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Inquiry into Regulatory Institutions and Practices
New Zealand Productivity Commission
PO Box 8036
The Terrace
WELLINGTON 6143

POWERCO

Dear Sir/Madam

Re: Issues paper – regulatory institutions and practices

This is Powerco Limited's submission on the Productivity Commission's issues paper *Regulatory institutions and practices*. We appreciate that this is an initial scoping paper that invites comment on issues that participants consider relevant to the inquiry's terms of reference.

We understand that this is not a review of individual regulators or the objectives of particular regimes, and neither is it about improving the policy-making process for developing new regulation or regulators. Rather, the exercise is about providing guidance to steer the design and establishment of new regulatory regimes and regulators in general, improve the monitoring of regulatory performance across central government and develop system-wide recommendations to help improve the operation of regulatory regimes over time.

The submission from the Electricity Networks Association (ENA) provides a fair case study of those elements of the electricity industry regulatory framework that have caused the greatest problems for electricity distribution businesses (EDBs), particularly lack of certainty with respect to some processes and uncertainty about the way in which breaches of the price-quality paths will be dealt with, as well as the issues caused by the jurisdictional overlap between the Commerce Commission and the Electricity Authority in relation to pricing methodologies and information disclosure requirements. We fully endorse the ENA submission and are sure the Productivity Commission will find its submission very useful.

In this submission, we identify a number of headings that seem to encapsulate the principal issues that the Productivity Commission has identified in its paper and make some observations and comments on those topics.

The sort of guidelines that would assist with the design of regulatory regimes

The Productivity Commission has been asked to produce guidelines to assist the design of regulatory regimes. The following are the categories of guideline that we think would be useful in practice:

1) *Guidelines for appropriate governance arrangements, including external monitoring and appeal rights and the "refreshment" of governance personnel to avoid capture by particular analytical frameworks, disciplines or schools of thought*

The design of regulatory regimes should aim to clarify and codify when and how independent reviews of regulators should be undertaken. At present, this sort of activity is left to ad hoc decisions, e.g. MBIE could, in principle, review the Commerce Commission, but, to the best of our knowledge this has not happened in any formal sense, at least in recent times.

The regulatory design template could possibly extend the legal rights to appeal regulators' decisions to the courts. At present, appeal rights are restricted in some sectors, e.g. Part 4 of the Commerce Act permits merits reviews of the input methodologies and customised price path determinations, but not of the setting of default price-quality paths or information disclosure requirements. The high level design could also consider the merits of establishing a specialist appeals body, possibly modelled on the Australian Administrative Appeals Tribunal. This may be justified by the specialist technical nature of many regulatory arrangements, which High Court judges can find difficult to comprehend fully, even with the assistance of specialist advisers.

It may also be worth considering time restrictions on appeal rights. The time taken to hear the merits appeals against some of the Commerce Commission's decisions on the electricity distribution input methodologies could be a case study supporting such restrictions.

2) *Guidelines relating to the clarity of objectives and the scope of the regulator's activities*

Guidelines could help to "flesh out" and aid the interpretation of the regulatory objectives in legislation such as the Commerce Act 1986. The legislated objectives are necessarily broad and consequently open to multiple interpretations, which can create uncertainty for regulated entities.

3) *Guidelines to help determine the degree to which a regulator is independent*

Most regulators are established as Crown entities. The Crown Entities Act 2004 establishes different categories of Crown entity with different degrees of independence, specifically Crown agent, autonomous Crown entity and independent Crown entity. However, it is not clear what criteria should be applied when determining which class of Crown entity a regulator should fall into.

The Electricity Commission was created as a Crown agent that was required to implement government policy. The Electricity Authority has been established as an independent Crown entity that is not bound by government policy and can pursue its own objectives. It is not clear what the rationale supporting this change was and it might have been a step too far. We suggest that it would have been more appropriate to establish the Electricity Authority as an autonomous Crown entity (an intermediate status which requires the entity to have regard to government policy), given the need to have some means by which to give effect to the various energy sector related Government Policy Statements.

Guidelines to help identify the appropriate degree of independence for a regulator could help to resolve this problem and create greater certainty.

4) *Guidelines to help determine how tertiary legislation should be developed and enforced, e.g.:*

   - *whether rule-making powers should be able to be devolved solely to unelected Board members or a Minister of the Crown should have the final decision on the creation of legally enforceable rules;*

The Electricity Governance Rules administered by the Electricity Commission were required to be approved by the Minister of Energy. However, rules in the new Electricity Industry Participation Code can be created and amended directly by the Electricity

Authority, without reference to an elected member of the government executive. Allowing a non-elected body to create laws in this way seems to be stretching the usual constitutional conventions that apply in New Zealand. Guidelines could help to identify when delegating law making powers to non-elected regulators would and would not be appropriate.

- *whether the rule development and rule enforcement functions should be separated (as in Australia);*

Currently, both the Electricity Authority and the Commerce Commission are responsible for creating rules and administering the rules that they themselves create. This dual responsibility generally works satisfactorily but separation of the rule making and rule interpretation functions (as occurs in Australia) would, we believe, be more consistent with good international regulatory practice and would remove any suggestion of a possible conflict of interest. Such separation would also encourage the drafting of clear rules that could be readily interpreted and applied by a disinterested body that had taken no part in the rule making process.

- *how consultation should be undertaken;*

There is case law that establishes what consultation means in a legal sense, but this still leaves considerable latitude for individual regulators to adopt their own particular approaches to consultation. Guidelines that further defined the consultation process and how the regulator should treat the information it provides could help to add clarity and certainty to the process.

- *whether rule-making should be subject to oversight or review by an independent panel in addition to the parliamentary Regulations Review Committee.*

In principle, Electricity Authority rules and other similar tertiary legislation is subject to review by the parliamentary Regulations Review Committee and any rule can, potentially, be struck down or referred back to the rule-making body should it be found to be *ultra vires* or to have been incorrectly made. However, in practice, due to limited resources and time, the Committee can only review a relatively small number of regulations, rules and orders. Consequently, it may be appropriate for a specialist review body or bodies to be established to enable rules made by particular sector-specific rule-making bodies to be reviewed on a more regular basis. This could help to improve the quality of rule making over time.

5) *Guidelines on liability for decision-making, e.g. should the regulator be at least partly culpable if their decisions produce poor outcomes (such as inefficient trading arrangements or inefficient transmission investments that lead directly to outages or unserved load)*

At the moment it is not clear who is ultimately responsible in these situations and to what extent. Guidelines could help to identify to what degree a regulator could be found to be culpable in cases where damage occurs as a direct result of the regulator's decisions, such as decisions that prevent a transmission service provider or electricity distributor from making an investment that would have prevented the the damage in question from occurring or creating rules that inadequately limit the scope for an undesirable trading situation to eventuate.

6) *Guidelines should cover the various institutional arrangements and regulatory practices set out in Fig. 4.1 of the issues paper.*

Factors that should be carefully managed when designing regulators and regulatory regimes

A critical factor that the designers of regulatory regimes need to be aware of is that government failure exists as well as market failure. The discussion paper covers this

point but we wish to emphasise that this should be a central consideration governing regulatory design. The mere existence of market failure is not sufficient to lead to the conclusion that regulatory intervention is justified – the intervention needs to be able to be shown to be superior.

Regulatory interventions need to be able to demonstrate that they deliver a net benefit to the economy as a whole. The designer of regulatory regimes should aim to find ways to discourage regulators from pursuing reform agendas beyond the point where they can demonstrate a clear net national benefit or the potential net benefit has become miniscule. The nine year review of transmission pricing by the Electricity Commission and, subsequently, the Electricity Authority would appear to be a case in point. The Authority is currently struggling to identify a clear net benefit to further work in this area and does not seem to be acknowledging the costs associated with the perceived uncertainty it is creating. Despite these concerns, which have been raised by multiple parties in submissions and public forums, the Authority is continuing to progress its review programme.

Including in the regulatory design a requirement that there be a regular independent review of the effectiveness of the regulator may be a way to address these issues.

Principal-agent problem

A principal-agent problem exists in relation to the approval of grid upgrades and the setting of price-quality paths by the Commerce Commission, because the regulated businesses inevitably know more about their assets and actual expenditure needs than the Commission. This situation encourages the Commission to develop incentive regimes with dual objectives – the promotion of particular desirable outcomes and also the extraction of information from regulated businesses about their true ability to perform and their real need to invest and/or increase operating expenditure.

Because of the information they provide, incentive schemes are attractive to regulators and, consequently, there is a risk that a regulator may be encouraged to develop multiple intersecting incentive regimes that could potentially send confusing signals that may have an unintended negative effect on the achievement of overall efficiency. The Productivity Commission could examine the electricity distribution and transmission sectors as current case studies of the development of multiple incentive regimes. At present, "s factor" incentives, which would modify maximum allowable revenue amounts depending on the degree to which particular quality or other objectives are achieved are being considered, together with incremental rolling incentive schemes (IRIS) that may apply to operating expenditures and capital expenditures.

Because these sorts of schemes are attractive to regulators as a possible way of attacking the principal-agent problem, it may be appropriate for regulatory design principles and guidelines to provide for regular independent reviews of the effectiveness of these schemes in order to guard against the risk of their excessive use or other perverse outcomes.

Unclear boundaries and overlapping responsibilities

The Commerce Commission is responsible for revenue setting, transmission investment approval and most information disclosure requirements, while the Electricity Authority is responsible for rules that either determine or constrain the pricing methodologies used to recover revenue, rules that govern the contractual arrangements used by EDBs and transmission service providers and some rules that require information disclosure. The Electricity Industry Act 2010 requires that the Electricity Industry Participation Code not purport to or actually regulate anything that the Commerce Commission is authorised or required to do or regulate under Part 3 or 4 of the Commerce Act 1986 (other than to set quality standards for Transpower and to set pricing methodologies for Transpower and

distributors). Meanwhile, the Commerce Act prevents the Commerce Commission from making pricing methodologies for EDBs and Transpower as long as the Electricity Authority has this power.

As a general principle, we believe this sort of division of powers is not appropriate and creates unnecessary scope for disputes and for the blurring of objectives, which can be costly from a national perspective. Therefore, we would recommend that a principle of regulatory design be that a single industry should have a single regulator unless a cost-benefit analysis is able to identify clearly why this should not be the case.

Appropriate workforce capability

Past experience has shown that the skill sets of some regulators' workforces can be unbalanced. For example, the former Electricity Commission was dominated by electrical engineers, while its successor, the Electricity Authority, has a larger complement of economists. There is no doubt that the skills of their respective staffs have influenced their work programmes. The Commerce Commission is dominated by economists, lawyers and accountants, and to a lesser degree engineers, but is responsible for approving technically complex grid upgrade proposals. Because of this, the Commission is forced to contract out much of its technical analysis.

It may be that the skill balance of a regulator's workforce is not something that is capable of being specified adequately in terms of regulatory principles or guidelines. However, it is something that has practical effects on the behaviour of regulators in the real world and is, therefore, a matter that we believe the Productivity Commission should take into account when assessing ideal regulatory design and evaluating case studies.

Other institutional forms

The discussion paper asks if there are other institutional forms for government-established regulators in addition to those described in Fig. 4.4. The Gas Industry Company is an example of another institutional form – it is a co-regulatory body established under the Gas Act 1992.

Thank you for the opportunity to make this submission. If you would like to discuss any aspect of it please contact Ross Weenink, ross.weenink@powerco.co.nz, ph. (04)978-0522, in the first instance.

Yours sincerely

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