerce Commission.

The implication of the Authority's proposal was that the Commerce Commission GIT process was resulting in inefficient outcomes. As the Authority had no jurisdiction over this approval process it was seeking to influence outcomes via reforms to the TPM.⁷

3 REGULATORY INDEPENDENCE AND INSTITUTIONAL FORM

Mighty River Power supports the characterisation of various elements of regulator independence outlined by the Productivity Commission in Figure 4.2. The regulation and institutional dimensions are likely in our view to be most important in terms of perceptions of regulatory independence.

The establishment of the Electricity Authority has largely addressed the perceived deficiencies of the Electricity Commission model, improving the independence and flexibility of decision making and the focus and timeliness of the work programme. This broadly accords with the Productivity Commission's framework.

⁷ See Appendix F of Mighty River Power's submission on the TPM for further discussion on the jurisdictional overlap. Available from: <http://www.ea.govt.nz/dmsdocument/14467>

However, while increased regulatory independence is desirable, we consider the overall performance of regulatory decision making still requires oversight.

In particular, there is increased risk the desire to deliver an expedited regulatory outcome overrides the regulatory impact assessment process and reform is advanced with uncertainty around problem definition or net benefit analysis. This can be exacerbated where there is a clear mandate for reform within a defined timeframe. Further, where a policy making and regulatory functions are integrated there is a risk that the implementation costs and issues may be discounted by a desire for rapid implementation.

Ensuring that regulatory decisions are subject to post-implementation review to assess whether the costs and benefits of reform accord with initial assessments is a vital step. Additional processes, like merits review and independent review of regulatory performance, can increase the credibility of regulatory decisions.

Mighty River Power has not observed material issues with regulator capture in any of the regulatory regimes under which it operates.

4 DECISION-MAKING STRUCTURES, PROCESSES AND APPROACHES

The quality and stability of regulatory decision making is paramount for the electricity sector given the long asset lives and the impact of regulatory uncertainty can have on the willingness for investors to commit significant capital.

New Zealand's short three electoral cycle and unicameral parliament structure means there is a higher likelihood that significant changes in policy direction can be implemented by a change in government and result in material impacts on shareholder value⁸.

Mighty River Power considers as a core principle regulatory decision making processes should aim to be as stable and predictable as possible. While regulatory outcomes cannot be guaranteed, the general process of regulatory decision making should be transparent. It should proceed according to best practice regulatory impact assessment principles and be regulatory decisions should subject to a high materiality threshold for change.

Where significant changes in regulation are considered, the nature of such changes should be signalled in advance and phased-in over time in a predictable manner. The property rights regime enshrined in common law countries like New Zealand also highlights the need for

⁸ See for example the share price impact from the Labour and the Green's recent joint policy announcement <http://www.nbr.co.nz/article/labour-greens-power-policy-hits-contact-energy-share-price-bd-138888>

regulators to consider transitional arrangements, such as the grandfathering of pre-existing rights, where significant regulatory changes are considered.

As noted by former Australian Minister for Resources and Energy, Hon Martin Ferguson⁹ in terms of the energy market reform process in Australia:

'To the extent reform is necessary [businesses] want it to be gradual and consensual, enabling them time to adjust... The focus of reform should be on a process of continuous learning rather than throwing the rule book out at the first sign of trouble. The pace of reform may frustrate commentators but they should appreciate that the legitimacy and quality of policy outcomes ultimately depend on proper process being observed.'

Historically, a range of options have been considered and implemented for the regulatory governance of the electricity market. The current Electricity Authority conforms to the multi-member model outlined in the issues paper. The previous Commissioner model has been replaced by a skills-based Board responsible for regulatory decision-making.

The most significant test of this model since the Authority's inception in 2010 has been in relation to attempts to resolve the long-standing industry issues around the Transmission Pricing Methodology as outlined in Box Three below.

Box Three: Electricity Authority Decision Making process and the TPM

Table One of Appendix A outlines the process for development of the Authority's proposal for reform of the TPM.

The New Zealand Treasury Regulatory Impact Assessment Handbook outlines the following broad steps for best practice regulatory development:

1. Defining the problem and assessing its magnitude;
2. Defining the policy objectives broadly enough to consider all relevant alternative solutions and identify the full range of feasible options;
3. Analyse the options and their impacts (e.g. via CBA and other qualitative methods)
4. Undertake a risk assessment (including impacts on various stakeholders).

As a first step, a legitimate option would have been for the recommendations of the previous TPAG review¹⁰ process to have been tested. However, this process was dismissed on the basis of TPAG not being able to reach consensus, despite the Authority undertaking analysis which indicated the magnitude of impact of the TPAG analysis was broadly accurate.

⁹ Hon Martin Ferguson, Australian Financial Review 17 September 2013 'Good energy policy must be marinated' http://www.afr.com/p/australia2-0/good_energy_policy_must_be_marinated_6CcFPIYCvvdN03Zlvh0b30

¹⁰ Transmission Pricing Advisory Group. See Appendix A for further detail.

Instead the Authority returned to first principles by consulting on a high level decision making framework. It then took seven months where there was no consultation or indication of approach to stakeholders to develop an issues and proposal paper.

On the basis of previous reviews, many stakeholders had expected a focus solely on the resolution of the long standing issues around the allocation of the costs of the inter-island HVDC link. Instead the Authority proposed a much wider problem definition which in its view required the reallocation of substantial historic sunk transmission costs.

The Authority's issues and proposal paper amalgamated many of the above stages of regulatory impact assessment:

- It put forward only a single option for reform;
- Used qualitative assessment to rule out other policy options;
- Applied a novel top down efficiency approach to calculating the benefits of its proposal rather than a more traditional 'bottom-up' assessment.
- Only released detailed analysis on the impacts to stakeholders, including consumers, after request.

Following strong feedback from stakeholders the Authority has revised its process to include further consultation via a series of working papers on core aspects of its proposal. Feedback to the Authority from the most recent consultation is that problem definition requires further consultation and more incremental approaches to reform should be considered¹¹.

The above highlights the merits and efficiency associated with predictable regulatory impact assessment process, in particular the importance of the problem definition stage.

Australian Energy Market Commission - Transmission Frameworks Review

<http://www.aemc.gov.au/market-reviews/completed/transmission-frameworks-review.html>

By way of comparison, the AEMC undertook a comprehensive review of its transmission frameworks that concluded in April 2013 following a three year consultation process.

The AEMC review proceeded according to its common framework established for all market reviews but also demonstrated flexibility to accommodate workshops on key issues as they arose. The specific steps included consultation on:

- Issues paper;
- Directions paper – framing the issues from the previous step;
- First interim options paper – broadly outlining the variety of options for consideration but with no options preferred;
- Second Interim Report – narrowed the options put forward in the first paper and

¹¹ See Submissions on Transmission pricing methodology: CBA working paper <http://www.ea.govt.nz/our-work/consultations/priority-projects/tpm-cba-working-paper/submissions/>

presented the Commission's proposals;

- Final decision.
- A Stakeholder Consultative Committee with a wide membership of stakeholders was also convened to input into the process.

The AEMC's process greatly assisted it in navigating a difficult and long standing policy issue.

5 DECISION REVIEW AND APPEAL

Mighty River Power agrees with the contention in paper that merits review can provide a useful check and balance on the regulatory process. However, the nature and form of merits review requires careful attention to avoid protracted and costly legal engagements. The recent experience of merits review within electricity network regulation has received mixed feedback though some lessons may be able to be taken to improve the process in future.

New Zealand could well benefit from the experience of overseas jurisdictions in the application of merits review. We would support the Productivity Commission investigating the value of an Australian Administrative Appeals Tribunal model for New Zealand.

6 FUNDING AND RESOURCING

Mighty River Power is not aware of any material issues with the incentives created by the funding arrangements of the regulators under which it operates.

The Electricity Authority is funded under levy arrangements. Mighty River Power considers the benefit of levy funding is that it is generally transparent (requiring annual consultation with stakeholders) and the Authority has demonstrated a commitment to manage its operating costs.

7 REGULATOR WORKFORCE CAPABILITY

New Zealand's small size and depth of labour markets mean access to the exact required technical and managerial expertise for regulators will always be challenging. It can also be difficult to strike an appropriate balance of industry, consumer and regulatory representation.

We agree with the Commission that the large range of regulatory and also policy agencies in New Zealand can fragment the availability and capability of the regulatory workforce. In the energy sector competing agencies requiring energy sector expertise include the Electricity Authority, the Commerce Commission, the Gas Industry Company, the Gas and Electricity Complaints Authority, Ministry for Business, Innovation and Employment, Ministry of Consumer Affairs and the Energy Efficiency and Conservation Authority.

This fragmentation can be exacerbated when regulators operate under an integrated rule maker/regulator model as with the Electricity Authority. One of the problems with this integrated model is that the skill set required for each function may be significantly different. The skills required for effective regulation tend to be generic across a range of sectors. While there are some unique characteristics of electricity, general competition law and regulation applies equally effectively to the competitive sector.

An alternative approach would be to consider concentrating regulatory functions in the Commerce Commission as an umbrella regulator but with some industry specific technical expertise. The Commission is already responsible for monopoly regulation in electricity. The benefits of this approach would be to provide sector specific rule-makers with more resource to focus on industry development rather than regulation, compliance and enforcement.

The separate rule-making/regulator model in Australia is an example of such a model. The Australian Energy Market Commission process for review follows a consistent model (as outlined in Box Three). The Australian Energy Regulator sits within ACCC and benefits from exchange of regulatory expertise.

There is also a trend within corporate boardrooms to seek Trans Tasman representation; a similar model could apply in the regulatory space. We note that the current Telecommunications Commissioner was recruited from Australia.

8 COMPLIANCE MONITORING AND ENFORCEMENT

Mighty River Power is subject to a range of regulatory regimes including from across the electricity market, environmental regulation at national, regional and the local level, labour law and health and safety.

Businesses value regulatory certainty as it enables planning. This certainty comes not just through clarity of the regulations or regulatory framework but also through the way regulators monitor and enforce regulation.

It is important that a consistent approach is taken for monitoring and enforcement. We have seen a wide range of approaches even within individual regulatory bodies where the nature of enforcement, or whether there will even be enforcement, seems to depend on the inclination/personality of the particular individual involved.

For example when we deal with local authority regulators in the context of reviews of our resource consents the approach tends to be collaborative with regular information feedback and monitoring with both parties focused on achieving common goals that link back to the planning legislation and local and regional planning documents.

This approach has enabled us to reach a position where the Waikato Regional Council decided not to review our consent conditions for operation of the Waikato hydro system. A collaborative approach while requiring more resource does tend in our view to provide greater certainty and foster better working relationships.

It is important that regulators concern themselves not just with enforcement where there is a breach but with working with businesses to improve processes to ensure future compliance. Costs of non-compliance are more likely to be minimised through clear communication of approach and a focus on improved education and processes.

A key challenge can be when the regulator is represented by too few personnel on the ground who can take no more than a cursory tick-box approach to compliance. We have also experienced situations where regulatory personnel have conflicts of interest that are not identified or addressed by the regulator. One of the challenges for regulators is to take a more rigorous approach to ensuring that conflicts of interest are not just declared but removed.

In terms of discretion, sometimes too much discretion comes not because the regulator is given it, but rather because personnel on the ground exercise it. As per the comment above, in our experience that discretion tends to be demonstrated through individuals and is not necessarily representative of the regulatory body itself. Although the exercise of discretion can be helpful and appropriate, it can also create uncertainty.

We agree with the Commission that where discretion is delegated to a regulator this should be exercised consistent with a set of clear guidelines or principles that have been consulted on and clearly communicated to the regulated parties.

9 ENGAGEMENT

We agree with the Commission's analysis that effective engagement is important to gather information to inform regulator decisions and provide early warning of potential problems. The general trend within electricity has been for major regulatory market design decisions to proceed slowly via consultation within specialist working groups which include a representative cross section of stakeholders.

One of the rationales for reform of the Electricity Commission was that the model had moved too far away from including stakeholders in the rule design process, a practice that had been put in place under the previous NZ Electricity Market¹². The Electricity Authority was required to establish a number of specialist advisory groups to inform its decision making process, though ultimate decision making remains with the Authority Board.

¹² See Business New Zealand – Regulation and Governance of the electricity sector by LECG. Available from <http://www.businessnz.org.nz/file/1636/Regulation%20and%20governance%20of%20electricity%20sector.pdf>

The time pressures placed on the Electricity Authority for recent reform have led to pressure to conflate the stages of the traditional regulatory impact assessment process and reduce the role of engagement primarily to a proposal/respond model.

This can be expedient where there is general consensus around problem definition and the need for reform, or where issues are technical in nature and largely uncontroversial. But it can have draw backs. For example the introduction of significant revisions to the Transmission Pricing Methodology after some limited consultation with Transpower meant that time and resources had to be devoted by a range of stakeholders to understand the very complex proposals, initially over a relatively short period of time. The Authority has recognised the limitations of this approach and has sought to consult further which we support.

We note that in other sectors of the economy, where major change is proposed that will have a significant impact on business investment decisions, generally collaborative engagement approaches have been preferred. For example, the Land and Water Forum process which looked at how to effectively manage water allocation and improve water quality utilised a far longer period of consultation and engagement on the basis that achieving a solid consensus and stakeholder buy would lead to a more durable outcome.

Another example of good practice is provided by the Commerce Commission, which generally takes a collaborative approach to problem definition. When considering its approach to information disclosure for Transpower the Commission held a workshop to get industry participants' views ahead of formulating its approach. The Commission contacted industry participants directly and actively encouraged workshop attendance.

Engagement is also important around setting priorities for future work and ensuring the regulatory resources are allocated to resolving material, rather than second order industry issues.

10 ORGANISATIONAL CULTURE

General challenges we observe relate to ensuring the regulator understands the commercial drivers facing the competitive sector. Regulatory staff working in the electricity sector tend to have backgrounds in economics or engineering, particularly in the economic regulation of network businesses.

This can lead to a reliance on quantitative assessment methodologies and economic theory rather than consideration of more qualitative impacts which are more uncertain. For example, what the longer term dynamic response will be from market participants to the proposed reform or how the electricity market reform plays out in the real world where New Zealand's geography, generation mix and small dispersed population pose significant challenges that are arguably not duplicated elsewhere in the world.

It can be challenging to introduce greater commercial sector experience within senior regulatory board appointments due to perceptions of regulatory capture. However, having clear policies on how conflicts of interest will be managed can help reduce such perceptions as well as ensuring a balance of representation. Probably the larger barrier to greater commercial sector representation is ability for small, resource constrained regulators to compete with commercial sector remuneration particularly given the likely complexity and time commitment of regulatory roles.

During the establishment phase for the Electricity Authority, consideration was given to a Board structure comprising members nominated from industry, consumers and government. However, many submitters raised concerns about the practicality and desirability of proposals for stakeholder groups to nominate Board members.

It was decided that more general criteria be included in legislation as to the types and range of skills required on the Board and that the Minister of Energy should invite nominations from stakeholders but not be restricted to recommending (to the Governor-General) only nominated persons¹³.

While a broad skills based approach can often be effective, the highly technical nature of electricity regulation can open up the potential for the views of individual members with particular expertise in the sector to dominate. This can be managed by greater transparency regarding Board level decisions. To its credit when it makes decisions that have a significant impact on market participants the Authority documents its reasoning.

Mighty River Power would support the Productivity Commission review considering what workable models exist both domestically and internationally to provide a wide range of skills and experience within industry regulatory bodies.

11 PERFORMANCE ASSESSMENT

We agree with the Commission's view that performance assessment is an integral part of the regulatory development process and should be seen, not as a compliance exercise, but as an important part of improving the quality and outcomes of regulation.

In electricity, performance assessment of the regulator is relatively ad hoc and primarily done through mechanisms such as stakeholder surveys the Authority undertakes and feedback from participants in the annual appropriations and work planning processes. The Authority also appears before the Commerce Select Committee for its annual financial review.

¹³ See page 29 of <http://www.med.govt.nz/sectors-industries/energy/pdf-docs-library/electricity-market/implementing-the-electricity-market-review-recommendations/background-papers-on-2009-review/Elec.0025%20-%20Electricity%20Market%20Review%20-%20Cabinet%20Paper.pdf>

The limitations of the self-reporting performance model are that it can raise the scope for reporting bias.

As a matter of principle we consider that consultation on regulator performance should entail both direct feedback to the regulator itself and to an independent body that monitors regulatory performance and makes its findings public. This is to avoid the moral hazard risk of the self-reporting of performance. The Office of Auditor General has in the past undertaken reviews of the performance of the Electricity Commission.

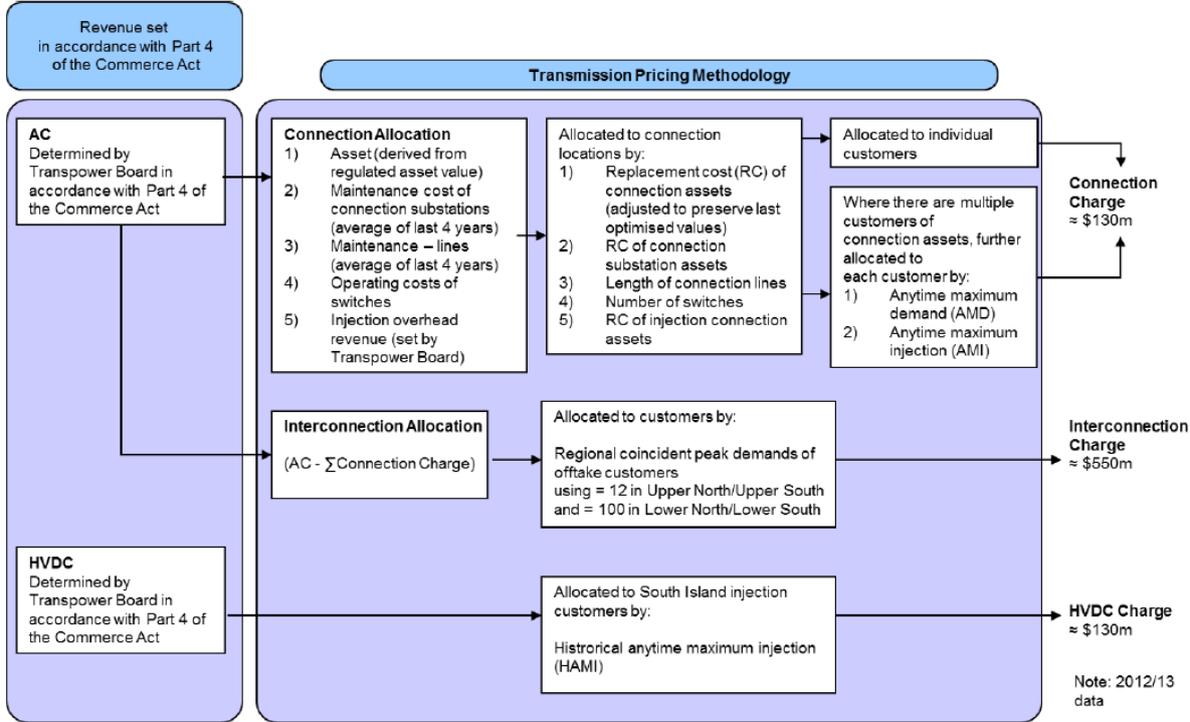
Mighty River Power would support the Productivity Commission examining in more detail how a consistent review regime of regulator performance could operate across multiple regulators.

APPENDIX A: TRANSMISSION PRICING METHODOLOGY CASE STUDY

Purpose

The Transmission Pricing Methodology (TPM) is administered by the Electricity Authority determines how Transpower’s annual revenue (circa \$800m in 2012/13) should be recovered from designated transmission customers. The amount of revenue to be recovered is set by the Commerce Commission under Part 4 of the Commerce Act.

Chart One: Overview of the TPM



Source: Schedule 12.4 of the Code.

Over the past decade around \$3.5bn in new transmission investment has been approved on the basis of providing increased reliability or wider economic benefits to New Zealand electricity consumers and/or the economy. Major projects include:

- North Island Grid Upgrade: new transmission assets connecting Auckland with renewable energy resources in the Waikato region.
- Upgrade to the High Voltage Direct Current (HVDC) link between the South and North Islands (called Pole 3);
- Upgrades to strengthen reliability to the north of Auckland and Northland region.

Several of these projects have been commissioned or are nearing completion with the costs progressively being recovered via the TPM.

Short History of TPM Development

The allocation of the large sunk costs associated with transmission investment has long been a contested space within the electricity sector. Numerous working groups (including industry, consumers and regulatory stakeholders) have been established since 2001 to consider the merits of reform¹⁴. In general these reviews have focussed on:

- Whether it is possible to allocate transmission charges according to “market-like” charges or a beneficiaries-pays approach.
- The investment and operational inefficiencies associated with the cost allocation of the HVDC-link solely to South Island generators and whether alternative allocation approaches would yield net benefits.

The general conclusion of the most recent review bodies has been that only incremental TPM reform was warranted given that:

“The current TPM was, for the most part, sound and not demonstrably inferior to alternatives. Those bodies also recognised that material changes would entail substantial wealth transfers and risk giving rise to unintended consequences.”¹⁵

The most recent review by the Transmission Pricing Advisory Group (TPAG), which concluded at the end of 2011, identified there were relatively material inefficiencies with the current treatment of HVDC cost. However, its members were divided on the appropriate response with recommendations divided into a majority and minority view:

- Majority view: HVDC costs should be socialised into the interconnection charge over a 10 year transition period.
- Minority view: retain the status quo charging arrangements.

TPAG’s recommendation¹⁶ was that the Electricity Authority should verify the extent of the HVDC efficiency losses and take a decision between the majority transition and the minority status quo view.

This modelling was undertaken by the Authority but not released publicly. The analysis concluded that the efficiency losses were actually slightly lower than those calculated by TPAG¹⁷.

¹⁴ For a summary of working group processes see letter from TrustPower “Request for Amended Process on TPM” [26 November 2012] Available from www.ea.govt.nz/dmsdocument/14163

¹⁵ Competition Economists Group (Feb 2013) “Transmission Pricing Methodology – Economic Critique” Appendix A Some History Pg 48 Section 167.

¹⁶ TPAG, Transmission Pricing Analysis. Report to the Electricity Authority, 31 August 2011, page 1, para [5].

¹⁷ Untitled draft report sent via email to Mighty River Power from David Lewis Electricity Authority 14/12/2012 ‘The updated GEM analysis on the impact of the HVDC charges on generation investment efficiency is broadly consistent with, but slightly lower than, the estimates that TPAG derived from its more simplified LRMC modelling.’ Section 1.7.1 pg 6.

Table One: Electricity Authority TPM Process

Date	Output
January to March 2012	TPAG recommendations rejected on the basis that the process was unable to achieve consensus. The Authority returned to a first principles approach, releasing its Economic and Decision Making Framework for Transmission Pricing ¹⁸ for consultation which proposed a hierarchy of preferred charging approaches, ranging from market-like through to administered forms of pricing.
October 2012	<p>After seven months of development without public consultation the Authority released an Issues and Proposal paper, initially for a six week consultation period. Following several requests from stakeholders the deadline for submissions was extended twice to March 2013¹⁹.</p> <p>The paper put forward a single option for consultation based on a beneficiary-pays approach. Rather than a focus on HVDC cost reallocation, the Authority proposed to reallocate the sunk costs of all transmission assets approved since 2004 over \$2m.</p> <p>Limitations with the beneficiary pays approach meant that residual transmission charges (which were the majority) were proposed to be allocated according to a 50/50 split between generators and consumers.</p>
December 2102 to February 2013	<p>A number of Q&A and modelling workshops were held. Main feedback from industry was that key elements of the proposal were still uncertain and undeveloped. As such, it was difficult for stakeholders to assess impact.</p> <p>Following requests from stakeholders, the Authority undertook modelling of the impacts on consumers and other stakeholders from its proposed approach.</p>
March 2013	The Authority received broad industry feedback that its proposal was not commensurate with a robust problem definition, was wider in scope than anticipated and likely to give rise to material inefficiencies not considered in the cost benefit analysis ²⁰ .
May 2013	In response to feedback, The Authority proposed a three day conference to enable Board members to ask questions of participants, consistent with a Commerce Commission style inquiry. Despite requests from stakeholders the Authority declined to provide an indication of questions to participants prior to the conference on the basis it was seeking "unedited" responses ²¹ .

¹⁸ See <http://www.ea.govt.nz/our-work/consultations/transmission/tpm-economic-framework/>

¹⁹ See <http://www.ea.govt.nz/our-work/programmes/priority-projects/transmission-pricing-review/issues-paper/>

²⁰ See PWC (March 2013) Review of Submissions on the Electricity Authority's TPM. Available from <http://www.ea.govt.nz/dmsdocument/14592>

²¹ See comments from EA Chair TPM Conference Transcript - Friday 31 May Pg 393 <http://www.ea.govt.nz/dmsdocument/15087>

September 2013	<p>The Authority releases the first in a series of proposed working papers on aspects of its proposal. First paper considered how it should apply an appropriate cost benefit analysis. Feedback from stakeholders was that the Authority's problem definition required further consideration and should form a separate working paper and that it was difficult to comment on a CBA process absent of a clear proposal or set of proposals²².</p> <p>Following consultation on the working papers, the Authority proposes to develop a second issues paper in mid-2014 which "is likely to materially alter the proposal that was in the consultation paper"²³.</p>
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²² See <http://www.ea.govt.nz/our-work/consultations/priority-projects/tpm-cba-working-paper/submissions/>

²³ CBA working paper section 1.2 available from <http://www.ea.govt.nz/dmsdocument/15683>