

8 May 2014

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Regulatory Institutions and Practices Inquiry
New Zealand Productivity Commission
WELLINGTON
New Zealand

By email: Steven.Bailey@productivity.govt.nz

Dear Steven,

Regulatory institutions and practices: draft report

We welcome the opportunity to submit on the Productivity Commission's draft report "Regulatory institutions and practices", March 2014. No part of our submission is confidential.

We commend the Productivity Commission progress so far in this challenging review. As was the case with our earlier submission we have not been able to devote as much to this submission as we might wish. Our submission is consequently focussed on a few key areas:

- economic regulators are generally doing a good job (but there is room for improvement)
- 'big bang' change is costlier and riskier than incremental reform
- getting the regulatory 'practices' right is a key ingredient in the recipe for success
- a non-legal 'critical friend' review mechanism will enhance regulatory quality

The Appendix to this submission contains our responses to some of the specific questions posed in the draft report.

A good job in difficult circumstances

The regulators that we deal most directly with are the Commerce Commission, who regulates Transpower under Part 4 of the Commerce Act 1986, and the Electricity Authority, who regulates Transpower under the Electricity Industry Act 2010.

We do not agree with every decision made by those regulators (and we frequently provide robust feedback to test and challenge their proposals); we have some concerns about their performance and we consider there are genuine areas for improvement. We discuss these further below.

However, our overriding view is that those regulators generally perform a challenging role, often in difficult circumstances, and do a good job. For example:

- the Commerce Commission has just completed the development of, and transition to, an entirely new and relatively complex regulatory regime within a relatively short timeframe. This is a significant achievement on its own, more so when one considers it has coincided with material telecommunications regulation reform and the assumption of new responsibilities (e.g. taking over grid investment approvals from the Electricity Authority).

- The Electricity Authority has, in a relatively short period of time, overseen a raft of changes to the operation of the electricity market which have materially changed the nature and intensity of competition between generators and retailers. While the full impact of those changes has yet to flow through to the headlines consumers are already experiencing the benefits.

We consider that the legislative frameworks that we are regulated under are fit for purpose and that this is contributing to the ability of the Commerce Commission and the Electricity Authority to be successful regulators. A key challenge for these regulators is striving to improve the way they operate: how they consult and engage stakeholders, analyse regulatory problems and the way they make decisions.

We acknowledge that our comments above are more positive than the results of the Productivity Commission's survey. That may in part be because Transpower has a high level of interaction with regulatory authorities which may have helped us understand our regulators' expectations and objectives (and conditioned our expectations) relative to a less intensively regulated firm with less direct regulatory interaction.

Opportunities for ongoing improvement

Although in our experience, the Commerce Commission and Electricity Authority generally do a good job in often difficult circumstances, we think there are opportunities to make improvements which should be pursued. We outline four areas for improvement, below.

Resourcing and prioritisation

We are supportive of ensuring regulators have sufficient budget and resources to undertake their regulatory responsibilities in a robust manner. However, even a well-resourced regulator has to prioritise and we consider that both the Commerce Commission and the Electricity Authority are guilty of taking too much on and being unrealistic about what they can achieve within set timeframes. The consequences for them and their stakeholders can be severe; for example: compromising on important but lower profile work, reduced decision quality, increased staff churn and undermining the credibility of, and stakeholder confidence in, the regulator.

It is hardly a secret that regulatory processes take longer, consume more resources and often deliver fewer benefits than first expected. Like the firms they regulate, regulators really should be realistic and disciplined in deciding and prioritising work plans (including providing contingency for emergencies).

Exercise of discretion

Predictability and certainty are as much a product of the regulator's behaviour as they are of the codified rules. While the Commerce Commission has done well to establish the input methodologies (IMs) equally important is the manner in which the Commerce Commission exercises its discretion over when to review and change the IMs i.e. the durability of the IMs can only be inferred from the Commission's 'form' vis-à-vis willingness to revisit the IMs and the threshold for changing the IMs.

We consider the section 52R purpose and certainty will be best achieved by the Commission establishing (through consultation) and adhering to a set of principles as to when it will revisit the IMs, outside the statutory review, and the threshold any change proposal must pass before introduction.

It all begins with getting the basics right

Even where robust processes are employed good regulatory policy is challenging to make. A key challenge for regulators is properly defining the problem they seek to solve and rigorously testing this to ensure its validity. For example, a recurring theme of submissions to the Electricity

Authority's TPM investigation is the absence of well-articulated and quantified problem definition and a perception that the review is solution-led.

Unfortunately, getting the basics right is easier said than done and is a product of process, analytical rigour and humility (one rarely gets it right first time around). In our view this is an area where investment in institutional processes and frameworks and in staff development is money well spent - it can improve: staff confidence and morale, decision quality, stakeholder confidence and reduce costs for the regulator, regulated firms and consumers.

Clear and transparent articulation of decisions and reasons

Chorus commented about the importance of "clear, well communicated and well understood" policy outcomes.¹ We agree and consider that regulators do not always articulate their position, or reasoning, on regulatory matters as well as they could. The consequences are uncertainty (which can prove costly and destabilising), poorly reasoned (and potentially arbitrary) decisions and the risk of re-interpretation of decision rationale over time. Professor Yarrow observed²:

"regulation itself is a monopolistic activity. It is, therefore, appropriately subject to checks and balances."

In our view clear justification of decisions is crucial to those checks and balances and it should be mandatory for regulators to provide reasoning in support of each decision they take and this should be sufficiently clear and detailed that affected parties can understand the regulator's reasoning and assumptions for all substantive decisions. Regulator work plans need to allow for this step.

These are generally behavioural matters the regulator could address itself, and don't warrant or require institutional or legislative change. They generally reflect a weakness in one or other of the key operational requirements described below.

Operating practices: a recipe for success

It is clear from submissions on the initial consultation that establishing regulatory institutions with clear functions and objectives, and a suitable degree of independence, are all important requirements for ensuring successful operation of regulatory agencies.

Fundamentally, though, whether a regulatory agency is successful or not comes down to the way it operates. Some of the fundamental requirements we believe are necessary for a regulatory agency to be successful are:

- **clear purpose and objectives:** the regulatory agency is clear about what it is trying to achieve (and why)
- **ruthless prioritisation:** potential workstreams are prioritised, and the regulatory agency explicitly distinguishes between essential and discretionary activities
- **organisational and people capability:** the regulatory agency has the necessary institutional and staff capabilities to deliver on its regulatory objectives and priorities (and is not unduly reliant on external support)
- **certainty and process:** regulatory decisions are predictable, clear and transparent

¹ Chorus, Chorus' Submission in response to the Productivity Commission's Issues Paper entitled "Regulatory Institutions and Practices", 11 November 2013, paragraph 15.

² Professor George Yarrow, Director, Regulatory Policy Institute, UK. Keynote presentation (17th October 2013) at Commerce Commission *Competition Matters* conference

- policy development processes are well-defined from the outset, with a consultation process that mirrors the multi-stage policy development process
- “regulatory ‘solutions’ are only proposed in response to a clearly defined problem[/market failure] that cannot be solved by any other means. In other words, intervention requires a significant and persisting market failure, that is likely to endure unless regulation is introduced”³
- “problems are well analysed and understood, and the regulator prefers the minimum intervention necessary to address the problem (i.e. intervention is proportionate). This includes an assessment of who is affected by a problem, the costs of action or inaction, and the costs of intervention vs. non-intervention”⁴
- **evidence based decision-making:** “decisions are based on broad and ‘best quality’ evidence, and competing evidence is carefully weighed and analysed”.⁵ The decisions on both whether to regulate and how to regulate should be evidence based⁶
- **open-minded consultation:** “regulatory decisions are preceded by genuine discussion and consultation with stakeholders”.⁷

We acknowledge that it is easier to prepare this list in a submission than for a new or existing regulatory authority to operationalise and, as indicated in our earlier submission, some may require external assistance.

The focus needs to be on incremental change and regulatory evolution

There should be a ‘bias’ in favour of incremental changes that reflect a logical and evolutionary enhancement of existing regulatory provisions. We note Chorus’ comment on frequent changes to regulation:⁸

The statutory regimes regulating New Zealand are subject to frequent change and amendment through legislation. Although such amendment is often designed to make improvements in the efficiency and operation of the sector subject to regulation, in our experience and opinion, such amendments often lead to an increasing risk of disconnects between what is intended in terms of policy outcomes and what is prescribed or interpreted in the legislation by the regulatory institution.

Regulatory reform should focus on making it easier for regulators to do their job well, rather than further upheaval and starting again which is tremendously disruptive and costly.

³ Vodafone, Productivity Commission Regulatory Institutions and Practices Issues Paper (August 2013), 1 November 2013, paragraph 6.

⁴ Vodafone, Productivity Commission Regulatory Institutions and Practices Issues Paper (August 2013), 1 November 2013, paragraph 6.

⁵ Vodafone, Productivity Commission Regulatory Institutions and Practices Issues Paper (August 2013), 1 November 2013, paragraph 6.

⁶ This is a clear learning from the High Court IM Merit Appeal decision, December 2013.

⁷ Vodafone, Productivity Commission Regulatory Institutions and Practices Issues Paper (August 2013), 1 November 2013, paragraph 6.

⁸ Chorus, Chorus’ Submission in response to the Productivity Commission’s Issues Paper entitled “Regulatory Institutions and Practices”, 11 November 2013, paragraph 29.

Review mechanisms: room for improvement

There has been much discussion of the role of formal decision review mechanisms (judicial review and merits review) and increasingly of the need to systematically review existing regulation to establish whether it remains fit for purpose (or necessary at all). If the latter functions well incremental regulatory reform and evolution should occur.

While these are clearly both critical components of the New Zealand regulatory ecosystem we consider there is a role for another, less formal, mechanism aimed at identifying and helping improve performance issues. This review mechanism would be an objective peer review of a particular decision or performance focused on identifying any deficiencies in the process or analysis undertaken and helping to identify opportunities for improvement. In this sense it provides a very different, but complimentary, role to formal legal reviews.

In our view, the prospect of being ‘named and shamed’ provides a stronger incentive for regulators to adopt best practice processes and procedures than can be provided through formal legal reviews. We consider that it would be desirable to place specific responsibility for review of the performance of regulatory bodies (including quality of decisions) within an oversight body. This could be an existing entity such as MBIE, The Treasury or the Productivity Commission. We note that the National Audit Office performs this function in the UK where it has reviewed the general⁹ and specific¹⁰ performance of the key regulatory authorities.

While legal reviews provide critical safeguards it is important to recognise that these carry significant costs meaning they should be viewed, at best, as a last resort and sometimes simply not an option. In practice this means that a regulator can make multiple poor decisions, causing severe detriment to the consumers they are charged with protecting, without necessarily triggering a legal challenge.

Where to from here?

The outputs we would like to see from the Productivity Commission inquiry include:

- guidance for regulatory agencies on what they need to do to ensure best practice and successful operation of their regulatory functions
- a clear framework for making decisions on regulatory reform that will, over time, help ensure predictable and stable regulatory regimes that evolve in a logical and incremental manner
- responsibility for review and oversight of the decision-making and operation of economic regulators, including periodic review and peer review of decision-making, should formally be included in a single Government Agency.

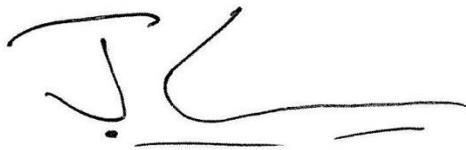
⁹ For example: http://www.nao.org.uk/wp-content/uploads/2011/02/Perf_Ofgem.pdf and <http://www.nao.org.uk/report/ofcom-the-effectiveness-of-converged-regulation/>

¹⁰ For example: 4G radio spectrum: lessons learned: <http://www.nao.org.uk/report/4g-radio-spectrum-auction-lessons-learned/>

Finally, we acknowledge that an issue for the Productivity Commission, especially in this review, will be distinguishing between legitimate concerns and criticism motivated by unfavourable decisions ('sour grapes'). Equally, ensuring legitimate concerns are not erroneously discounted on the basis that "they would say that, wouldn't they".

Please let me know if you have any questions or would like to discuss any of the points made in this submission.

Yours sincerely,

A handwritten signature in black ink, consisting of a stylized 'J' and 'C' followed by a horizontal line.

Jeremy Cain
Chief Regulatory Advisor

Appendix: Responses to Productivity Commission questions

Question	Transpower response
5.1 How can the role of the Regulations Review Committee be strengthened, if regulators are delegated greater regulation-making powers?	<p>We support a formal periodic review mechanism for all regulatory agencies.</p> <p>A component of the review mechanism could be to identify any performance issues/barriers to successful promotion of the regulatory agency's statutory objective that may be caused by the existing legislation/require legislative change to resolve. This would be a useful input for the Regulations Review Committee.</p>
8.2 Are there examples of consultation provisions that are working well, or alternatively, not as well as they should? What factors contribute to a consultation provisions working well/poorly?	<p>Consultation provisions in legislation can cause problems where, for example, they impose limits on the consultation period that the regulator is able to provide.</p> <p>Factors that contribute to consultation provisions working will include:</p> <ul style="list-style-type: none"> • adequate time for submitters to engage • consultation steps mirroring the policy development steps (particularly on complex and substantive matters) • early consultation (before the regulator has formed strong views that it may be reluctant to depart from) • provision of sufficient time for the regulator to change its proposed course/policy solutions, subject to consultation • regulator clearly and transparently articulating its views and reasoning (including responses to previous submissions) • consultation with a clear link between problem definition (and materiality) and the options being considered by the regulator • ensuring the regulator consults with an open-mind.
13.2 Would there be net benefits from imposing a general obligation on regulatory agencies to consult before fees or levies are introduced or amended?	<p>This is a standard process for the Commerce Commission and the Electricity Authority and generally works well. A key requirement is that the regulator provides sufficient justification for its expenditure proposals, linking to specific objectives and workstreams, for submitters to meaningfully submit.</p>
14.1 Are there other questions or characteristics that a monitoring approach for Crown entity	<p>A successful monitoring approach should provide a positive performance tension on regulators in a similar way that judicial review or merit appeals can. It should be seen as a complement and an alternative to legal</p>

Question	Transpower response
regulators should include?	<p>avenues for challenge of a regulator’s performance and decisions.</p> <p>A monitoring approach for regulators should include:</p> <ul style="list-style-type: none"> • opportunity for interested/affected parties to submit their views/raise specific concerns • review of adequacy of resourcing and staff capability • review of the performance of the regulatory, including the quality of specific decisions (particularly where interested parties have raised concerns), against a prescribed set of criteria¹¹ • guidance for regulatory agencies on what they need to do to ensure best practice and successful operation of their regulatory functions • a requirement for the regulator to have regard to the review, including an obligation to respond and detail any remedial action (if applicable).
15.1 What would be the advantages and disadvantages of increasing the role of Parliament in scrutinising how the stock of regulation is managed? If Parliament’s role should increase, what approach should be used to achieve it?	<p>Refer to the responses to Q5.1 and 14.1.</p> <p>Introduction of periodic review provisions of the nature proposed above could be coupled with a requirement to report to Parliament/Commerce Select Committee.</p>
16.2 Which is the best location for a support agency for a minister with responsibility for the regulatory management system?	<p>We consider that The Treasury, MBIE or the Productivity Commission are all valid candidates.</p> <p>There are already concerns about the number of regulatory agencies in New Zealand (including even just for the energy sector) so we would be reluctant to support the establishment of a new Independent Agency.</p>

¹¹ Refer to the criteria in the section “Fundamental requirements of a successful regulatory agency”, contained in this submission.