

8 November 2013

Murray Sherwin
Chair
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Dear Murray

Regulatory Institutions and practices

The Electricity Authority (Authority) welcomes the opportunity to make a submission on the New Zealand Productivity Commission's (Productivity Commission) review of Regulatory Institutions and Practices. This submission addresses specific questions in the Issues Paper that the Authority, through its experience and expertise of its staff and Board members, feels well positioned to contribute to. This submission augments the oral comments that were made by the Authority's Chairperson and staff in earlier separate meetings with the Productivity Commission on the inquiry.

Q6

Can you provide examples of regulatory regimes with particularly clear or (conversely) unclear objectives? What have been the consequences of unclear regulatory objectives?

Q8

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?

The Electricity Commission, the Authority's predecessor, had a broad unclear objective and multiple functions. Its objective included economic efficiency, fairness, environmental sustainability, promotion of energy efficiency and seven more detailed outcomes. The consequences of these objectives and multiple functions on the effectiveness of the Electricity Commission as a regulator were considered in some detail in the 2009 Ministerial Review of the New Zealand Electricity Sector. The relevant papers from the Ministerial Review can be found here:

<http://www.med.govt.nz/sectors-industries/energy/electricity/implementing-electricity-market-review-recommendations/background-papers-on-the-2009-ministerial-review-1>.

In summary, the review found that the Commission's unclear broad objectives and multiplicity of functions resulted in the Commission's resources being spread too thinly which contributed to delays in rule making and market development.

Q10

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?

Section 15 of the Electricity Industry Act (Act) sets out the Authority's functions as:
(a) to maintain a register of industry participants in accordance with [subpart 2](#), and
to exempt individual industry participants from the obligation to be registered;

- (b) to make and administer the Electricity Industry Participation Code in accordance with [subpart 3](#);
- (c) to monitor compliance with the Act, the regulations, and the Code, and to exempt individual industry participants from the obligation to comply with the Code or specific provisions of the Code;
- (d) to investigate and enforce compliance with this Part, [Part 4](#), the regulations, and the Code (see [subpart 4](#) of this Part);
- (e) to investigate and enforce compliance with [Part 3](#) (see [subpart 2](#) of Part 3);
- (f) to undertake market-facilitation measures (such as providing education, guidelines, information, and model arrangements), and to monitor the operation and effectiveness of market facilitation measures;
- (g) to undertake industry and market monitoring, and carry out and make publicly available reviews, studies, and inquiries into any matter relating to the electricity industry;
- (h) to contract for market operation services (but see subsection (2)) and system operator services;
- (i) to promote to consumers the benefits of comparing and switching retailers; and
- (j) to perform any other specific functions imposed on it under this or any other Act.

Of these, the functions provided for by (b), (f), (g) (partly) and (i) are policy in nature. The Authority considers that these policies are clearly defined and that the performance of them is easily recognised to contribute to the Authority's statutory objective (section 15 of the Act) of promoting competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.

Q11

Can you provide examples where two or more regulators have been assigned conflicting or overlapping functions? How, and how well, is this managed?

Q12

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?

Certain functions of the Electricity Authority are closely aligned with those of the Commerce Commission, particularly with regard to aspects of transmission pricing and distribution pricing, and competition in electricity markets.

One of the Authority's functions under section 16 of the Electricity Industry Act is to undertake industry and market monitoring. The Authority's objectives for the function are to promote competition, reliability and efficiency in the electricity for the long-term benefit of consumers.

In regard to monitoring competition, the Authority's focus is on the competitiveness of electricity markets rather than the conduct of any particular market participant or group of participants. The Authority's focus in promoting competition is on effecting pro-

competitive measures through Electricity Industry Participation Code (Code) amendments and market facilitation measures, where doing so is consistent with the Authority's statutory objective.

The Commerce Commission's role under the Commerce Act is to promote competition in markets for the long-term benefit of consumers within New Zealand by prohibiting contracts or arrangements that could lead to a substantial lessening of competition, the taking advantage of substantial market power to deter or eliminate competition, and mergers or acquisitions that would substantially lessen competition. The Commerce Commission enforces, adjudicates and provides information and advice relating to competition law generally, that prohibits anti-competitive behaviour and structures in markets.

From time to time, the Authority and the Commerce Commission have areas of common interest in regard to the regulation of Transpower, in particular with respect to the:

- approval of Transpower's grid upgrade plan proposals, including setting and applying grid reliability standards and the value of lost load;
- price and quality of goods and services provided by Transpower;
- pricing methodologies applicable to Transpower (also distribution line owners); and
- information disclosure requirements that apply to suppliers of electricity lines services.

Section 156 of the Electricity Industry Act 2010 inserts section 54V into the Commerce Act 1986. Section 54V of the Commerce Act sets out ways in which the exercise of functions by the Electricity Authority and by the Commerce Commission may interact. Specifically:

- the Electricity Authority must consult with the Commerce Commission before amending the Code in a manner that would affect the Commerce Commission in the performance of its functions;
- the Electricity Authority must advise the Commerce Commission after making Code provisions, making decisions under the Code, issuing guidelines, or giving directions to Transpower in relation to transmission agreements, if any of those things would be relevant to the powers or functions of the Commerce Commission;
- the Electricity Authority must advise the Commerce Commission following changes to the Code that would increase costs to Transpower or distributors; and
- the Commerce Commission must, if asked to do so by the Electricity Authority, reconsider a determination made by the Commerce Commission under section 52P.

The Act authorises the making of the Code. Section 32 of the Electricity Industry Act sets out what the Code may and may not contain. The Code may not purport to do or regulate anything that the Commerce Commission is authorised or required to do or regulate under Part 3 or 4 of the Commerce Act, which deal with business acquisitions, and regulated goods or services including electricity, other than certain matters relating to transmission and distribution pricing.

The Electricity Authority and the Commerce Commission have in place a Memorandum of Understanding to assist them to negotiate these boundaries. The Memorandum of Understanding recognises that the two organisations share certain common interests in

relation to their respective statutory functions with regard to the electricity industry and explains how they intend to coordinate their respective roles under the Electricity Industry Act and the Commerce Act.

Under the Memorandum the Authority and the Commerce Commission agree that to coordinate their respective roles:

- The Commission will take into account, before exercising its powers under Part 4 of the Commerce Act, the matters specified in section 54V of that Act, and any Commission requirements relating to Transpower quality standards in a section 52P determination will be based on, and be consistent with, quality standards set by the Authority (as required by section 54V(6) of the Act).
- The Authority will take into account the price-quality paths set by the Commission in relation to suppliers of electricity lines services, and the information disclosure requirements imposed by the Commission on suppliers of electricity lines services under Part 4 of the Commerce Act.
- The Authority will consult with the Commission where a new or changed rule under the Code may affect determinations on price-quality and information disclosure regulation under the Commerce Act.
- The Authority and the Commission will coordinate their respective initiatives in the areas of distribution losses and non-technical losses to ensure consistency of information provided by suppliers of electricity lines services.

Q13

Can you provide examples of where two seemingly similar regulatory areas are regulated under different regulatory structures? What factors have contributed to differences in the regulatory structures?

Gas and electricity industries compared

Prior to 2003, both gas and electricity markets were self-regulating. On 16 May 2003 the result of a referendum by electricity industry participants and customer representatives on a proposed set of self-regulating rules failed to meet the requirements of the Government, and regulation of the electricity market was introduced under the Electricity Governance Rules 2003 and Electricity Governance Regulations 2003, known collectively as the EGRs. Now government directly regulates the electricity market industry through the Authority.

By comparison, the government co-regulates New Zealand's gas market in association with the industry-owned Gas Industry Company. This co-regulatory model was introduced in December 2004. The co-regulatory form of regulation was emplaced after a united front of gas industry participants persuaded the Government that this approach better suited the regulatory needs of the gas sector, and in particular was favourable to the Electricity Commission (would have become the Energy Commission) assuming responsibility for regulating gas.

A number of specific factors were raised as reasons for a different regulatory approach for gas than for electricity. These included:

- that electricity is seen as an essential industry - there is electricity in almost every home in New Zealand, but the same cannot be said for gas;

- that the electricity market is much larger than the gas market, and at the time the electricity market was regulated the predominant Maui gas field was considered to be in decline, raising doubt if New Zealand would continue to have a reticulated gas market;
- that there is more vertical integration of market participants in the gas market than in the electricity market; and
- that the gas market is closely linked to the upstream petroleum market, which is not regulated by an industry specific regulator.

Q26

How effective and consistent are the review and appeals processes provided for in New Zealand regulatory regimes?

The following two rights of appeals are specified under the Electricity Industry Participation Code:

- by a participant to the Rulings Panel in relation to the refusal by another participant to supply requested information (clause 2.14)
- by a participant to the Rulings Panel against a decision by the system operator in relation to an application for dispensation for an equivalence or alternative ancillary service arrangement (clauses 8.36 and 8.53)

Neither of the appeals processes provided for in the Code has ever been invoked, so the Authority is unable comment on the operation of the review and appeal processes of the regime.

Q28

What are the advantages and disadvantages of a general merits review body like the Australian Administrative Appeals Tribunal?

In the Authority's view, a general merits review body is unlikely to be any better suited to dealing with errors of law or process than the court under the process already available for judicial review.

As for industry-specific issues, in our experience electricity industry disputes are often complex and technical, requiring specialised electrical engineering or economic knowledge or both. We consider that an industry-specific body, with deep knowledge of the operation of the industry and how it operates, built up over time, would have an advantage over a general merits review body.

Further, a disadvantage of the merits review process is that it would risk undermining the regulator and the decision-making process. As the substantive issues could be re-litigated in a merits review process, regulated parties and consumers would be disinclined to engage as effectively as they could in the regulatory process, waiting instead for the court litigation. Accordingly, the regulatory process risks becoming an entrée to the court process with parties restricting themselves to stating their points to get them on record as opposed to engaging fully and meaningfully to best meet the objectives of the regulator.

Q30

Can you provide examples of where the mix of funding sources contributes to the effectiveness or ineffectiveness of a regulatory regime?

Although it is generally understood that the Authority is funded by an industry levy, this is not strictly correct. All of the Authority's core funding is subject to the Parliamentary appropriations process, and the levy is paid to the Crown.

The Authority has commissioned two papers in the last 18 months on the subject of its funding arrangements. The papers, which accompany this submission, identified a number of issues with current funding arrangements for the Authority and made recommendations for the ability for improvements.

One approach would be to introduce the ability for the Authority to charge fees in certain circumstances. The other would be to operate in a modified way within the existing legislative framework. These approaches are explained in detail in the accompanying papers.

Q37

What is the potential to improve capability through combining regulators with similar functions, compared with other alternative approaches?

While the Authority acknowledges that there would be some potential to improve capability through combining regulators, we are concerned that combining regulators to improve capability, risks compromising the focus that regulatory agencies have on their statutory objective. In the Authority's case, as outlined earlier in this submission, this focus is extremely sharp and is key to the successful performance of its functions and its overall effectiveness. Furthermore, amalgamation is usually disruptive, especially in the lead up to amalgamation and in the short-medium term thereafter.

The Authority's experience is that as a regulatory organisation with approximately 60 full time equivalents, we have good scale on most activities except in a few areas such as Information Technology (IT), Human Resource (HR) and compliance.

In those areas where we do not have sufficient scale, we believe that the best mechanism to ensure we have scale and thus sufficient capability is to establish agreements with other government organisations for specific support activities. The Authority already has an agreement with the Commerce Commission on IT services and we have approached the Productivity Commission for a similar agreement for HR services.

We believe there is scope to improve the range of skills available by establishing links with other agencies in relation to expert investigatory functions such as interviewing techniques, obtaining factual statements, and presenting evidence. These activities could be coordinated across relevant regulatory bodies, with shared resources and expertise as appropriate.

Q40

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?

The Authority's statutory functions include enforcing compliance with the Electricity Industry Act, regulations made under the Act, the Code and some provisions of the Commerce Act.

Investigations into alleged breaches of the Code are carried out under the Electricity Industry (Enforcement) Regulations 2010.

Unusually, the legislation provides no enforcement tools of any kind to the Authority. At the conclusion of an investigation into an alleged breach of the Code, the Authority may either discontinue the investigation or lay a formal complaint with the Rulings Panel, which is an industry-specific but independently-appointed body.

All enforcement powers rest with the Rulings Panel, which may make orders ranging from a private warning through to a pecuniary penalty of up to \$200,000.

The Authority has adopted the practice of sending warning letters to participants, but there is no legislative basis to follow up on a warning with any action. Referral to the Rulings Panel, on the other hand, is seen as an extremely serious matter. The Authority has no mid-range enforcement tools available to it.

A broader range of tools would allow the Authority to take enforcement action that was in proportion to the level of alleged offending in each case, taking into account such things as the damage actually and potentially incurred, and any history of reoffending. This would allow a response that was appropriate to each matter investigated.

Q41

What sort of regulatory regimes are suited to more (or less) discretionary enforcement?

One approach to regulation is to set an extensive range of detailed outputs that must be delivered and to monitor progress closely. This approach, however, may not result in the ideal outcomes, or may cost more than alternative solutions. Output-focussed solutions have also been criticised for constraining those who are regulated from being able to choose different, better, solutions.

An alternative approach is to focus more on ensuring the delivery of the broader outcomes that are valued by the wider society, rather than prescribing detailed inputs and outputs. Outcomes are the higher-level objectives that actions, activities and achievements are intended to help deliver. Outcomes are generally continuous, long-term requirements that may be delivered over decades.

Such a framework could comprise a small number of outcomes that are to be achieved plus performance indicators that measure progress towards these outcomes; and specific outputs only where necessary (for example, where there is a risk of poor performance or in a high-risk area where prescription is considered essential).

Regulatory regimes with strict enforcement requirements require little discretion on the part of the regulator.

Discretionary regimes, on the other hand, are better suited to those regimes that exhibit one or more of the following:

- the regime specifies a standard that must be met (such as all reasonable steps) rather than a particular outcome to be achieved;
- they deal with complex situations or highly event-specific scenarios;
- longer-term consequences of choosing the wrong enforcement option are low; and
- parties have appeal rights.

Q43

Can you provide examples of where risk-based approaches have been used well? What are the critical pre-conditions for effective implementation of risk-based approaches to compliance monitoring and enforcement in New Zealand?

One requirement for an effective risk-based approach to enforcement is an in-depth knowledge of the relevant industry. This is essential to build a reliable risk matrix that can deliver a good frequency/ consequence score.

One key challenge is in realising after the event that risks were wrongly assessed and resources therefore wrongly allocated. This can result from not being in tune with industry or not being focussed on the correct risk areas.

Q47

What forms of engagement are appropriate for different types of regulatory regime? When do formal advisory boards work or not work well?

Section 39 of the Electricity Industry Act requires the Authority to consult on any proposed amendment to the Code. This section requires the Authority to consult on an accompanying regulatory statement which must include the description of the objectives of the proposed Code amendment, an evaluation of the costs and benefits of the proposed amendment and an evaluation of the alternative means of achieving the objectives of the proposed amendment.

In accordance with section 41 of the Act, the Authority prepared a Consultation Charter which sets out guidelines relating to the processes for amending the Code. The Charter contains a set of principles, nine in total, which the Authority and its Advisory Groups will have regard to when considering amendments to the Code. The Consultation Charter also details the process, in general terms that the Authority and its Advisory Groups intend to follow when consulting.

When consulting, the most common form of engagement used by the Authority and its Advisory Groups is through written documentation. The Authority typically releases a document, for instance a proposed Code amendment, and encourages interested parties to make a written submission by a specified date. Often the Authority also augments this formal written engagement approach with stakeholder briefings, and one-on-one meetings with stakeholders of groups of stakeholders.

This process of engagement, which is centred around the release and receipt of written documentation, is an appropriate approach for achieving engagement in the electricity regulatory setting for a number of reasons:

- First, and most significantly, the electricity industry is complex. Providing information in written form reduces the potential for ambiguity and assists parties to fully understand the issues and make informed submissions.

- Secondly, the written engagement process ensures that there exists an enduring record of the Authority's work, including proposals and submitter's views.
- Thirdly, the written engagement process is consistent with a transparent regulatory process, because all documents, the Authority's and stakeholder's submissions, are made available to the public on the Authority's website. Only rarely does the Authority at the request of submitters withhold information from submissions on commercial and confidentiality grounds.
- Fourthly, the Authority has been actively engaged in participating in the strategic vision and development of a Government Online Engagement Service with the understanding that a sophisticated approach to using engagement tools and processes will enhance the quality of engagement. A centralised engagement service will also support efficiencies for agencies and stakeholders. It is expected this will be available in the 2014 calendar year.

Increasingly, the Authority is supporting its written form of engagement with meetings with parties on the content of its consultation papers. We have found that, one-on-one discussions have been especially effective when parties hold strong views about a particular issue. Such meetings very visibly afford an opportunity for a party to be heard and present their views in person to the regulator. We have also found that a more constructive form of engagement can occur where parties can explain in person their views and understand the Authority's reasons why, for instance, a proposed Code amendment better meets the Authority's objectives.

The Authority also on occasions, depending on the issue being consulted on, releases accompanying "lay-persons" guides to assist parties, especially consumer representatives, to understand a proposal. This approach has had variable success. On some occasions they have been read and favourably received by a number of parties whilst on other occasions they have been read by only a few parties and the feedback we have received has indicated that the extra value of the "lay-persons" guide was negligible. Notwithstanding, this variable level of success, the Authority intends to continue to release "lay-persons" guides especially when the issue in question is complex technically or involves difficult economic or financial concepts.

The complex nature of the electricity industry also lends itself to the establishment of advisory groups. The advisory group model enables the expert skills and knowledge of industry participants and consumers to be incorporated into the development of new Code and market facilitation measures.

The Authority has three standing advisory groups. These are the Wholesale Advisory Group (WAG), the Retail Advisory Group (RAG) and the Security and Reliability Council. These groups were established shortly after the Authority was formed. The Authority's advisory groups, especially the WAG and the RAG, have successfully developed and recommended a number of important amendments to the Code to provide for improved electricity market design outcomes. From our experience, the key features that make advisory groups work well are:

- the development and enforcement of a clear charter and terms of reference for advisory groups which set out the administrative processes which govern the group and its members;

- close engagement by the regulator with stakeholders, industry and consumers, including thorough consultation on the role of the advisory groups, the terms of reference and charter;
- a strong expectation in the charter and terms of reference that the advisory group members will strive for consensus recommendations to the Board and a requirement that they demonstrate how their recommendations satisfy the Authority's statutory objective and Code amendment principles;
- the assignment to advisory groups of meaningful projects that consumers and industry stakeholders recognise are important issues for the industry to progress;
- competent chairs that ensure that the various members' views are effectively heard and strive towards overcoming differences in members views; and
- a "hands-off" approach from the regulator' staff. Authority staff provide secretariat and administrative support services to the groups. While the Board assigns the groups, in consultation with them, a particular issue to progress Authority staff do not lead or direct the group's work. Consequently, the groups have a great deal of autonomy, within the confines provided by the Authority's objective, the consultation Charter principles, and the charter and terms of reference to address the issue in the manner that they think is effective and best meets the Authority's statutory objective.

Q49

What elements of a regulatory regime's design have the biggest influence on culture? Why?

The Authority agrees with the paper's premise that organisational culture is a critical element of regulatory performance. From the Authority's experience the most influential elements of a regulatory regimes design on culture are:

- A clear and concise objective and a clear understanding amongst all parties within the Board, regulatory staff, advisory groups, stakeholders more generally) of what the objective means, viz: our Interpretation of our statutory objective. The Authority's objective is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers. This clear objective, which is focussed on the betterment of electricity consumers underpinned by economic criteria, provides a strong common purpose for staff. This in turn drives the ownership of work, and a drive by staff to "go the extra mile" to fulfil the objective.
- Independence. The Authority is an independent crown entity. There are pros and cons in making a regulator of an industry like the electricity industry independent of the executive. These were well recognised and discussed in the 2009 Ministerial Review that led to the establishment of the Authority. However, in terms of the effect of independence on staff culture, the Authority has found that it has been a positive influence. It has helped create throughout the organisation a culture of staff empowerment and responsibility. As a general comment, regulators such as the Authority are likely to be composed of analysts (economists, lawyers and engineers) and as is the case with most analysts they are rational people, and accordingly are likely to work less effectively and be less comfortable in a political environment where decisions can be made for non-rational or political ends.

- Explicit statutory requirement to consult with stakeholders. While administrative law requires a Government decision-maker like the Authority to give parties affected by its decisions the opportunity to be “heard”, the explicit consultation requirements in the Act reinforce the need for the Authority to be transparent in its functions. This in turn has created a very strong culture of openness in the Authority staff. The Authority’s staff place a great deal of emphasis on engaging with consumers and industry participants, and understanding their views to ensure that they are considered and had regard to in the decision-making process.

While the elements of a regulatory regime’s design are influential on staff culture, the key influencer remains the competency and leadership ability of the Board and the Chief Executive.

Q50

How well do regulatory agencies ensure consistency of approach between or amongst regulatory staff, so that individual variations are minimised?

The Authority endeavours to ensure consistency of its approach between or amongst its regulatory staff through a number of means. First, through its foundation documents; the Authority’s Interpretation of its Statutory Objective and its Consultation Charter, which incorporates a set of Code amendment principles, encourages consistency by providing regulatory staff with a clear framework within which to undertake Code development and market performance work. Likewise, these foundation documents apply to the Authority’s advisory groups which encourage consistency at that level.

Secondly, the Authority has consistent templates for external documents including consultation papers and consistent organisational wide approaches for undertaking aspects of policy/regulatory development – e.g. cost/benefit analyses.

Thirdly, all non-minor regulatory work proceeds through a hierarchy of management and is reviewed and approved by the Board. This internal process ensures consistency of approach between and amongst regulatory staff.

Q59

When are feedback loops being used well to improve the performance of New Zealand regulatory regimes? When aren’t they?

The Authority has in place a programme of monitoring the effectiveness of the industry arrangements, with a view to identifying opportunities for improvement. Typically the Authority undertakes around six ad hoc reviews of particular topics each year. These reviews can be instigated in response to obvious issues, or perceived opportunities to further the statutory objective of the Authority.

Reviews may also be undertaken to assess the effectiveness of specific interventions by the Authority. Such post-implementation reviews are starting to commence now, as sufficient time has passed since implementation of a number of initiatives to assess their impact.

The Authority also undertakes a comprehensive annual assessment of the performance of the market. These various reviews provide valuable feedback that has on several occasions caused a modification or re-prioritisation of the Authority’s work-plan.

An important aspect of the monitoring regime is the provision of data and models, in an accessible format that enables other parties to also monitor the industry. The

transparency in the market arrangements so afforded, itself provides a discipline on the conduct of the participants. On several occasions, reviews have been prompted by participants using models and data provided by the Authority to highlight a problem.

It is the Authority's experience that the provision of data and open-source models has greatly assisted in the industry's awareness of its own functioning, and opportunities for improvement.

We trust that these comments assist your inquiry. If you would like to discuss any of the points made please do not hesitate to contact me.

Yours sincerely

A handwritten signature in blue ink that reads "Carl Hansen". The signature is fluid and cursive, with the first name "Carl" and last name "Hansen" clearly distinguishable.

Carl Hansen
Chief Executive