

TRANSPower NEW ZEALAND LIMITED

Submission to the
Ministry for Economic Development

on

Review of Regulatory Control Provisions under the Commerce
Act 1986: Discussion Document

July 2007

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EXECUTIVE SUMMARY

Introduction and Overview

1. Transpower welcomes the opportunity to provide this submission to the Ministry of Economic Development (MED) on its discussion paper entitled “Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document” (Discussion Document).
2. In overview, Transpower’s perspective on reform of the regulatory regime for transmission can be summarised as follows:
 - *Fundamental reform is necessary.* There are inherent, and ultimately intractable, problems with the current regulatory arrangements that cannot be addressed satisfactorily by piecemeal amendment or evolution. More fundamental reforms are necessary and will likely entail legislative changes.
 - *A timetable for change is essential.* To enable orderly preparations to be made for implementing a new regime, it is essential that a clear time-frame for reform is established to signal the changes to stakeholders well in advance. Setting out a clear reform path and timetable will eliminate alternative agendas and allow for more concerted and co-operative interactions between stakeholders.
 - *Improvements in the meantime are equally important.* Interim improvements, in line with the Government’s policy expectations, are vital, given that the transition to a new regime will take time, and critical investment decisions will need to be made before the current arrangements are superseded. However, making the best of the current arrangements is not a substitute for long-term reform.

Investment incentives

3. Transpower agrees with the MED, that changes should be made to the regulatory regime applying to monopoly businesses. It is essential that the regulatory arrangements provide effective incentives for investment and innovation in New Zealand’s essential infrastructure.
4. Getting the right regime for Transpower is particularly important, given the essential role of electricity transmission in the New Zealand economy and the need for Transpower to undertake approximately \$5 billion of investment over the next ten years.
5. In determining the appropriate regulatory arrangements for electricity transmission, the asymmetric consequences of sub-optimal transmission investment decisions should be taken into account; i.e. the negative consequences of investment that is just too late or insufficient far outweigh the costs of investment that is just too early. As well, the regime must have sufficient flexibility that it can recognise and provide incentives for innovation.

Background and context

6. The Discussion Document focuses on constraining businesses with market power. Transpower notes that the possible abuse of market power is not the primary reason for regulating Transpower. Transpower's market power is constrained by the essential nature of electricity transmission and the size, role and sophistication of its customers. The major disruption that would be caused by disconnecting a generator or a distribution company means that it is not feasible in practice for Transpower to cut supply to enforce its charges. Further, as a state-owned enterprise (SOE), Transpower is required to balance commercial and wider social obligations. This was reflected in Transpower's previous self-regulatory approach, which was designed explicitly to prevent the extraction of monopoly charges.
7. Rather than being designed only to restrain market power, Transpower considers that, more importantly, regulation of electricity transmission is required for the following reasons:
 - To enable investment in and payment for interconnected assets, which have the characteristics of 'public' or 'club' goods;
 - To test the efficiency of Transpower's investment and operating activities;
 - To ensure that Transpower is able to earn a commercial return on its assets;
 - To enable Transpower to establish legal relationships with its customers;
 - To enable Transpower to obtain payment for its services and secure its revenue; and
 - To enable Transpower to contribute to a sustainable energy future for New Zealand.
8. Transpower is subject to two parallel and overlapping regulatory regimes: the Part 4A thresholds regime under the Commerce Act 1986 and the Electricity Governance Rules (EGRs) under the Electricity Act 1992. Part F of the EGRs (Part F Rules) provides a framework for establishing the contractual terms between Transpower and its customers, approvals for grid investment, the allocation methodology for pricing by Transpower and financial transmission rights (the latter have yet to be developed).
9. Transpower does not fit comfortably within the Part 4A thresholds regime. In the past, the Commerce Commission (CC) used comparative analysis to benchmark efficient prices and performance, and to establish thresholds. Such comparative analysis does not work for Transpower, because of the difficulty of benchmarking against other businesses. Instead, Transpower's thresholds need to be based on Transpower's own performance. This means, however, that a thresholds approach does not achieve significantly lower compliance costs than control for Transpower, yet it involves significant uncertainty for the regulated business.

10. Transpower has been subject to a post-breach inquiry, a draft notice of intention to declare control, and negotiation of an administrative settlement process under Part 4A. It has submitted a number of investments to the Electricity Commission (EC) for approval, and has worked with the EC to develop the transmission pricing methodology and the Benchmark Agreement under the Part F Rules. Transpower's views of the regime are therefore informed both by practical experience and by theoretical analysis.
11. Transpower's main concerns with the regulatory regime applying to electricity transmission under both the Commerce Act and the Electricity Act are as follows:
 - The price path thresholds that have been set for Transpower to date have been inappropriate. The thresholds were set at a level which meant that Transpower would inevitably breach if it proceeded with its investment programme. The need for, and scale of Transpower's investment programme has been known from the start of the thresholds regime.
 - The CC's analysis during the first stage of the post-breach inquiry into Transpower was less robust than adopted in the Part 4 inquiries (into airports and gas). In particular, the CC did not use the building blocks analysis used in the Part 4 inquiries and proposed in its post-breach inquiry guidelines. The result was, in Transpower's view, an erroneous conclusion that control of Transpower might be justified. The CC's approach has also created significant uncertainty as to how future threshold breaches might be treated.
 - The overlap in responsibility of the EC and CC in relation to Transpower's investment, and in particular the CC's reservation of the right to determine whether investment approved by the EC is 'appropriate', puts Transpower at risk of not being able to earn a commercial return on its investment, notwithstanding EC approval.
 - The Part F Rules and the EC's interpretation of these, has led the EC to an increasingly hands-on involvement in the planning of the transmission system which has blurred accountability for grid performance between the EC and Transpower.
 - There is currently no separation of rule making from rule implementation, and Transpower has no ability to appeal the decisions of the regulators.
 - The quality thresholds applying to both the distribution businesses and Transpower do not effectively screen potential candidates for control. The design of the quality thresholds has resulted in a high probability of businesses breaching because of the normal variability of quality from year to year.
 - The overlap in responsibility between the EC and CC for quality creates confusion and additional costs.
12. Transpower believes that the regulatory regime applying to Transpower could be significantly improved by the following:

- Applying conventional revenue path control to Transpower and codifying the processes and input parameters for this form of control in rules and/or regulations.
- Clarifying Transpower's accountability for investment by removing the EC's ability to substitute its judgements on investment for those of Transpower.
- Having a single economic regulator that is responsible for setting the allowed revenue requirement and separating rule setting from rule implementation. Transpower's preferred option would have the CC setting the rules and the EC implementing them.
- Allowing merits review of both the CC's and EC's decisions.

13. These are considered in turn.

Conventional revenue path regulation

14. The conventional revenue path regulation favoured by Transpower and similar to that used in Australia and the United Kingdom (UK), typically operates as follows:
- The regulator determines an ex ante revenue path (or revenue cap) using building blocks analysis;
 - The revenue cap is based on forecast operating expenditure, capital expenditure, a return on capital, depreciation and taxation;
 - The revenue cap contains an ex ante allowance for all capital expenditure, with the exception of 'contingent' projects which are treated separately;
 - Within the overall revenue cap, companies have flexibility to determine their own detailed expenditure plans and priorities in response to changing circumstances; and
 - Typically, the cap applies for five years.
15. Certain procedural requirements and constraints apply to the regulator's determination of the building block cost allowances. The regulated company's cost estimates are subject to regulatory scrutiny. However, the regulator is required to accept the regulated company's proposed investment plans and operating expenditure proposals if satisfied that a company's cost estimates have been prepared in accordance with specified 'regulatory' guidelines and that they reasonably reflect efficient and prudent costs, and realistic forecasts of demand and cost inputs. Incentives are provided for capital efficiency and service quality.
16. Transpower believes that a more conventional revenue path regulatory approach would not be significantly more costly than using tailored thresholds under Part 4A. The benefits of a more conventional approach would be greater certainty, coherency and improved accountabilities.

Clarifying Transpower's accountability for grid planning

17. Transpower considers that accountability for grid planning needs to be clarified. Application of a conventional revenue cap regime would help to achieve this clarity. Under this approach, the regulator would scrutinise Transpower's investment processes, and undertake an ex ante review of Transpower's proposed investment programme. Transpower would, however, be responsible and accountable for investment decisions.
18. Pending the wider regulatory reform proposed by Transpower, the Part F Rules should be amended to make clear that the role of the EC is one of audit and review to provide assurance that Transpower's grid investment plans are 'reasonable'. Critically, the original intent of the Statement of Opportunities (SOO) as an 'information only' document should be reinstated.
19. Transpower's proposals are consistent with the expectations of the October 2006 Government Policy Statement on Electricity Governance (GPS). Notwithstanding the expectations in the GPS, no changes have been made to the Part F Rules.

Separation of rule making from rule implementation

20. Separating rule making from rule implementation avoids the inherent conflict which arises when a regulator is responsible for determining the need for its own regulatory services. Separation also results in rules that are clearer and more transparent than otherwise and improves the accountability of regulators for their decisions.
21. Given the potential costs of establishing a separate body responsible for rule making, and concerns about the availability of skills and expertise in New Zealand, improved separation, at least in relation to investment regulation, may best be achieved by redefining the roles of the CC and the EC, rather than establishing a separate rule making body.

Single regulator responsible for all building blocks

22. Transpower considers there should be a single regulator responsible for implementing economic regulation of electricity transmission. Establishing a single regulator would improve accountability for regulatory decisions, provide better incentives for performance and improve transparency. Having a single regulator would also ensure consistent and coherent treatment of the various building blocks making up the revenue requirement.
23. The institutional options for establishing a single regulator in New Zealand include:
 - Adapting the institutional and regulatory design of the EC so that it could operate as a more conventional economic regulator. In this scenario, the CC could act as the rule setter; or
 - Have the CC take fuller responsibility for setting the allowed revenue, including responsibility for approving transmission investment. The EC could act as a technical adviser to the CC on investment matters.

24. At present, neither the CC nor the EC possesses all the attributes necessary to be a fully-functioning economic regulator.
25. Transpower's primary concern is to see resolution of current regulatory deficiencies by moving to a single economic regulator whether that be the EC or the CC.
26. Transpower's preferred option would be for the CC to act as the rule setter and for the EC to be responsible for setting Transpower's revenue path. If the EC were to adopt this role, Transpower would have a strong preference for it to be independent from political influence (i.e. either as an independent or, at least, an autonomous Crown entity).

Merits review to improve regulator accountability

27. The ability to appeal major regulatory decisions to an independent body by way of a 'merits review' would help to maintain consistency, transparency and fairness of the regulatory decision-making process, and would ensure that regulators were accountable for their decisions.
28. Without the ability to appeal regulatory decisions, there is always the risk that a regulatory body's decision-making may deviate from good practice over time and remain uncorrected.
29. Transpower believes that both the CC's and the EC's decisions should be subject to merits review.

Implementation of proposed changes

30. Transpower believes that electricity transmission should be excluded from Parts 4, 4A and 5 of the Commerce Act and instead controlled via specific legislative provisions. The legislation would:
 - Include a requirement that Transpower be controlled using a revenue path methodology;
 - Include a purpose statement relevant to electricity transmission.
31. Transpower proposes also that the option of establishing the CC as a rule maker (with the EC as economic regulator of Transpower) be investigated, and if feasible implemented through legislative change.

1. OVERVIEW

1.1. Introduction

32. This section provides background on the MED's review, and outlines the structure of Transpower's submission.

1.2. Background

33. The Discussion Document considers whether changes to the Commerce Act could help achieve long-term benefits for consumers and reinforce the Government's infrastructure investment objectives. It considers the intent, design and accountability for regulation imposed under Parts 4, 4A and 5 of the Commerce Act. Most relevant to Transpower is the discussion of whether the Part 4A threshold regime applying to electricity lines companies including Transpower, is meeting regulatory objectives and how the regime could be improved.
34. Transpower considers that the issues raised by the Discussion Document are important, and that many of the possible changes discussed by the MED would improve the regulatory regime. However, Transpower is also subject to regulation under the Electricity Act, and the interaction with these constraints is important in considering the changes to the Commerce Act that might improve regulation of Transpower.
35. The Discussion Document does not specifically consider some aspects of regulatory design that Transpower considers important: notably the investment uncertainties created for Transpower by the separate investment approval regime under Part F of the Electricity Governance Rules 2003, and the lack of clarity of around the role, responsibilities and accountabilities of Transpower and the EC.
36. Transpower notes that establishing the right regime for Transpower is particularly important, given the essential role of electricity transmission in the New Zealand economy, and the need for Transpower to undertake approximately \$5 billion of investment over the next ten years. It is essential that regulatory arrangement provide incentives for investment and innovation in New Zealand's essential infrastructure including the National Grid.
37. While the Discussion Document does not specifically address these concerns, it asks whether there are issues with the current regime that should be considered as part of the review. In response to this, Transpower has taken the opportunity to note the problems that it faces under the current regime and to propose possible changes that would address these issues. Transpower also provides commentary on some of the specific issues raised by the Discussion Document.
38. We note that the wider policy framework and market design for electricity and energy more generally are currently being reviewed by a number of government initiatives, including the New Zealand Energy Strategy and the EC Market Design review. It is important that changes made to the regulatory regime are consistent with one another.

1.3. Transpower's submission

39. Transpower's submission is set out as follows:

- Section 2 of the submission discusses the particular issues facing Transpower and transmission that should be reflected in the regulatory regime applying to Transpower. It recounts the difficulties that Transpower has experienced under the threshold regime, as well as the problems created by the overlapping responsibilities of the CC and EC.
- Section 3 introduces Transpower's preferred regulatory option for electricity transmission which would involve a more conventional revenue cap constraint. It also discusses the changes to the regulatory institutions which Transpower believes are necessary to achieve a stable and effective regulatory regime.
- Section 4 provides a more detailed description of Transpower's preferred regulatory option drawing on Australian and UK experience with the revenue cap approach. This section compares the Australian and UK approach with Transpower's administrative settlement proposal in relation to the CC's notice of intention to declare control of Transpower under Part 4A.
- Section 5 discusses the options for reforming the regulatory structure, focussing on the problems created by the overlapping responsibilities of the CC and EC. It considers a reallocation of the responsibilities of these regulatory bodies, as well as the possible benefits of separating rule making from rule implementation.
- Transpower presents the reasons why it supports merits review of the decisions of both the CC and the EC in section 6.
- Section 7 discusses how Transpower's preferred option might be implemented.
- Appendix 1 expands on Transpower's view of the desirable features of a regulatory regime.
- Transpower has responded to the questions posed in the Discussion Document in the Appendix 2.

2. TRANSPOWER'S EXPERIENCE WITH THE CURRENT REGULATORY REGIME

2.1. Introduction

40. Transpower's submission focuses on the optimum regulatory arrangement for electricity transmission. Transpower recognises and expects that it will be subject to regulatory controls, given its position as a monopoly supplier of an essential service, the particular features of the commercial relationship between Transpower and its customers and the 'public good' nature of investment in the interconnected grid. Transpower believes that the regulatory restraints it faces should reflect the distinctive situation of Transpower, which is regulated under both the Commerce Act and the Electricity Act and through its ownership structure as an SOE.
41. Section 2.2 considers the relevance of the threshold regime to Transpower. It begins by noting that the key reasons for regulating Transpower are not concerns about the exercise of its market power but rather the need to secure payment for its services, to provide incentives for efficiency and to enable it to undertake investments in the interconnected grid and secure a return on those investments. Transpower discusses the reasons why it does not prefer a thresholds approach for its own regulation, and questions whether a thresholds regime is likely to be effective even in principle.
42. The difficulties that Transpower has experienced under the Part 4A regime are discussed in section 2.3. These include the problems created by inappropriate initial thresholds, the CC's analysis during the post-breach inquiry, and uncertainty as to CC's likely approach to future breaches and to control under Part 5.
43. Section 2.4 outlines Transpower's concerns with the overlap in the responsibilities of the EC and CC in relation to investment, quality and the system operator. Other concerns, which include the blurred accountability for grid planning and investment decisions, uncertainty in regulatory requirements and the impact of the Resource Management Act, are noted in section 2.5.

2.2. Relevance of the thresholds regime to Transpower

2.2.1. *Reasons for regulating Transpower*

44. The conventional anti-trust argument justifying the regulation of an electricity transmission or distribution business via the Part 4A price path threshold provisions runs as follows:
- The business has a dominant market position with no risk of competitive entry, which gives it a great deal of market power in relation to its customers;
 - It will use its market power to set prices which will generate monopoly profits unless it is constrained from doing so;

- The business will over-invest and generally utilise resources inefficiently unless it is constrained from doing so; and
 - A CPI-X price path threshold restricts a business' ability to price in order to generate monopoly profits and provides an incentive to achieve operational efficiencies.
45. When applied to Transpower, this line of reasoning is flawed because:
- Transpower is not in a strong market position in relation to its customers; and
 - Constraints on Transpower's pricing have been applied by Transpower's shareholder (government).
46. Transpower's market power in relation to its customers is constrained. This is because of the essential nature of electricity transmission and the size and role of the customers themselves. The major disruptive impact of disconnecting a generator or a distribution company means that in practice Transpower cannot cut supply to enforce its charges. Its customers know this, and this has put them in a strong market position in relation to Transpower. Historically, in the absence of regulations requiring payment, some transmission customers persistently refused to pay transmission charges.
47. Many transmission customers have also refused to enter into binding contracts with Transpower to receive transmission services – but continued to take the services without having a legal agreement to do so. In these circumstances Transpower has posted terms which it considers should apply to the provision of its services, but has found that, in practice, these terms are not legally enforceable.
48. The grid's common good nature provides no incentive for transmission customers to agree to pay for investments that will provide significant benefits to non-contracting parties. Attempts to address this by mutual agreement via a voluntary industry framework, which would enable investment in the interconnected grid, collapsed in 2003.
49. The alternative available to distribution companies, i.e. simply invest and raise the distribution charges to recover a return on the investment, is not available to Transpower, because, for the reasons explained above, Transpower cannot practically withhold its services to enforce payment in the way that distribution companies can.
50. To overcome these problems, the EC was established to administer rules which enabled it to apply a 'plan and tax' approach to investment in the interconnected grid, with a grid investment test used to assess the efficiency of proposed investments.
51. The idea that the price path threshold regime is required to control Transpower's pricing power is incorrect. In reality, Transpower's prices have always been controlled, even in the days of the 'light handed' information disclosure regime of the 1990s. The control of Transpower's prices in the past was exercised by government by way of Transpower's Statement of Corporate Intent (SCI), which required its prices to be set to recover a return on the value

of its assets equal to its weighted average cost of capital (WACC). This has continued under the Part 4A regime, although the thresholds developed as part of the administrative settlement proposal between Transpower and the CC under Part 4A will substitute a CC-determined WACC for a shareholder-approved WACC.

52. The value of the asset base was also constrained by using the optimised deprivation valuation (ODV) method. The use of ODV has meant that the return on investments made by Transpower has frequently been less than its WACC. In some cases the Transpower Board made investments knowing that the cost of the investment would significantly exceed the ODV valuation and consequently, a return below Transpower's WACC would be earned on those assets. The Board has made decisions of this sort in order to maintain grid security, in line with Transpower's status as an SOE which has obligations to balance commercial and wider social objectives. In Transpower's view, an improved regulatory framework should permit Transpower to continue to act in the public interest, but also secure a commercial rate of return when doing so.
53. In summary, Transpower sees the regulatory problem with respect to electricity transmission, being somewhat different from that posed by the Discussion Document. The Discussion Document examines in some detail the circumstances of market power abuse that might trigger some form of regulatory control. In Transpower's view, for the reasons discussed above, these issues are of limited relevance in relation to electricity transmission in New Zealand (and in this regard transmission can be distinguished from other infrastructure monopolies). Rather, electricity transmission needs to be regulated for the following reasons:
- To enable investment in and payment for interconnected assets, which have the characteristics of 'public' or 'club' goods;
 - To test the efficiency of Transpower's investment and operating activities;
 - To ensure that Transpower is able to earn a commercial return on its assets;
 - To enable Transpower to establish legal relationships with its customers;
 - To enable Transpower to obtain payment for its services and secure its revenue; and
 - To enable Transpower to contribute to a sustainable energy future for New Zealand.
54. The problem definition set out above is substantially different from the more conventional monopoly/antitrust analysis presented in the Discussion Document. For example, the discussion about the balance between efficiency and consumer protection in relation to controlling monopoly profits should be viewed in the context of the balanced objectives Transpower is required to pursue as an SOE and the fact that Transpower has, through the SCI process, adhered to a self-managed regulatory regime that ensured it did not earn monopoly profits.

55. Transpower contends that, for the reasons set out above, electricity transmission must be regulated in the collective interests of Transpower, its customers and the community as a whole. The regulation of electricity transmission should not be seen as a punishment for commercial misbehaviour, but a normal and continuing process, which is required to enable the electricity transmission business to function effectively. The issue then is how to design regulatory arrangements which will achieve the objectives of good regulatory design while minimising compliance costs. This is discussed in more detail in this submission.

2.2.2. Transpower and the thresholds regime

56. Transpower does not fit comfortably into the thresholds regime. As currently implemented by the CC, the Part 4A thresholds regime tries to use comparative analysis to establish a benchmark for efficient prices and performance.

57. Transpower is the only transmission business in New Zealand, and cross-country comparisons are problematic. Any attempt at 'benchmarking' against equivalent businesses would be highly questionable because all other transmission businesses operate in different jurisdictions which have different geographies and different investment and operating requirements. It is not possible to establish a threshold for Transpower based on comparative analysis.

58. Further, over the next ten years Transpower expects to spend around \$5 billion on a major programme of new transmission investment which is essential to maintain the security of electricity supply and remove critical constraints in the existing grid while meeting increased demand growth and connecting significant quantities of wind and other renewable generation. To date, in practice the thresholds regime has not adequately taken into account the long investment cycles present in the transmission business and the large scale, or 'lumpiness' of the individual investments.

59. These considerations suggest that any threshold constraints need to be based on Transpower's own situation. But in basing the threshold constraints on Transpower's performance, the thresholds would no longer be set using an approximate, less resource intensive, comparative approach. This means that the hoped-for lower costs of using a supposedly 'light handed' threshold are significantly reduced.

60. These concerns have been borne out in the administrative settlement process which has been ongoing since April 2006. During that process, Transpower and the CC have developed thresholds that are more appropriate to Transpower. However, while the CC's original intention was that the new thresholds would be 'light handed', the reviews of operating and capital expenditure have involved a significant degree of detail. It appears that such intrusiveness is inevitable given the regulator's need for assurance that the building blocks making up the threshold revenue and expenditure paths are reasonable.

61. Transpower notes also that the costs associated with a breach of a threshold (post-breach inquiry) are significant and arguably no less onerous than the costs applying under control.

62. Consequently, Transpower's view is that the benefits of the thresholds regime in relation to Transpower are largely illusory.
63. The nature of the electricity industry, and the special role of transmission, also cautions against applying generic rules to it. The electricity sector differs from other sectors because electricity is supplied in real time and cannot be stored on a large scale. This means that, if electricity supply becomes unreliable, consumers have limited ability to switch to alternative services in the short term. However, many parts of a modern economy depend on a continuous electricity supply to function. These factors help to explain the emphasis in electricity industry regulation on security of supply.
64. Given the size and importance of Transpower's investment programme, an important regulatory design consideration is the asymmetric impact of regulation: regulation that is too stringent (i.e. which does not allow a business to earn a normal rate of return) and which may adversely affect investment and dynamic efficiency, may have serious consequences for security of electricity supply. Conversely, constraints that are not set sufficient stringently may result in investment being built too soon, or overbuilt, or some transfer of income to Transpower. Transpower therefore agrees with the Discussion Document that, to the extent the regulation is aimed at constraining market power, the objective should be to limit monopoly profit rather than to eliminate it.
65. Transpower believes that electricity transmission is sufficiently different from other natural monopoly businesses to justify separate regulatory treatment. While Transpower appreciates that this approach is at odds with the MED's aspiration to have a universal regime applying to all industries, Transpower nevertheless believes that a special regime for electricity transmission is necessary to enable the business to operate effectively. It believes that the benefits of tailoring regulation to the particular requirements of electricity transmission are likely to outweigh the costs.

2.2.3. Feasibility of a threshold regime in principle

66. Transpower is doubtful that even at a conceptual level a threshold regime offers significant benefits over a more conventional approach to regulating electricity transmission. It concurs with the assessment of the Australian Competition and Consumer Commission (ACCC) regarding the use of thresholds or 'regulatory triggers':¹

[T]here is an unavoidable tension involved in attempting to make 'light-handed' monitoring regimes more effective at constraining market power, while at the same time maintaining the 'light-handed' nature of the regime and avoiding detrimental effects on appropriate investment or possibly increased uncertainty.

The [use] of monitoring with pricing principles and threshold monitoring both attempt to make monitoring more effective by strengthening the credibility of the threat of re-regulation. However... this runs into a number of problems.

¹ Submission 39, pp 101-2 quoted in Productivity Commission, *Review of Price Regulation of Airport Services*, Draft Report, December 2006, p 56.

Firstly, where cost efficiency incentives are not part of the regime, which may be the case particularly for monitoring with pricing principles, such monitoring regimes risk resembling 'shadow' rate of return regulation, with the associated distortion of incentives for technical efficiency and appropriate investment.

Secondly, attempting to make the trigger and threat of re-regulation more credible inevitably brings with it greater compliance costs and 'intrusiveness', lessening the degree to which such a regime can be described as 'light-handed'. Indeed the compliance costs of such a regime may well be greater than a well-designed direct regulatory regime.

Thirdly, while the intention of creating a more credible threat of re-regulation is designed to constrain the use of monopoly power, such direct monitoring regimes are unlikely to be able to achieve this as effectively as direct price regulation (but at a possibly higher compliance cost).

Finally, and most importantly, these regimes are likely to be highly uncertain and risk inhibiting investment. Uncertainty arises in the case of monitoring with pricing principles in terms of the practical applications of the principles and determination of what the consequences of non-compliance will be. Under threshold monitoring, uncertainty arises as to when thresholds are actually designated breached and what the likely consequences of the breach and the outcome of the subsequent investigation will be.

67. Transpower's experience with the thresholds regime to date bears out the ACCC's concerns with this regulatory approach. The ACCC's final comment is particularly pertinent. Uncertainty has been a major negative and ongoing aspect of the current threshold regime which has affected all lines businesses, not just Transpower.
68. Transpower expands upon the difficulties it has experienced with the thresholds regime in the sub-sections below.

2.3. Difficulties Transpower has faced under the current regulatory regime

2.3.1. Introduction

69. Transpower has been subject to a series of thresholds resets, a post-breach inquiry extending across multiple assessment periods, a draft notice of intention to declare control, and negotiation of an administrative settlement under Part 4A of the Commerce Act. It has submitted a number of investment projects to the EC for approval under the Part F Rules and has worked with the EC to develop the transmission pricing methodology and the Benchmark Agreement. Transpower's views of the regime are therefore informed both by practical experience and by theoretical analysis. Transpower's main concerns with the regime, focusing on electricity transmission, are discussed below.

2.3.2. Inappropriateness of the initial price path thresholds

70. The price path thresholds that have been set for Transpower to date have been inappropriate. As such, the thresholds have never acted as a screening mechanism. While the detail of Transpower's investment programme has been developed since the initial thresholds, the need for, and scale has been known from the start of the thresholds regime.

71. The starting date for Transpower's price path threshold represented a period of historically low investment. The CC did not adjust the initial or subsequent thresholds (which have been reset on an annual basis) to take account of Transpower's substantially increased investment programme.
72. Further, Transpower believes that a price path is not well suited to Transpower. Transpower determines an annual revenue requirement which is allocated to customers, rather than setting tariffs for customers. Costs are not directly linked to the volume of sales (as is assumed under a price path), but rather to capacity and investment. Transpower has consistently argued in the past that a revenue path would be a more appropriate form of constraint than a price path.
73. The price path threshold has not acted as an effective 'filter' for Transpower, in terms of identifying behaviour that signals a need for control. Because the initial thresholds did not take into account Transpower's need to undertake significant expenditure to be in a position to deliver its large investment programme, breach of the thresholds has been inevitable. The result for Transpower has been the reputational damage associated with breach, the costs of the post-breach inquiry and negotiation of a settlement agreement with the CC. The whole process has resulted in considerable uncertainty for Transpower, its customers and other stakeholders.
74. The new thresholds proposed as part of the administrative settlement process, if formally accepted by the CC, will establish more appropriate thresholds and provide Transpower with some certainty as to its allowed revenue over the next four years. However, there is no certainty beyond that period. The CC may continue to develop the revenue path approach, or adopt another threshold. Such uncertainty is not conducive to efficient investment of the scale and timeframes required for major transmission upgrades, or commercial certainty for Transpower or other electricity industry participants.

2.3.3. Quality thresholds problematic

75. The quality thresholds which have been implemented to date for the distribution businesses and for Transpower do not effectively screen potential candidates for control.
76. The design of the quality thresholds means there is a high probability that businesses will breach them because of the normal statistical variability of quality performance from year to year which is outside business' control. In the absence of an improving trend in quality performance, businesses have an approximately 50 percent probability of breaching the quality thresholds in any year.
77. Concerns about the poor filtering ability of the quality thresholds have been realised in practice. A significant number of the distribution businesses and Transpower have already breached their quality thresholds. In many cases, the CC has not confirmed whether or not it will be taking action, resulting in significant uncertainty, over a prolonged period.² In none of these cases has

² More detail is provided in the submission prepared by the distribution businesses. See Electricity Distribution Lines Businesses in New Zealand, *Response to MED Review of the Regulatory Control Provisions Under the Commerce Act*, July 2007.

the CC yet found that the businesses should be controlled because of their poor quality performance.

78. In response to concerns about the quality threshold, the CC released draft guidelines on the treatment of force majeure events. However, the proposals in the draft guidelines do not address the concern that normal and expected variations in quality performance are leading to a majority of the observed breaches.
79. Because the quality thresholds provide a poor filter for identifying businesses, they might be failing to meet the objectives of Part 4A of the Commerce Act. Transpower therefore believes that more fundamental changes to the quality thresholds are required.
80. Transpower has further concerns about the regulation of the quality of its services which are discussed below.

2.3.4. CC's analysis during the post breach inquiry

81. The post breach inquiry process has been costly, not only in dollar terms, but also in terms of diverting senior management and board members from other, productive matters. In Transpower's view, there have been several problems with the approach adopted by the CC that have unnecessarily led to the costly post breach inquiry processes and substantial uncertainty for Transpower and other regulated businesses. These problems included:
 - The long time taken to resolve breaches;
 - The CC using analysis that was less robust than and/or different to that used in previous Part 4 inquiries (i.e. the airports and gas industries);
 - The CC following a process that differed from its guidelines for post breach inquiries;
 - The CC considering the 'whether to' control question separately from the 'how to' control question; and
 - The CC assuming benefits of control that actually fell outside its jurisdiction.
82. It has taken a long time to resolve breach inquiries. Transpower's breach relating to the first assessment period was still unresolved when the CC issued its notice of intention to declare control in December 2005. Many breaches by the distribution businesses remain unresolved. Transpower also believes that the CC should have engaged in further consultation with Transpower prior to it issuing the notice of intention to declare control.
83. The CC's analysis of Transpower's breach of its thresholds was much less robust than that conducted during its Part 4 inquiries. For example, the CC asserted that Transpower had earned excess profits. However, the application of Transpower's revenue requirement methodology and, in particular, the Economic Value (EV) adjustment mechanism meant it was impossible for Transpower to earn excess profits over the long-term.

84. The CC's control inquiry guidelines indicated that the CC would undertake a building blocks analysis when assessing a business' breach of the thresholds. When Transpower set its transmission charges it used a building blocks approach on the expectation that the CC would use the same approach in any post breach inquiry.
85. However, in preparing its notice of intention to declare control, the CC did not apply that approach to Transpower. The CC justified its position as follows:³
- In Transpower's case, the Commission does not consider that ...a building blocks approach is currently practicable, because it is neither appropriate nor possible at this stage to attempt to construct a factual price path based on an assessment of Transpower's efficient prices going forward.
86. In Transpower's view, the CC had sufficient information to undertake a building blocks analysis. For example, Transpower had provided the CC with detailed information on how the 2006/07 transmission charges had been set. Not applying the building blocks methodology proposed in the guidelines has created significant uncertainty as to how the CC will behave in the future.
87. Differences in the CC's approach to different investigations under Part 4A and Part 4 (and the CC's other regulatory responsibilities) has increased uncertainty for regulated businesses, because it is not clear what standards of analysis the CC will apply. As a result, the price path and quality thresholds have tended to become de facto price control.
88. A major concern with the CC's analysis of Transpower (as with investigations under Part 4) related to the CC's position that it was unable legally to consider the form of control at the same time as determining whether to impose control. The CC has acknowledged that its approach involves a risk that control could be deemed to be necessary, when consideration of actual control parameters would result in an opposite conclusion.
89. The CC argued that controlling Transpower would improve investment efficiency by enforcing Part F requirements. Part F is under the jurisdiction of the EC and enforcement of Part F is the EC's responsibility, not the CC's. This is an example of why it is important to have clear accountabilities. It also supports having a single economic regulator for electricity transmission.

2.3.5. Future uncertainty as to the treatment of a breach

90. The Discussion Document states that an ongoing concern with the threshold approach is the uncertainty regarding how the CC is likely to treat a breach of the thresholds in the future.⁴ Transpower shares this concern.
91. As noted above, the CC's treatment of different businesses has varied. The CC's guidelines have been of limited value in indicating its likely approach. In the case of Transpower, as discussed above, the CC chose not to follow a

³ Commerce Commission, *Intention to Declare Control: Transpower New Zealand Limited*, 16 February 2006, para 130.

⁴ MED, Discussion Document, April 2007, p 19.

building blocks approach when assessing Transpower's breach. This adds to uncertainty as to the approach the CC might adopt to future breaches.

92. Another example relates to the treatment of technical breaches of thresholds. The CC's Inquiry Guidelines state:⁵

[S]ome breaches may be in the nature of a "technicality"...or due to events that are not fully controllable by the lines business...in such cases, the Commission may be satisfied the breach does not warrant further investigation (para 55).

93. In the case of Vector, however, the CC used a technical breach to examine other issues. Vector's breaches were as follows:⁶

- 31 March 2006, breach of the price path by \$76,927 (0.028%);
- 31 March 2004, breach by 18 minutes of SAIDI (22%) and 0.134 interruptions of SAIFI (10%);
- 31 March 2006, breach by 32.6 minutes of SAIDI (38%) and 0.203 interruptions of SAIFI (15%).

94. The CC's response to Vector's breach was:⁷

...the Commerce Commission is of the view that its basis for declaring control may be unrelated to the specific cause of the breach.

95. In both the Vector and Unison cases, the CC used a breach of the threshold to pursue its concerns about pricing for different customer groups and regions. This concern formed no part of the thresholds, and no guidelines for the preferred regulatory treatment had been issued by the CC.

2.3.6. Administrative settlement process

96. The administrative settlement proposal, if accepted by the CC will result in Transpower's thresholds being reset. The thresholds will impose revenue and expenditure constraints on Transpower although constraints will apply to individual components of Transpower's revenue requirement, rather than to the overall revenue requirement.
97. The proposed thresholds will take account of Transpower's actual operating circumstances including its substantial investment programme. They will also provide incentives for operating expenditure efficiency.
98. Transpower considers that the proposed thresholds will be an improvement on the previous price path thresholds and make the best of the current regulatory arrangement. However, the uncertainties inherent in a threshold regime mean that it is not an ideal long-term solution.

⁵ Commerce Commission, *Assessment and Inquiry Guidelines*, 19 October 2004, para 55.

⁶ Sundakov, Alex, *International Trends and Thinking on Economic Regulation*, presentation to the Regulatory Evolution Summit, Wellington, June 5, 2007.

⁷ Commerce Commission, *Intention to Declare Control: Vector Limited*, 9 August 2006, para 110.

99. The process of negotiating the administrative settlement has been costly and time consuming, with an uncertain outcome. While the establishment of new thresholds might be expected to take a significant amount of time, nevertheless the uncertainty that has resulted is of concern both for Transpower and for its customers.

2.3.7. Uncertainty as to form of control under Part 5

100. Transpower agrees with the Discussion Document that there is considerable uncertainty as to how regulation under Part 5 of the Commerce Act might operate. It also endorses the suggestion that the ability of the CC to settle on and change methodologies 'as it goes' is unsatisfactory.⁸
101. Despite Vector and Powerco's gas businesses having been under formal control since August 2005, the final shape of control is not known. The CC published a draft form of control paper in July 2006, but has yet to publish a final decision paper.
102. While establishing efficient revenues for the first time will inevitably take a considerable amount of time, the regime could better accommodate this uncertainty by deferring regulatory action until the work has been undertaken, rather than imposing ad hoc control on businesses, or imposing approximately calibrated constraints that may potentially distort behaviour.

2.4. Overlap of CC and EC responsibilities

2.4.1. EC and CC not bound by each other's decisions

103. Both the CC and the EC have statutory responsibilities in relation to electricity transmission.
104. The EC and CC recently released an updated Memorandum of Understanding (MoU) and accompanying Protocol which aimed to clarify how their statutory roles will work with regard to transmission. In Transpower's view, the MoU and Protocol do not satisfactorily resolve the overlap of regulatory responsibilities for electricity transmission.
105. Under the Protocol, the CC reserves the right to determine whether investment approved by the EC is 'appropriate' when considering breaches of the threshold. This means that Transpower could potentially breach its threshold (and incur the cost of a post breach inquiry) as a result of undertaking investment that the EC has approved. The Protocol does not clarify whether or not the CC believes its discretion extends to control. If it does, then the CC could possibly exclude EC-approved expenditure from the regulatory asset base, and consequently prevent Transpower from earning a fair return on investment that has been approved by the EC.
106. The CC's concern to retain this discretion appears to represent a change from its position in 2004, when it signalled that EC approval of Transpower's

⁸ MED, Discussion Document, April 2007, p 18.

investments meant that optimisation, under the ODV approach, would not be necessary.⁹

107. In Transpower's view, the suggested ability of the CC to determine that EC-approved investment is not 'appropriate' makes Transpower's revenue less certain and is a good example of regulatory overlap leading to blurred accountabilities. Such uncertainty is likely to be unfavourably regarded by the credit rating agencies and could ultimately affect Transpower's cost of capital.
108. The Protocol also suggests that the CC may scrutinise the apportionment of prices in a post-breach inquiry, even though the establishment of a pricing methodology is the responsibility of the EC and Transpower is obliged to implement it. This could also result in Transpower facing conflicting requirements.
109. While these concerns might be dismissed on the basis, that with good will, and a better MoU, they could be addressed, the test of good regulatory arrangements is their robustness in the face of disagreement. The current arrangements would not meet that test. In Transpower's view, restructuring the regulatory institutions to remove unnecessary overlap would achieve greater certainty.

2.4.2. Regulation of quality

110. One specific area that is of concern to Transpower relates to the regulation of quality. Currently, the CC's and EC's responsibilities overlap in relation to quality.
111. The Part F Rules require Transpower to achieve the Grid Reliability Standards defined by those Rules. Part C of the EGRs defines quality standards for voltage and frequency that Transpower is required to achieve. The Benchmark Agreement and the new Interconnection Rules, both of which form part of the Part F Rules, apply extensive capacity, availability and reliability service measures to Transpower. As well, they create a number of specific customer service measures such as the length of time taken to report on breaches of other service measures and respond to complaints about service, and requirements to provide incident reports and consult affected customers before planned outages.
112. Given the breadth of these quality requirements, it seems inappropriate for the CC also to set a quality threshold under Part 4A. Further, section 57G of the Commerce Act requires thresholds to be set 'for the declaration of control'. However, the CC has no power under Part 4A to make any authorisation or accept any undertaking in respect of all or any component of Transpower's quality standards. It is therefore inappropriate for the CC to set quality thresholds, a breach of which may give rise to a post-breach inquiry as to whether or not control should be imposed.

⁹ Commerce Commission, *Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses*, 30 August 2004, p 17.

2.4.3. Threshold for System Operator

113. The CC has required Transpower to propose a threshold for the system operator function as part of the administrative settlement threshold proposals. Given that the system operator services are governed by a contract with the EC there is the potential for inconsistency between the agreement with the EC and any threshold set by the CC.

2.5. Other Issues

2.5.1. Accountability for grid planning and investment decisions

114. Transpower considers that the regulatory regime for transmission should provide incentives for efficient transmission investment, and clear accountability for judgments and decisions around transmission investment.
115. Transpower considers that the present regulatory arrangements are not well suited to meeting either of these inter-related objectives. Primarily this is a function of the design of the Part F Rules that rely on mutual agreement and shared accountability for security of supply between Transpower and the EC. While the GPS has provided greater clarity that investment is Transpower's responsibility, the Part F Rules in their current form do not clearly reflect this.
116. As well, the EC has demonstrated an increasing trend to hands-on involvement in the planning of the transmission system. Rather than acting in an oversight and audit capacity as a regulator, the EC has effectively assumed a parallel role of transmission engineer by planning, developing and presenting its own transmission solutions.
117. If the EC's view on an investment decision differs from Transpower's, the result will be an impasse or the EC will effectively make the investment. While the EC is exercising more judgement with respect to investment decisions, it is not subject to a process for reviewing its decisions or a merits review procedure, nor is it primarily accountable for system security.
118. The EC's insistence that the Grid Upgrade Plans be prepared using the forecasts contained in the SOO is a practical example of the problem. A literal reading of the Part F Rules suggests that the SOO has an 'information only' purpose, to help identify potential opportunities for efficient management of the grid and elicit alternative investment proposals, which may help to achieve the objectives of a Grid Upgrade Plan, but the EC has applied a different interpretation, which cannot be practically appealed.
119. Transpower is likely to be held responsible for any deterioration in the reliability of the system irrespective of the EC's role. Because of this, the EC's incentives are not clearly aligned with the need to maintain grid security, and it will not necessarily face sanctions for poor decisions. The proposed merits review of regulator decisions, if applied to the EC as well as the CC, may go some way to addressing this concern.
120. Transpower notes that a more conventional approach as illustrated by the regime in Australia, would involve a regulator reviewing investment planning processes to ensure that they were consistent with good industry practices without being involved in any investment decision-making.

2.5.2. Uncertainty in requirements

121. A major problem with both Part 4A of the Commerce Act and the Part F Rules is the degree of ambiguity and uncertainty that their drafting permits. This has been viewed favourably in some quarters as creating 'flexibility' but, in practice, the uncertainty and ambiguity of the regulatory requirements have led to a great deal of unproductive effort and unnecessary additional cost.
122. For example, problems have arisen with Transpower's grid investment proposals being considered under the Part F Rules. The ambiguity of some of the Rules has led to requirements being modified as the process has progressed, which has again led to a poor use of staff resources by both Transpower and the regulator.

2.5.3. Resource Management Act (RMA)

123. The RMA process is a key element of the regulatory environment in which Transpower currently operates. Transpower is heavily affected by the RMA processes due to its need to use land or easements for its transmission lines and other facilities. For example, in order to proceed with any grid upgrade project, Transpower must: (1) receive EC approval pursuant to the Part F Rules; (2) receive approval as required by the RMA; and (3) obtain the necessary property rights. The current RMA process has the potential to affect the feasibility of a project that may have had prior regulatory approval under Part F Rules. The current lack of integration between these two approvals processes, in terms of the factors considered, reinforces the deficiencies of the current regulatory framework.

3. TRANSPOWER'S PREFERRED REGULATORY ARRANGEMENTS

3.1. Introduction

124. This section provides an outline of Transpower's preferred regulatory arrangements.
125. The features of a regulatory regime which Transpower considers desirable are briefly outlined in section 3.2. Transpower notes the importance of regulatory certainty for transmission, and the need for regulatory arrangements tailored to Transpower's circumstances.
126. Section 3.3 outlines the key elements of the regulatory regime that Transpower considers should be changed. These include applying a conventional revenue path control regime to Transpower, clarifying Transpower's accountability for investment, and reforming regulatory structures.
127. Section 3.4 briefly notes the desirability of changing the purpose statement. Section 3.5 comments on the regulatory options proposed by a number of the distribution businesses. Transpower supports the distribution businesses' proposals, but believes that separate regulatory provisions should apply to Transpower.

3.2. Key Features of a regulatory regime

128. Transpower, for the most part, agrees with the desirable characteristics of a regulatory regime specified in the Discussion Document.¹⁰ Transpower considers that the following are features of a good regulatory regime:
- Clear regulatory objectives;
 - Regulatory certainty;
 - Transparent processes;
 - Sound regulatory institutions which ensure accountability; and
 - Regulatory intervention which is appropriate to the problem.
129. Transpower assigns a high weighting to regulatory certainty, given its large investment programme and sunk assets. It also believes that regulatory arrangements should be tailored to Transpower's circumstances rather than necessarily being the same as other industries. It believes that regulatory accountability and political independence are important. These issues are discussed in more detail in Appendix 1.

¹⁰ MED, Discussion Document, April 2007, p 13.

3.3. Key elements of the regulatory regime that Transpower believes should be changed

130. Transpower believes that the regulatory regime applying to Transpower could be improved by the following:
- Application of a conventional revenue path control with constraints applying to the overall revenue requirement. This would include an ex ante five year allowance for capital expenditure with some provision for uncertain projects (contingent projects);
 - Clarification of Transpower's accountability for investment and in particular, removal of the ability of the EC to substitute its judgements on investment for those of Transpower;
 - Having a single regulator responsible for setting the allowed revenue requirement;
 - Possible separation of the setting of the regulatory rules from the implementation of those rules;
 - Ensuring the regulator is independent of political influence; and
 - Allowing merits review of both the CC's and EC's decisions.
131. While some further changes can be made under existing arrangements, Transpower does not believe that an acceptable level of certainty can be achieved under the current regulatory framework. In Transpower's view institutional change is likely to be required to achieve a stable regulatory regime. Possible options for implementing Transpower's preferred arrangements are discussed in more detail in section 7.
132. Below, Transpower provides an overview of its preferred form of regulation. A more detailed description of the conventional revenue path approach, as applied in Australia and the UK is discussed in section 4, and compared with the thresholds in Transpower's administrative settlement proposal to the CC. Options for institutional change are also discussed below, and in more detail in Section 5.

3.3.1. Form of regulation: conventional revenue path approach

133. Transpower advocates that the form of regulation applying to it should be based on the conventional revenue path approach used in Australia and the UK. Under this approach, the regulator determines an ex ante revenue path (or revenue cap) based on a revenue building blocks analysis. The five-year revenue cap includes an ex ante allowance for capital expenditure, with the exception of large uncertain projects which are subject to a separate allowance. Within the overall revenue cap companies are free to determine their own detailed expenditure plans and priorities in response to changing circumstances.
134. The proposed administrative settlement, in combination with the Part F approval process run by the EC, will create thresholds that are effectively a form of revenue (and expenditure) constraint based on a building blocks approach for

Transpower. Thus, some of the benefits of a more conventional approach can be achieved under the current regime.

135. However, compared to a more conventional regulatory regime such as the one applying in Australia and the UK, the New Zealand arrangements are uncertain, lack coherency, and blur accountabilities for transmission performance.
136. Transpower does not regard thresholds under Part 4A as imposing significantly lower costs than more conventional regulation. At the same time, important elements of the regime remain uncertain. For example, the process for any reset of the thresholds and the consequences of a breach of the thresholds are not known. In addition to these concerns, the overlapping of the responsibilities of the EC and CC creates conflicts and additional administrative costs.
137. Transpower believes that changes to the institutional arrangements in New Zealand along the lines of those applying in Australia and the UK could result in significant improvements in regulatory outcomes. Full implementation of a conventional revenue path approach would require changes to the Commerce and Electricity Acts and establishment of a single entity responsible for the economic regulation applying to Transpower.
138. The shape of a more conventional revenue path regulatory approach is discussed in more detail in section 4.

3.3.2. *Accountability for grid planning*

139. Transpower considers that accountability for grid planning needs clarification. This could be achieved by applying a conventional revenue cap regime. Under this approach, the regulator would scrutinise Transpower's investment processes, and undertake an ex ante review of Transpower's proposed investment programme. Transpower would be responsible and accountable for investment decisions.
140. Pending the wider regulatory reform proposed by Transpower, the Part F Rules should be amended to make the role of the EC one of audit and review to provide assurance that Transpower's grid investment plans are 'reasonable'. Notably, the requirements to use the forecasts contained in the SOO must be removed and greater latitude allowed for reasonable application of the Grid Investment Test (by Transpower). This would be consistent with a conventional regulatory approach.
141. Transpower's proposed approach is consistent with the clear expectations of the GPS. Notwithstanding the expectations in the GPS, no changes have been made to the Part F Rules.

3.3.3. *Separation of rule making from rule implementation*

142. Separating rule making from rule implementation avoids the inherent conflict of interest which arises when a regulator is responsible for determining the need for its own regulatory services. Separation also results in rules that are clearer and more transparent than otherwise. Given the potential costs of establishing a separate regulator, it may be possible to achieve a form of separation by redefining the roles of the CC and the EC.

143. Transpower's position on separation of rule making from rule implementation is discussed in more detail in section 5.

3.3.4. Single accountable regulator responsible for all building blocks

144. Transpower considers that there should be a single regulator responsible for economic regulation of electricity transmission. Establishing a single regulator would improve accountability for regulatory decisions, and provide better incentives for performance. Having a single regulator can also improve the transparency of decisions.
145. Having a single regulator responsible for decisions in relation to economic regulation will ensure consistent and coherent treatment of the various building blocks making up the revenue requirement. Options for a single regulator are discussed in more detail in section 5.

3.3.5. Regulator is independent from political influence

146. It is desirable for the government to establish its regulatory objectives in a clear and transparent way and to avoid ongoing involvement in the regulatory regime. The regulator is then accountable for achieving the government's stated objectives.
147. Political involvement in regulatory decision-making, particularly if pursued in a non-transparent manner, can increase risk for businesses, and the cost of capital. It is particularly important to insulate long-term investment decisions from the vagaries of short-term political concerns.
148. The regulatory regime can allow political directives, but these should be made transparently. The process of issuing section 26 statements under the Commerce Act provides a reasonable model.
149. Options for achieving more robust arrangements for the regulator are discussed in more detail in section 5.

3.3.6. Merits review to improve regulator accountability

150. The ability to appeal major regulatory decisions to an independent body by way of a 'merits review' or equivalent appeal process is a feature of good governance, which helps to maintain consistency, transparency and fairness of the regulatory decision making process. The review body should be required to adjudicate on whether or not the most appropriate decision was reached, given the available information.
151. There is always scope for experts to reach different conclusions on reasonable grounds. The appeal body's role should be to correct decisions which can be shown to have been wrong. Without the ability to appeal regulatory decisions, decisions may be allowed to stand simply because they were open to the decision maker in the first instance (the decision not being ultra vires or unreasonable in a judicial review sense), even though they could be shown to not have been the most appropriate decision on the evidence.
152. Transpower's position on merits review is discussed in more detail in section 6.

3.4. Purpose statement

153. Transpower proposes that electricity transmission be excluded from Part 4, Part 4A, and Part 5 of the Commerce Act, and that separate legislative provisions be established which define the regulatory constraints to apply to electricity transmission. Transpower has proposed a purpose statement relevant to this approach. More detail is provided in section 7.
154. In terms of current regulatory arrangements, Transpower supports the Discussion Document's proposed introduction of a purpose statement applying to both Part 4 and Part 4A, and endorses the explicit inclusion of a reference to incentives for investment. Transpower also considers that the regulatory criteria proposed in the Discussion Document, with the modifications proposed by the distribution businesses¹¹ (discussed below) would improve regulatory outcomes.

3.5. Distribution businesses' proposed approach

3.5.1. Proposed changes

155. The electricity distribution businesses have collaborated to produce a submission on the Discussion Document.¹²
156. They suggest a number of amendments to the purpose statement and the regulatory criteria to reduce ambiguity. In Transpower's view, the proposed changes appear sensible within the context of regulation of the distribution businesses.
157. The distribution businesses propose that the current thresholds regime be replaced by three regulatory 'pathways' which would include alternative arrangements, a default price/quality path, and a propose/respond model.
158. Transpower supports the distribution businesses' proposed approach to regulating the distribution businesses. Transpower considers that trust, customer, and council and government ownership can substitute for direct regulation. These ownership arrangements substantially reduce the incentives to extract monopoly rents. The imposition of regulation on top of the ownership constraints is likely to impose costs for minimal benefits.
159. Transpower also agrees that for the distribution businesses, it is may be sensible to retain a default price/quality path option. The price/quality path could possibly be improved by, as suggested, taking into account the circumstances of individual businesses.
160. Transpower also considers that there would be advantages to adopting a 'propose/respond' methodology. Transpower's administrative settlement could

¹¹ Electricity Distribution Lines Businesses in New Zealand, *Response to MED Review of the Regulatory Control Provisions Under the Commerce Act*, July 2007.

¹² Electricity Distribution Lines Businesses in New Zealand, *Response to MED Review of the Regulatory Control Provisions Under the Commerce Act*, July 2007.

be considered a variant of such an approach. Transpower's preferred regulatory option for transmission would include the propose/respond approach.

161. The distribution businesses suggest that the input parameters should be established prior to any regulatory process and that they should be legally binding on the regulator. The input parameters should be set either by an expert panel or by the regulator (not the Minister).
162. Transpower supports measures that will increase certainty. It therefore agrees that the input methodologies should be specified in advance, where possible.
163. The distribution businesses propose that accountability of the regulator would be enhanced by allowing merits review by way of re-hearing for all substantial decisions of the regulator (including the setting of input methodologies). The regulator should be obliged to provide reasons why it considers its decisions to be consistent with the purpose statement, regulatory criteria and any other requirements it is obliged to consider.
164. Transpower supports the adoption of merits review. Its position is discussed in more detail in section 6.
165. The distribution businesses recommend that the economic regulator function should remain with the CC unless the structure of the EC is changed to achieve independence from political influence.
166. Transpower proposes an option where the CC sets the rules for the regulatory regime, and the EC implements them as economic regulator. Transpower agrees with the distribution businesses that it would be highly desirable to change the structure of the EC to achieve independence from political influence.

3.5.2. *Transpower's approach in relation to distribution businesses' proposals*

167. In summary, Transpower fully supports the approach taken and the recommendations made in the distribution businesses' submission in respect of the review of regulatory control provisions under the Commerce Act 1986, as applied to distribution companies.
168. Transpower, however, proposes that separate regulatory provisions should apply to transmission, to address specific issues relevant to Transpower's position as the sole transmission service provider in New Zealand. Transpower's preferred arrangements are discussed in the remaining sections of this submission.

4. MORE CONVENTIONAL REVENUE PATH REGIME

4.1. Introduction

169. This section discusses the conventional revenue path regime, drawing for the most part on the Australian approach, which has many of the regulatory attributes that Transpower believes would help establish an environment conducive to efficient investment, while imposing constraints that protect the interests of consumers in terms of price and service quality.
170. Section 4.2 provides an overview of regulation of electricity transmission. It compares the conventional approach with the thresholds proposed under Transpower's settlement proposal. The discussion illustrates the greater certainty and coherency provided by the conventional approach vis a vis the thresholds approach applying in New Zealand.
171. Section 4.3 compares the regulatory structure of the Australian/UK regime with that applying to New Zealand. It notes the desirable aspects of the conventional regime applying in Australia which includes separation of rule making from rule implementation, a single economic regulator, and access to merits review of regulator decisions.
172. Process considerations are addressed in section 4.4. The importance of clarity of processes, predictability and good communication and consultation are noted.

4.2. Comparison of regulatory constraints

4.2.1. Overview

173. Under the Australian and UK regimes, there is an ex ante revenue path (or revenue cap) determined by the regulator based on a revenue building blocks analysis. Typically, the cap applies for a five-year period.
174. The constraint applies to overall revenue rather than to individual revenue (cost) components. This arrangement reflects a recognition by policy makers and regulators that once a revenue cap is set, companies should be free to determine their own detailed expenditure plans and priorities in response to changing circumstances, subject to:
- The overall revenue constraint not being breached; and
 - Minimum service quality requirements being maintained.
175. In this context, the following passage, taken from the Australian Energy Regulator's (AER's) June 2007 Final Decision on the revenue cap to apply to Powerlink Queensland is noteworthy:

Under the ex ante framework, Powerlink has full operational discretion to allocate its expenditure allowances as it sees fit. It has an incentive to seek more efficient ways of delivering its services in order to maximise its profits while maintaining the service standards that have been set in this decision. These arrangements should provide benefits to users over the longer-term.

176. The revenue cap is based on forecast operating expenditure, capital expenditure, a return on capital and depreciation of the regulatory asset base (which is not subject to re-optimisation), and a benchmark allowance for taxation expenses.
177. Additional costs associated with certain unforeseen events may be 'passed through'.
178. The five-year revenue cap contains an ex ante allowance for all capital expenditure, with the exception of 'contingent' projects. The latter are large, uncertain projects, which in Australia, are subject to a separate revenue allowance if the project is required to proceed during a revenue cap period.
179. Certain procedural requirements and constraints apply to the regulator's determination of the building block cost allowances underpinning a revenue cap. The regulated company's cost estimates are subject to regulatory scrutiny and decision-making. However, the regulator is required to accept the transmission business' proposed investment plans and operating expenditure proposals if satisfied that they reasonably reflect efficient and prudent costs and are based on realistic estimates of forecast demand and cost inputs.
180. Service quality incentives are provided as part of the revenue cap.
181. Incentives for capital expenditure efficiency are provided by allowing the company to retain some benefits of efficiency savings over time.
182. The changes to Transpower's thresholds suggested in the administrative settlement proposal move some way towards a revenue path approach. However, the changes do not fully implement the approach. The threshold proposals involve the following:
- There is a mix of ex ante revenue building blocks combined with some expense constraints;
 - Constraints are imposed on individual components, rather than the overall revenue requirement;
 - Constraints are based on five year forecasts for operating expenditure, two year forecasts for non-Part F capital expenditure, and actual expenditure for other building blocks;
 - There is a separate review by the EC of capital expenditure that falls under the Part F Rules;
 - Incentives are provided for operating expenditure efficiency (Transpower keeps any gains in efficiency, and bears the costs of over-expenditure). Limited incentives are provided for capital expenditure efficiency. (Transpower may breach the threshold if it spends too much on non-Part F capital expenditure);
 - There is no certainty as to the approach the CC will use to reset the thresholds at the end of the administrative settlement period; and
 - Quality is regulated by both the EC and the CC.

183. The proposed thresholds impose less forecasting risk on Transpower than a conventional approach. However, it also provides less certainty and less flexibility because constraints apply to individual building blocks. It also involves on-going scrutiny and involvement by the regulator rather than periodic review.
184. The proposed thresholds combine an ex ante and ex post process. Transpower will continue to deal with forecasting risk through EV adjustments. These adjustments ensure that any inadvertent economic gains or losses generated due to forecasting error are returned to, or recovered from customers at a later date.
185. The EV approach provides both Transpower and customers with certainty that neither party is being economically short changed. This is its key advantage. However, it moves Transpower's regulatory arrangements closer to rate of return regulation and can therefore reduce efficiency incentives.

4.2.2. Investment and innovation

186. The issue of the impact of regulatory decision-making on incentives for investment and innovation has been the subject of considerable debate in Australia in recent years. Much of the impetus for regulatory reform in Australia originated with the Productivity Commission's 2001 review of access regulation.¹³ The Commission's annual report of February 2002, which emphasised the need for 'better regulation of infrastructure' stated:

With the inherent uncertainties and information difficulties, there are limits to what regulators can achieve...

[The Commission's recently completed review of the national access arrangements] found that modifications and refinements are needed to reduce the risk of regulatory error and overreach and to ensure a long-term pay-off to the community...

[The] major risk associated with the regulation of essential infrastructure is that setting prices too low could deter new investment in the facilities themselves. Access and price regulation can involve a significant intrusion into the property rights of facility owners and affect their investment behaviour. While available evidence of adverse impacts on past investment is largely anecdotal and difficult to verify, the potential risks of adverse consequences from regulatory action appear to be looming larger.

187. Similarly, in a speech given on 15 March 2002, the Productivity Commission's Chairman commented that:

The Commission's recent inquiries have revealed a need to re-balance the emphasis in infrastructure regulation away from achieving immediate gains for users and consumers from existing assets - much of them government owned or previously government owned - to a regulatory framework that will also facilitate efficient investment in new facilities. In this way, pro-competition regulation is more

¹³ The Productivity Commission is the Australian Government's chief independent adviser on policy matters relating to regulation and microeconomic reform.

likely to ensure that Australia has modern infrastructure which is developed and used efficiently, with long-term benefits to the Australian community.

188. The present round of regulatory reform in Australia is now in its final consultation stage. Statements by policy makers on the design of the new regime, and the objectives and pricing principles that are to be included in the law, point to recognition of the negative asymmetric effects of regulation that is overly focused on short term price reduction to the detriment of long term investment incentives. In this regard, it is noteworthy that under the detailed rules governing the regulation of electricity transmission revenues in Australia, the regulator is required to accept the transmission business' proposed investment plans and operating expenditure proposals if it is satisfied that they reasonably reflect efficient and prudent costs and are based on realistic estimates of forecast demand and cost inputs. The regulator reviews investment for 'reasonableness' but does not second guess possible approaches.
189. These provisions have only recently come into effect. Thus, it is not possible to point to any established practices in their application.
190. A further noteworthy feature of the Australian arrangements is the incentives provided for investment and innovation. In relation to this matter, the Australian Energy Market Commission, (the AEMC) the body responsible for rule making, issued a recent determination of the rules governing the regulation of electricity transmission revenues which stated:¹⁴

A principal focus of the Revenue Rule is to provide incentives for efficient, adequate and timely investment in new and replacement network capacity. The Commission has sought to do this by reducing the regulatory risk faced by TNSPs when investing in transmission capacity. At the same time the Commission sought to ensure that consumers do not pay more than necessary for transmission services. The challenge has therefore been to design an incentive package that finds an adequate balance between encouraging investment in new capacity and ensuring TNSPs undertake such investment efficiently.

A key mechanism for managing the investment risk for TNSPs was to 'lock-in' and roll forward the RAB [regulatory asset base] from one regulatory period to the next. This aimed to give greater security to investors in the transmission system that their investments would be treated in an appropriate way over time. More specifically, the RAB would not be subject to optimisation at regulatory resets to reflect the economic value of the assets to users, which would otherwise present a significant risk to investors.

In terms of the arrangements to encourage TNSPs to develop, operate and price their networks efficiently the Revenue Rule provides for use of a package of mechanisms. Firstly, the arrangements provided for the TNSPs to retain the benefit of any underspend, or incur the cost of any overspend, compared to the capital expenditure forecast for the remainder of the relevant five year regulatory control period (with the benefit or cost being determined by applying the return on capital to, and depreciation on, the amount of under or overspend).

¹⁴ AEMC, *Rule Determination: National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006, pp 97-99.

While the [initial draft] Proposed Rule had proposed to allow the AER to conduct an *ex post* review of the prudence of capital expenditure, this has been removed following stakeholder concern that such a review would undermine the incentive powers of the regime.

In general the criticism of the proposed *ex post* prudence review was that it undermined the incentives of the *ex ante* cap and contributed to the investment uncertainty that the remainder of the package sought to overcome. Submissions also raised the legitimate concern that *ex post* prudence reviews are, by their very nature, an intrusive form of regulation. An *ex post* review effectively requires the regulator to put itself in the position of a TNSP at the time that they were undertaking a particular project to determine if the project was undertaken efficiently. Previously, this process has been the subject of controversy when it has been applied to network businesses. For these reasons, the Commission has removed the arrangements for *ex post* reviews and instead focused more on improving *ex ante* incentives.

The Commission has also incorporated mechanisms to reduce TNSPs' risks related to the costs of unforeseen outcomes or difficult-to-predict events. This has included adopting a 'contingent project' regime for large capital projects that are planned but uncertain as to timing or cost. In addition, the Revenue Rule provides for a reopening of the revenue cap determination if the TNSP is obliged to invest in a major project (at least five per cent of the value of the RAB) and that investment would cause the TNSP to exceed its capital expenditure allowance for the entire regulatory period. These measures are intended to avoid encouraging TNSPs to defer necessary major investment where it would cause them to exceed their capital expenditure allowance for the period.

191. In the UK, the regulator has adopted a 'sliding scale' approach to setting the investment allowance, which provides incentives for businesses to state their expected capital expenditure, rather than 'gaming' the estimate. Businesses are able to keep a proportion of the amount under spent, relative to their own estimate and that of an Ofgem consultant, providing incentives for efficiency. They obtain a higher amount the more accurate is their own estimate of required capital expenditure.¹⁵
192. Under the New Zealand regime, both the CC and the EC have responsibility for investment. Transpower has concerns that the EC's practice and its interpretation of the Part F Rules, has tended to shift greater responsibility to the EC, as it seeks to remove the exercise of judgement from Transpower in its planning and investment proposals, but without a corresponding shift in accountability. Transpower has also noted its concern that the CC has retained discretion to review investment already approved by the EC.
193. By contrast, the arrangements in Australia (described above) provide clear and effective incentives for efficient investment. It is also particularly noteworthy that the Australian incentive arrangements apply to transmission companies that are solely responsible and accountable for the efficient planning and development of their networks, and for the service performance of those networks.

¹⁵ Scott, John, technical director, Ofgem, *Networks at the Edge*, presentation to Auckland EEA, June 2007, pp 8-9.

4.2.3. Regulation of quality

194. Quality of service is integrated into the overall revenue cap in both the Australian and UK regimes. The Australian regime allows a transmission business to earn more revenue (up to 1 percent of the revenue cap) if it exceeds its performance targets. It also creates incentives to limit the extent of any failure of quality standards because the penalty for failure is graduated. The UK has a similar incentive scheme, with the revenue exposed under the scheme varying from 1.2 percent to 1.8 percent depending on the quality measure.
195. Under the New Zealand regime, quality is not integrated with the revenue thresholds. The CC has continued to set a separate quality threshold for Transpower despite not being able to control quality under Part 5. The EC also has responsibility for quality through the Part F Rules, and particularly the Benchmark Agreement and Interconnection Rules. Transpower considers that if current arrangements are retained, there is no need for a separate quality threshold, although it considers that information disclosure on quality measures may be appropriate. Over time, it would be desirable to integrate quality measures with the revenue cap.

4.2.4. Penalties for breach

196. Differences in the penalties under the different approaches potentially result in a difference between a thresholds regime and control under a more conventional approach. However, the distinction between the two is not particularly clear cut. While a regulated cap cannot be breached at will, the use of pass through allowances, together with the ability of the regulated company to request an ex ante re-determination if it anticipates the need to breach provide important protections for the transmission business.
197. By contrast, the thresholds developed as part of Transpower's administrative settlement proposal have been defined in a way which potentially makes it difficult to justify a breach (particularly for operating expenditure) so that the ability to breach without penalty will be limited. As well, the costly nature of a post-breach inquiry also suggests that breach of a threshold is not a 'soft' option.

4.3. Regulatory Structure

4.3.1. Objective of regulation

198. In Australia, the National Electricity Law sets out a number of revenue and pricing principles to guide the development of the more detailed regulatory rules, and the application and interpretation of those rules. These principles include:¹⁶
- A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator

¹⁶ The NEL is set out in schedules to acts passed by each state in Australia.

incurs in providing regulated network services; and complying with a regulatory obligation or instrument.

- A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to regulated network services the operator provides. The economic efficiency that should be promoted includes: efficient investment in a network with which the operator provides regulated services; the efficient provision of network services; and the efficient use of the network with which the operator provides regulated network services.
- Allowance should be made for the value of a network with which a network service provider provides regulated network services. Regard should be had to any valuation of a network set out in any previous regulatory determination.
- Regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider in the network with which the operator provides regulated network services.
- Regard should be had to the economic costs and risks of the potential for under and over utilisation of a network with which a regulated network service provider provides regulated network services.

199. The policy maker in Australia, the Ministerial Council on Energy, or MCE, has recognised that:¹⁷

Effective economic regulation is a key to successful market reform. The regulation of network access (prices and standards) seeks to balance energy users' short-term interests in price benefits with their long-term interests in a reliable supply, service enhancements and timely investment in new capacity. The making of market and regulatory rules aims to provide reasonable stability to market participants, while ensuring that the rules can evolve to meet challenges that will inevitably arise. The enforcement of those rules maintains an important discipline on market conduct.

Sound economic regulation requires expertise, independence from commercial interests, and close consultation with affected parties. The processes must be made more efficient and streamlined, responsive to market developments, and occur within a clear framework of government policy...

The MCE proposes the establishment of two new statutory bodies to undertake these tasks. One body will focus on rule-making and market development (the Australian Energy Markets Commission or AEMC), the other on network access regulation and market rule enforcement (the Australian Energy Regulator or AER).

200. In light of the MCE's comments and the pricing principles set out in the exposure draft of the National Electricity Law, one could infer that Australian policy makers recognise that regulation which is unduly focussed on eliminating

¹⁷ MCE, *Reform of Energy Markets*, December 2003, Report to the Council of Australian Governments, pp 7-8.

monopoly rents may damage incentives for investment, and lead to outcomes that are not in the long term interests of consumers.

201. As noted in the Discussion Document, the objectives of regulation in New Zealand are not clearly specified in the Commerce Act.

4.3.2. Separation of rule making from implementation

202. As discussed in more detail in section 5, in Australia a separate regulator (the AEMC) sets the rules, while the AER implements them. Such separation can improve regulatory accountability and the transparency of decision-making.

203. There is no separation of rule making from implementation under the New Zealand regime. The CC is effectively establishing the rules and then implementing them.

4.3.3. Single regulator

204. A single regulator (the AER) is responsible for the overall revenue path, including allowed capital expenditure. This means that a single regulator is accountable for application of regulatory rules. In the UK Ofgem is responsible for the economic regulation of the electricity and gas industries.

205. In New Zealand there are two regulators with responsibility for transmission, with conflicting objectives, rules and mixed accountability.

206. The AER is also responsible for market rules. Transpower does not believe that the same regulator should necessarily be responsible for setting the revenue path and for overseeing the market rules. What is required is a clear definition of the relative responsibilities.

4.3.4. Constraints on regulator power

207. In Australia, there is limited merits review of regulator decisions.

208. There is no merits review of regulator decisions in New Zealand. Transpower supports changing this. A more detailed discussion of Transpower's position is provided in section 6.

209. The administrative settlement process potentially reduces the accountability of the CC for regulatory outcomes. Although a settlement offer is presented as a proposal by the regulated business, in fact the CC has defined non-negotiable aspects of it. A regulated business is constrained from objecting to the trade offs it has had to make to get agreement, because the settlement is presented as the business' offer. The CC is consequently relieved of accountability for outcomes that result from the constraints.

4.4. Process considerations

4.4.1. Clarity of process

210. The process and timetable for establishing the regulatory constraints are well specified in the Australian approach. Information that must be presented to the regulator is known in advance. The process of review is well specified.

211. In contrast, in New Zealand, the process is not well specified, and has been developed in an ad hoc manner. The information requirements are not known in advance. However, they may be better understood when it comes to resetting the thresholds, as long as the CC uses the same approach.
212. The process of review of regulator decisions is lacking in New Zealand. A timetable for decision making on regulatory issues is not generally specified.

4.4.2. Predictability

213. The Australian regime has attempted to balance the need for regulatory discretion and the importance of predictability for investment certainty. Detailed consideration has been given as to how the regime and the regulator's discretion within it are to be defined and specified within a hierarchy of instruments which includes legislation, rules, and regulatory decisions.
214. Further, the regime has settled on a revenue cap form of regulation. Since the mechanics of the building blocks approach to determining a revenue cap are well known, the Australians have codified components of the approach into Rules. To the extent possible parameters are specified in advance. This has improved the predictability, transparency and consistency of the regime without compromising good regulatory outcomes.
215. In New Zealand, the parameters involved in setting the constraints on building blocks have not been specified in advance, with the exception of WACC, where the CC's approach is comparatively well defined.

4.4.3. Consultation and communication

216. In Australia, there is consultation on draft decisions and parameters, and explanation of decisions.
217. The CC's consultation during its regulatory processes has generally been good. However, in Transpower's view, greater consultation between Transpower and the CC in the period between Transpower's breaches of the threshold, and the issuing by the CC of the notice of intention to declare control, would have been beneficial.
218. The CC has consulted with Transpower throughout the administrative settlement process, and proposes to consult more widely once an agreement is reached.

5. REFORM OF THE REGULATORY STRUCTURE

5.1. Introduction

219. A wholesale overhaul of the New Zealand regime applying to electricity transmission by adopting rules and institutional arrangements similar to those applying in Australia, would, in Transpower's view, most probably achieve a significant improvement in regulatory outcomes. Such an approach would require changes to the Commerce Act and the Electricity Act.
220. Transpower notes that some of the required changes cannot be achieved through amendments to the Commerce Act alone and therefore extend beyond the changes contemplated by the current review process.
221. Transpower believes that separating rule making from rule implementation could achieve significant benefits, and that a form of separation could be achieved by redefining the roles of the CC and EC. This is discussed in section 5.2. This sub-section considers in some detail the reforms in Australia and the reasons given there for establishing such separation.
222. Section 5.3 provides an overview of the options for establishing a single regulator. It considers the relative merits of the EC or CC assuming responsibility for setting Transpower's allowed revenue. Transpower's preferred option of the CC setting the regulatory rules and the EC applying them is discussed, and a possible overall framework presented in a diagram.

5.2. Separation of Rule Making from Rule Implementation

223. Australia is currently implementing further reforms to the economic regulation of infrastructure in that country. One of the key issues being addressed by these reforms is governance arrangements, and in particular, the separation of the roles of policy making, rule making and rule enforcement. The objectives of the latest Australian reforms are directly relevant to the New Zealand context. These include:
- Strengthening the quality and timeliness of governance of the energy markets, to improve the climate of investment; and
 - Streamlining and improving the quality of economic regulation across energy markets to lower the cost and complexity of regulation facing investors, enhance regulatory certainty, and lower barriers to competition.
224. As part of these recent regulatory reforms in Australia, policy makers (the MCE) have established new institutional arrangements that separate policy development from the administration of policy. Under these new arrangements, the AEMC is responsible for rule making, while a separate body, the AER is responsible for rule enforcement. Issues of regulatory accountability and

transparent decision-making were important drivers of the MCE's decision to establish a new national regulator and to separate the roles of rule-making from rule-enforcement. The MCE commented that:¹⁸

The AER will operate within an enhanced framework of accountability to governments and market participants through clear consultation, reporting and transparency obligations and accessible avenues of appeal against regulatory decisions.

225. Under the new institutional arrangements in Australia, the discretion applied by the economic regulator will be guided by the law (at the highest level) and the rules (which give effect to the law, and which are made independently by the AEMC). The rationale for these institutional arrangements is summarised in the following passage taken from the Expert Panel's Report to the MCE on Energy Access Pricing:¹⁹

The formal guidance that applies to the regulator is important for reducing the potential for error or systematic bias, and so promoting the net benefit from regulation. Well-designed procedural requirements, which include substantial opportunity for interested parties to participate and create an environment of transparency, also provide useful pressure for the regulator to administer the regime in an appropriate manner. Effective options to review decisions are a further mechanism.

226. The detail of the regulatory arrangements in New Zealand currently differs significantly from the Australian regime. However, the concerns expressed by the MCE regarding the need for enhanced regulatory certainty and an enhanced framework of regulatory accountability through clear consultation, reporting and transparency obligations are not dissimilar to some of the issues raised in the Discussion Document. This includes for example the concern that the CC has the ability to settle on and change methodologies 'as it goes'.
227. The institutional arrangements adopted in Australia (and in particular, the separation of rule making from rule enforcement) ensure that:
- Important aspects of methodologies to be applied by the economic regulator (for instance, in determining a revenue cap) are prescribed in the rules;
 - The economic regulator's discretion is exercised within clearly defined boundaries prescribed in the rules; and
 - The rules are determined through a transparent rule-making process which is independent of the rule-enforcing body itself.
228. As noted above, the Australian arrangements are intended to enhance the climate for investment, by providing greater transparency, consistency and predictability of regulatory decision-making.

¹⁸ Ministerial Council on Energy, *Report to the Council of Australian Governments: Reform of Energy Markets*, 11 December 2003, p 9.

¹⁹ Expert Panel on Access Pricing, *Report to the Ministerial Council on Energy*, April 2006, p 12.

229. Separating rule making from rule implementation avoids the inherent conflict of interest which arises when a regulator is responsible for determining the need for its own regulatory services. Separation also results in rules that are clearer and more transparent than otherwise.
230. Adoption of similar institutional arrangements in New Zealand may deliver similar outcomes, and would address some of the issues raised in the Discussion Document particularly in relation to the regulatory uncertainty that exists under the present arrangements in which the CC is in effect, a rule maker as well as a rule enforcer.
231. Transpower acknowledges concerns about the availability of skills and expertise in New Zealand and the additional costs that might be involved in separating the rule making from rule implementation. Transpower considers that it may be possible to achieve a form of separation by redefining the roles of the CC and EC. In particular, as discussed in the next section, one option would be to establish the CC as the rule maker in relation to electricity transmission with the EC as the rule enforcer.

5.3. Options for establishing single regulator

232. In a well structured regulatory regime for transmission (such as operates in the UK or Australia) a single regulator is responsible for oversight of all of the building blocks of the transmission provider's revenue requirement, including the existing asset base, capital expenditure, depreciation, cost of capital, operational expenditure, productivity improvement and efficiency.
233. The same regulator is responsible for oversight and approval of the allowed revenue and for pricing structures. Having a single regulator responsible for all components avoids regulatory duplication and helps to promote regulatory certainty and clear efficiency incentives.
234. The institutional options for establishing a single regulator in New Zealand include:
- Adapting the institutional and regulatory design of the EC so that it could operate as a more conventional economic regulator. In this scenario, the CC could act as the rule setter; or
 - Have the CC take full responsibility for setting the allowed revenue, including responsibility for approving transmission investment. In this scenario the EC would act as a technical adviser to the CC on investment matters. The EC would be responsible for reviewing Transpower's capital expenditure plans on a five year ex ante basis, for input in the revenue path determined by the CC.
235. At present, neither the CC nor the EC possesses all the attributes necessary for a fully-functioning economic regulator. In Transpower's view the transmission regulator should have the following attributes:
- Independence;
 - Industry and economic knowledge; and

- Accountability.
236. In considering the reallocation of functions, the following are relevant considerations:
- Which body would find it easier to acquire the missing attributes? Alternatively, are there a number of possible ways of combining the roles of the EC and CC to provide the relevant attributes without duplication?
 - If skills are to be transferred, which skills are more easily transferred? For example, is it easier for the CC to develop specific electricity sector knowledge, or for the EC to acquire the CC's economic expertise?
 - How much legislative and other change would be needed to equip either one or the other body with the full institutional characteristics of an effective economic regulator?
237. Any reallocation of functions for economic regulation will need to consider carefully the status of the CC as an independent Crown entity, and the EC as a Crown agent.

5.3.1. EC as the single regulator

238. The EC has engineering expertise and knowledge of the industry.
239. The EC is responsible for the market rules, so there may be some synergies achievable by combining responsibility for this regulation and economic regulation.
240. However, the wide scope of conflicting functions of the EC (including being a wholesale market participant), may be incompatible with the role of an independent economic regulator.
241. For example, the EC is able to use an industry levy to contract for generation to meet its security of supply objectives. In doing this, it in effect becomes a direct participant in the wholesale electricity market. In some cases, generation and transmission may be complementary, but in other cases they may be in competition. In other words, there will be circumstances where the EC would be both a participant in the electricity market and the regulator.
242. Similarly, the EC has a specific mandate to focus on energy efficiency and to promote demand side response. This function is quite distinct from the economic regulation of transmission. However, the EC's view of the prudence and efficiency of transmission investment will clearly be coloured by its energy efficiency objectives. In assessing market needs for transmission services, Transpower in part makes judgements about the likely effects of the EC's energy efficiency interventions. It is common for organisations involved in promoting energy efficiency to have a more optimistic view of their effectiveness than is commonly held by the market. As a regulator of transmission services, the EC may be tempted to validate its spending on energy efficiency through its load forecasts, and hence may question the prudence of transmission investments that are based on a more commercial assessment of market needs.

243. Overall, organisations with conflicting objectives tend to make non-transparent trade-offs between those objectives. The lack of independence of the EC from political influence raises significant concerns. It creates risks which cannot be readily understood or managed by the policy makers or market participants. For this reason, the best practice approach internationally is to create independent economic regulators, whose sole objective is to provide oversight of the prudence and efficiency of regulated natural monopolies. The current structure of the EC is a reason why having the EC as the single economic regulator might be undesirable.
244. Australian analysis indicates that there are benefits to separating rule making from rule implementation. If the EC were to become the economic regulator, the CC could assume the role of rule maker. It has the economic expertise to undertake this role.
245. Under this approach, the CC would be responsible for establishing the input methodologies, which would desirably be set in advance of the imposition of control. As discussed in section 7, Transpower would prefer the form of regulation to be defined in the legislation. If not, determining this would also be a CC responsibility as rule maker.
246. Assigning the role of rule maker to the CC would reduce the concerns about the EC's lack of political independence, because some of the important elements of the regulatory regime would be under the control of an independent regulator. Keeping the CC as the rule maker would also ensure a substantial degree of consistency was maintained between the regulatory requirements applying to transmission and to other regulated industries.

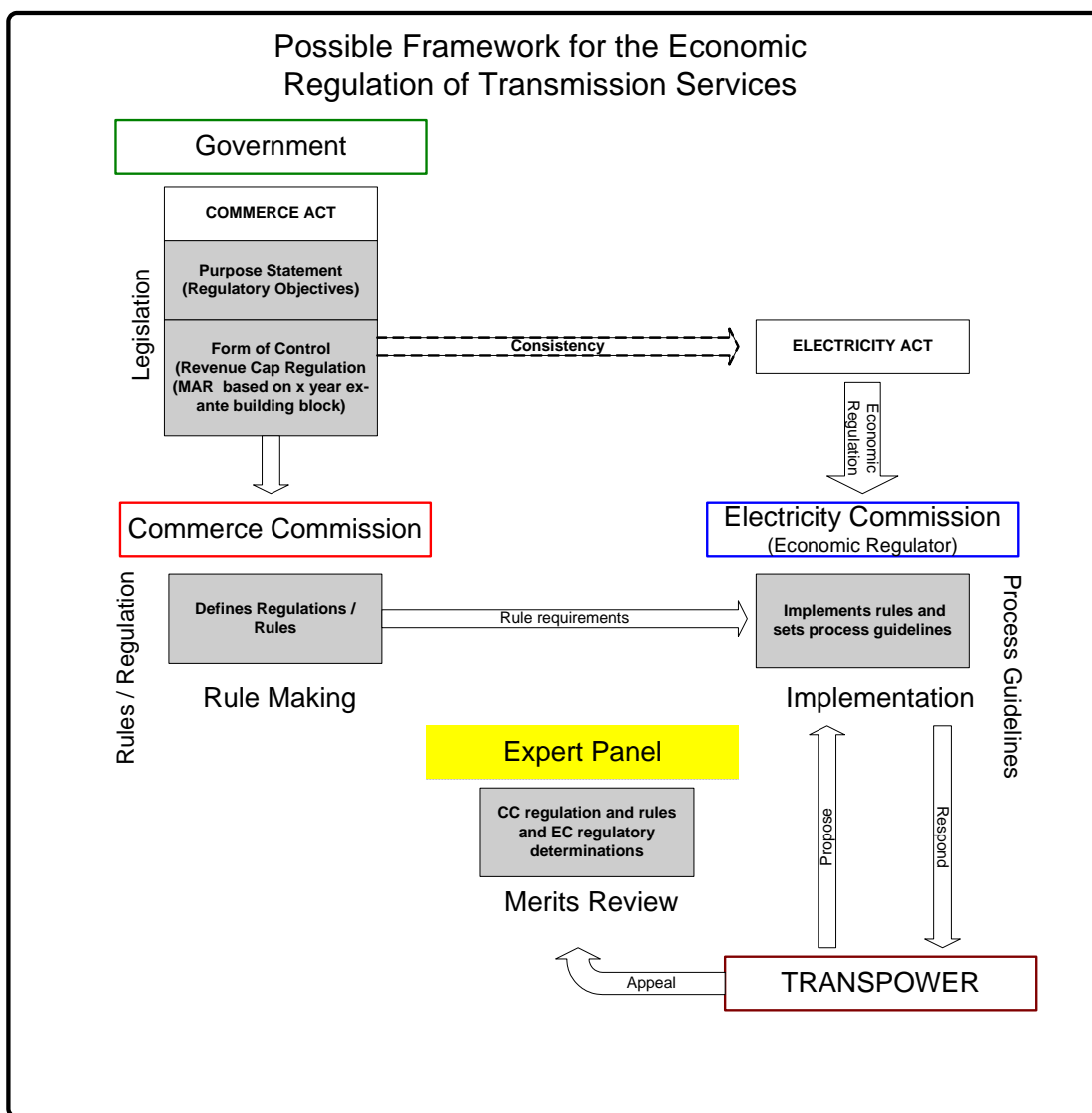
5.3.2. CC as the single regulator

247. The CC has greater economic expertise, and experience in economic regulation than the EC. It would need to contract in experience to review capital and operating expenditure plans. This could be provided either by the EC or by an external adviser, with the CC retaining ultimate responsibility for decisions. Contracting in technical expertise is common practice in other jurisdictions. Arguably there may be some synergies between the CC's regulatory responsibilities for electricity and its responsibilities for other monopoly industries.
248. The EC does not currently have sufficient economic expertise of an appropriate kind to be an effective rule maker. It also has conflicting responsibilities and lacks independence from political influence, which would argue against giving this responsibility to it without significant institutional change. Thus, unless a separate rule maker is established, under this option the CC would be both the rule maker and rule enforcer.

5.3.3. Transpower's preferred option for regulator

249. Transpower is somewhat ambivalent as to which institution should have jurisdiction for economic regulation. Transpower's primary concern is to see resolution of current regulatory deficiencies and a move to a more stable regulatory framework that ensures the company can finance and implement a prudent and efficient level of investment.

250. However, on balance Transpower believes that the option where the CC sets the rules and the EC is responsible for Transpower's revenue cap may offer advantages. Under this option, it would be desirable to resolve the EC's conflicts of interest noted above, including the concerns about its lack of political independence.
251. An option for implementing Transpower's preferred regulatory structure is shown in the diagram below.



252. The legislative changes required to implement this proposal are discussed in section 7.

6. MERITS REVIEW

6.1. Introduction

253. This section considers the possibility of introducing merits review of regulatory decisions by the CC and EC.
254. Section 6.2 briefly outlines the Discussion Document's proposal for a limited form of merits review.
255. Section 6.3 considers the relative advantages and disadvantages of judicial review versus merits review. Transpower considers that improving regulator accountability and providing incentives for performance are key elements which will help achieve long-term improvements in performance. It therefore supports creation of a merits review process.
256. Section 6.4 considers the possible limits that should apply to merits review. Transpower notes that merits review should be by way of a rehearing, and that such review should apply more widely than to control decisions.
257. The preferred structure of a merits review body is discussed in section 6.5. Transpower notes its preference for a specialist body, possibly established as an arm of the High Court.
258. Transpower notes in section 6.6 that the EC's decisions should be subject to merits review.

6.2. Discussion Document's proposal

259. The Discussion Document observes that the availability of merits review is likely to improve the quality of, and confidence in regulatory decision-making. However, because of the significant costs associated with merits review, the Discussion Document suggests that merits review should be limited to some regulatory decisions only, an appeal should be by way of a rehearing, and review should be limited to material issues of contention.

6.3. Judicial review versus merits review

260. Transpower is affected by regulatory decisions made under Part 4A because it is a large electricity lines business. Transpower is the only transmission business regulated under Part 4A, with the remainder of the large electricity lines businesses all being distribution businesses.
261. Transpower believes that the provision of merits review under Part 4A is desirable, and that judicial review does not provide sufficient restraint on regulatory decisions made in this regard. It appears anomalous to Transpower that, as the law currently stands, merits review is provided for the mergers and acquisition decisions of the CC but not for decisions made under Part 4A. In Transpower's view, merits review is required to ensure that regulators remain more accountable for their decisions, and to provide incentives for better and more consistent decisions.

262. The issues that arise under Part 4A are highly complex. They frequently involve input parameters and the application of methodologies about which there is seldom consensus at an academic or industry level (for example, the debates around historical and replacement cost valuation methodologies). Difficult judgements are involved and may require regulators to work with assumptions and models which contain uncertain elements. The statutory provisions governing the process are broad and leave considerable discretion for interpretation by the regulator. There is the prospect that on each occasion that a decision is made under Part 4A, the decision may be inadequate in some respects or inconsistent with other decisions made in equivalent circumstances.
263. The consequences of a poor decision under Part 4A are potentially serious. A poor decision could, for example, lead to financial losses for a particular firm. More significantly for the nation as a whole, the result may be under-investment or inefficient use of infrastructure, with negative effects for the industry and consumers. It is important that decisions are as well founded as possible.
264. Judicial review is only intended to address errors in the process followed to reach a decision and not the substance of the decision itself. Consequently, judicial review is unable to address the situation where several options were available, the decision maker has chosen a path open to it and yet it is subsequently shown not to be the best option. Judicial review is better suited to analysing prescriptive decisions, and assessing whether or not proper processes have been followed to ensure that the right matters have been taken into account, rather than determining whether or not the right decision has been reached.
265. Similarly, the remedies available through judicial review ordinarily require a decision to be re-made by the original decision maker and do not allow for rectification of errors through review. It is only an appeal (whether de novo or by merits review) which allows the merits of the decision to be considered and allows for a decision to be refined on review. Further, only an appeal process allows the review body to substitute its own decision for that of the original decision maker.
266. The possibility of a merits review will also act as an incentive for high quality decision making at the first instance, given the prospect that the decision-maker may be held to account for its decision. An independent review body may also be able to have the benefit of seeing things differently because it will not be as operationally close to the issues.
267. The provision of a merits review conducted by an independent body will enable precedent to develop which will assist in generating certainty, both for firms and for potential stakeholders.
268. In the absence of merits review, a number of firms have attempted to challenge decisions by judicial review, forcing it beyond its traditional parameters in an attempt to bring issues concerning a decision within the traditional grounds of review. These traditional grounds are not well suited to resolving the core issues in dispute.
269. Further, the judge who may be allocated to consider an application for judicial review may not necessarily have the appropriate expertise to consider the complex issues to be determined. There is a practical difficulty with the extent

to which the courts can call on expert evidence. (See the comments of Wild J in *Powerco Limited v Commerce Commission* (CIV 2005-485-1066, 9 June 2006.))

270. Transpower also observes that the Legislative Advisory Committee recommends that a right of appeal should be provided where decisions of bodies affect important rights and interests, unless the cost, delay, significance of the matter, need for finality or competence of the decision-maker are such as not to require it. Issues of cost, finality and the competence of the decision-maker at first instance cannot outweigh the benefit of encouraging good quality regulatory decisions through merits review under Part 4A and recognising the complexity and significance of the issues involved in these areas. In terms of any concern over delay, this risk is already present with the possibility of judicial review and Transpower considers that it is better to have the benefit of merits review, with the associated advantages described above, rather than compelling parties to rely on the judicial review process and possibly endeavouring to extend its scope inappropriately.

6.4. Limits on merits review

271. Transpower agrees with the Discussion Document that merits review should be by way of a rehearing. A rehearing will create an incentive for high quality decision making at the first instance and will enable precedent to develop. It should also assist with alleviating concerns around tactical delay and forum shopping, as the hearings will be shorter than with a de novo appeal and the parties will also need to ensure that their position is well prepared at the first instance. However, should a defect in information become apparent, or more up-to-date information be available which a review body should be aware of, this information could be put before the body, unlike an appeal merely on a question of law.
272. In terms of what merits review should cover, given the significance of the matters addressed through regulation, it should be wider than simply control decisions. Obviously much will depend on the outcome of the current review including the treatment of input methodologies and related matters, but potentially many other elements of regulatory decisions will affect the rights and interests of firms. This is particularly the case in New Zealand given the small number of firms operating in particular markets and Transpower could be uniquely affected by decisions outside of purely 'control decisions'.
273. Decisions about input methodologies, particularly if those decisions could then affect whether or not control would even be considered (perhaps in an equivalent manner to the current threshold scheme), could have a significant impact on the goals of economic efficiency and for the reasons stated above, would benefit from merits review. While Transpower acknowledges that guidance about input methodologies might be beneficial in providing certainty for businesses, if these were to amount to binding rules with ramifications for regulatory controls, merits review should be available. Otherwise there is a risk that judicial review will continue to be sought by parties concerned that the firm is exposed by waiting to seek a merits review later. Further, the benefit of merits review will be hampered if the review body cannot fully consider all matters, potentially restricting the remedies in a similar manner to those

encountered with judicial review. In any event, over time, merits review will provide greater certainty with the development of precedent.

274. While there is a risk that businesses might use a merits review as a stalling tactic, arguably the risk is already present with the availability of judicial review. By providing for merits review an appellant will be required to get to the core of its concern and put the relevant issues squarely in issue rather than traversing how its arguments fit within the judicial review framework. Ultimately, this will be more efficient and involve less delay than forcing aggrieved parties to seek to artificially frame and argue their concerns within the ambit of judicial review principles.
275. Depending on the constitution of the merits review authority, it is possible for the merits review to be addressed more swiftly than might otherwise occur with a judicial review application to the High Court.
276. In relation to the Discussion Document's suggestion that tactical delays could be addressed by ensuring that a merits review does not of itself prevent the regulator's decision coming into effect, Transpower notes that this may encourage applicants to use judicial review to seek interim orders to prevent this. Transpower suggests instead that there should be an opportunity for the merits review body to consider at a preliminary stage of the review proceedings whether the regulator's decision should come into effect.

6.5. Preferred composition of a merits review body

277. Transpower would prefer the merits review body to be a specialist body consisting of at least one judge (or equivalent legally trained person) with specialist experience in regulatory/competition law, an economist and a person with industry expertise. The body could be established as a specialist tribunal in its own right or as a specialist arm of the High Court (with the accompanying ability to appoint lay members).
278. Transpower proposes that a pool of people be established who could be called upon to sit on the review body, depending on the issues raised in each case. Given New Zealand's small size, overseas expertise in addition to New Zealand specialists could be used.

6.6. Application of merits reviews to EC decisions

279. If Transpower's proposal for regulatory change is adopted, merits review should be provided for in relation to the EC's (as well as the CC's) decisions. For the reasons set out above, Transpower considers that the consequences that might arise should the EC may make a wrong decision are potentially serious and must be subject to merits review. Merits review will encourage accountability and transparency, thereby encouraging better quality decisions in the first instance and will assist in achieving clear accountability for judgements and decisions around transmission investment.
280. Transpower also proposes that should the EC (or any other regulatory body) retain responsibility for determining grid reliability standards and grid investment approvals, that these determinations should be subject to merits review.

7. IMPLEMENTING CHANGES PROPOSED BY TRANSPOWER

7.1. Introduction

281. This section discusses how the changes proposed by Transpower could be implemented through legislative change and/or changes within the current rules.
282. Section 7.2 briefly discusses some possible incremental changes towards Transpower's preferred regulatory arrangements. Transpower notes, however, that it does not believe that incremental change will deliver the best outcomes.
283. Section 7.3 discusses how Transpower's preferred option of a conventional revenue cap regulatory regime could be implemented through new legislative provisions which would include a purpose statement relevant to the transmission industry.

7.2. Incremental change

284. Transpower does not believe that incremental changes to the regulatory regime applying to transmission will resolve the problems experienced by Transpower. Transpower's view is that:
- Fundamental change to the regime is required. Transpower proposes in section 7.3 how this might be achieved;
 - A timetable for implementing the proposed changes needs to be agreed;
 - Because fundamental change is likely to take some time to achieve, there will be benefits from making incremental changes to the regime in the interim.
285. The implementation of the thresholds in Transpower's administrative settlement proposal is one incremental change that would provide benefits compared with the existing arrangements. Over time, the thresholds could be adapted to move towards a more conventional overall revenue path.
286. Better coordination between the EC and the CC could be achieved by amending the MoU and Protocol to clarify their relative roles. In particular, the CC's role could be restricted to ensuring that Transpower conforms with the approvals given by the EC. Transpower understands that the EC and CC are considering steps in this direction.
287. The Part F Rules should be amended to define the role and functions of the EC more explicitly and remove those provisions which do not clearly align with the GPS and which intentionally or otherwise, have fostered an approach to approving particular grid investments which is more of a planning nature, than review and approval.

7.3. Revenue path regulation with single regulator

7.3.1. *Implementing a revenue path approach*

288. The introduction of Transpower's preferred approach of a more conventional revenue cap regulatory regime would require changes to the Commerce Act 1986 and the Electricity Act 1992. Transpower would be explicitly excluded from any generic thresholds or other economic regulatory regime and would be subject to an electricity transmission-specific regime. This specific regime for electricity transmission would be effected by way of new legislation, possibly in a Part 4B to the Commerce Act. The framework for the new regime could be substantially based on the National Electricity Law enacted by Australian states, as Transpower's preferred option mirrors many of the Australian regime's characteristics. The hierarchy of these laws and rules would be:

- Primary legislation (the equivalent of the National Electricity Law);
- A set of 'rules' initially promulgated by the Minister but to be reviewed and amended by the CC (the equivalent of the National Electricity Rules); and
- Guidelines published by the EC.

289. In brief, the new legislation would state:

- The objective of regulation (see discussion of a possible purpose statement below);
- The form of regulation which the EC and CC would implement and enforce as being a revenue cap model set for, say, five years;
- The CC's revised functions and powers relating to making, reviewing and amending rules, the scope of the rules and the procedure that must be followed;
- The EC's revised functions and powers to enforce the legislation and rules and its obligation to follow the rules (as needs be amending the Electricity Act 1992);
- Means of enforcement of rules, dispute resolution and any penalties and immunities for breaching obligations; and
- A limitation on the Minister's ability to direct the EC in its economic regulation role.

290. The first set of 'rules' relating to the economic regulation of transmission assets under the new statutory wording should be implemented as part of the establishment of the new regime. These rules would detail the procedure to be followed and the substantive issues to be addressed by the EC when considering Transpower's revenue cap, including a form of the 'propose and respond' model considered in the Discussion Document. The rules would also set strict deadlines for the EC to issue guidelines in relation to specified issues (because the current 'as soon as practicable' language in the Commerce Act

has not been a workable solution). These suggestions would be consistent with the Australian regime.

291. Transpower strongly recommends that the Minister's ability to give directions to the EC due to its status as a Crown agent be excluded with respect to its new role in economic regulation. As Transpower has set out above, international best practice is to minimise the possibility of political interventions in the application of regulatory rules in order to maximise certainty and therefore minimise investment risk for market participants.

7.3.2. Purpose statement

292. Transpower suggests the following purpose statement for the new Part 4B relating to the revenue cap regulation of Transpower:

The purpose of this Part is to provide for economic regulation to address inefficiencies in the electricity transmission market, where, and to the extent required, to do so would be for the long term benefit of consumers of New Zealand. Any regulation under this Part must seek to ensure that:

- (a) Transpower has incentives to innovate and to invest, including in replacement, upgraded and new assets and in related businesses; and
- (b) Transpower has incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) Without limiting paragraphs (a) and (b) above, Transpower:
 - (i) is limited in its ability to earn excessive profits; and
 - (ii) shares the benefits of efficiency gains with consumers, including through lower prices.

Goods or services may only be regulated if, and to the extent that economic regulation is necessary or desirable to:

- (a) Provide efficiencies in the transmission market; and
- (b) Provide long term benefits to consumers of New Zealand that substantially and clearly exceed the direct and indirect costs of regulation.

APPENDIX 1: DESIRABLE REGULATORY FEATURES

Introduction

This Appendix provides an overview of the key desirable features of a regulatory system. It begins by noting the characteristics which the Discussion Document considered important, before discussing Transpower's view.

Discussion Document's desirable regulatory characteristics

The Discussion Document states the following as being desirable features of a regulatory regime:

- Regulatory uncertainty is minimised and stability and predictability of regulatory outcomes are improved over time;
- Regulatory approaches are consistent and coherent across different firms/industries over time;
- Regulatory processes are transparent, cost effective and timely and also tailored to New Zealand's small scale in terms of resources and business size;
- The regulatory regime is sufficiently flexible to account for firm/industry specific circumstances, changing market conditions, innovation and experience; and
- There are appropriate levels of regulatory accountability and independence.

Transpower's view of desirable characteristics

Transpower broadly agrees with the Discussion Document's preferred characteristics for a regulatory regime. Transpower would, however, give a high weighting to regulatory certainty, given its large investment programme and sunk assets. It believes that in designing regulation, in the case of transmission, significant weighting should be given to the fact that the impact of regulation is asymmetric i.e. the economic costs of regulation that is too binding far outweigh the problems created where regulation is not sufficiently binding.

Transpower also believes the regulatory arrangements applying to Transpower should be tailored to Transpower's circumstances rather than necessarily being consistent with other industries. Transpower agrees with the suggested need for regulatory accountability and independence. It notes the problems that arise with the overlap in responsibilities between the EC and CC in relation to Transpower, which blur accountability. Transpower's views on key desirable regulatory features are discussed in more detail below.

Clear regulatory objectives

Good regulatory design requires the following:

- The regulatory problem should be clearly defined;

- The extent of regulation should be appropriate to the problem and no more than is required to address the problem, meaning that the benefits of regulation should exceed the costs;
- The regulatory design should aim to keep compliance costs to a minimum;
- The accountabilities of the regulators and those being regulated should be clear and unambiguous; and
- The regulatory process should be transparent and independently verifiable.

Transpower believes that the desirable regulatory characteristics could be endorsed in rules and/or prioritised to provide regulators and the regulated with greater guidance as to the focus of regulatory action.

Regulatory certainty versus flexibility

To minimise the compliance costs associated with regulating the transmission business, the regulatory requirements need to be established with a high degree of certainty. In Transpower's view, the major problem with both Part 4A of the Commerce Act and the Part F Rules is the degree of ambiguity and uncertainty that their drafting permits. This has been viewed favourably in some quarters as creating 'flexibility' but, in practice, the uncertainty and ambiguity of the regulatory requirements have led to a great deal of unproductive effort and unnecessary additional cost.

For example, problems have arisen with Transpower's grid investment proposals being considered under the Part F Rules. The ambiguity of some of the Part F Rules has led to requirements being modified as the process has progressed, which has again led to a poor use of staff resources by both Transpower and the regulator.

The establishment of more certain regulatory requirements should help to simplify the control and approval procedures and consequently minimise compliance costs. The clearer the regulatory requirements are made, the smaller should be the scope for misunderstanding and disputes, and, ideally, the greater the consistency of behaviour over time by all participants. Again, this should contribute considerably to minimising the costs of regulation.

The need to minimise regulatory uncertainty and thereby reduce compliance costs is typically considered desirable, but is often not addressed in a practical way. It is inevitable that regardless of how well regulatory rules are written, unforeseen issues or grey areas will arise that create uncertainty for businesses. This uncertainty could be reduced by establishing a process which allows for ex ante consideration of particular actions. For example, the Inland Revenue Department has a process whereby taxpayers can seek binding rulings on a particular tax treatment before committing to that treatment. This provides the tax payer with certainty ahead of any actions. This approach could possibly be extended to the regulatory treatment of electricity lines businesses.

Transparent processes

Regulatory processes should be transparent and independently verifiable in order to maintain the confidence of those subject to the regulation, and of the industry as a whole that is expected to benefit from the regulation. Decisions should be published and subject to public consultation. This should generally not conflict with commercial

confidentiality, as Transpower's business is already subject to extensive information disclosure.

The ability to appeal decisions to an independent authority is required to independently verify the reasoning applied to the decision-making process. This is consistent with the convention of including checks and balances in good governmental design. At the moment the CC sets the rules, implements the regulation, and decides actions in the case of breaches.

Sound regulatory institutions

Beyond transparency, sound regulatory design requires the accountability of institutions to be clearly defined. For example, if the EC is responsible for maintaining grid security, this should be clearly stated. Alternatively, if the responsibility for maintaining grid security rests with the EC and the CC jointly, or with Transpower, this should be clearly stated, along with details of who is responsible for which aspects. If Transpower is responsible for grid planning and the EC for auditing grid plans, that should be made clear.

Once institutional accountabilities have been clearly defined, the institutions concerned should be given the resources that they reasonably require to achieve those accountabilities and a degree of autonomy from political interference in order to achieve them.

Experience has shown that it is best to have an arm's length relationship between central government and regulators, as the retention of the ability of governments to direct the regulators can result in short-term political considerations impeding the achievement of longer term regulatory objectives.

Regulatory intervention appropriate to problem

Regulatory oversight needs to be in proportion to the potential harm that might be caused to transmission customers and final consumers. Focussing a large amount of regulatory effort on costs that form a small part of Transpower's budget may be inappropriate, not just in terms of the direct cost of regulation, but also in terms of the possible creation of perverse incentives for Transpower to under-resource some aspects of its business.

Other

While consistency and coherence across different industries may appear desirable, the need for specialised industry knowledge, and for regulation adapted to different risks in different sectors, argues for it to be tailored, and for the regulator to have specialist knowledge.

Transpower notes also that it is important to avoid uncompensated asymmetric risk, in which businesses face downside risk with no potential upside, because it may discourage investment.

An example of asymmetric risk is the ongoing use of ODV as the regulatory asset valuation methodology. The use of optimisation only carries downside risk for the

companies. Under ODV, replacement costs are based on 'a significant scale of construction... and an efficient new entrant that is not constrained by past practices...'.²⁰ In practice, however, most investment is small scale replacement of existing equipment in an existing environment. Typically these small scale investments cost more than the allowable building block replacement costs and as a result, if returns are constrained by the application of ODV, a disincentive for investment is created.

Transpower also considers that the importance of cash flows to business operations should be recognised. Cash flows are critical to the ongoing survival of businesses and are of particular importance for businesses that need to spend significant amounts on capital expenditure.

An example where the current regulatory regime potentially creates cash flow problems is the treatment of replacement cost gains within the regulatory asset base. The preferred treatment is to treat replacement cost gains as income in the year that they occur. In effect, businesses are supposed to deduct from customer charges the increase in replacement costs in the knowledge that customers can be charged more in later years. This approach swaps cash now for cash later, which penalises businesses that require the cash now.

²⁰ Commerce Commission, *Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses*, 30 August 2004, p 25.

APPENDIX 2: RESPONSE TO MED QUESTIONS

Introduction

This appendix provides Transpower's responses to the questions raised in the Discussion Document.

Chapter 1

1. Do you have any comments on the desirable characteristics of a regulatory regime as outlined in this Chapter?

Transpower agrees with the desirable characteristics of a regulatory regime noted in the Discussion Document. Transpower's views on the desirable characteristics are discussed in detail in Appendix 1. As noted in Appendix 1, Transpower places a high weighting on regulatory certainty, given its experience of the high compliance costs associated with regulatory ambiguity. Transpower also believes that the special characteristics of electricity transmission, which include the particular importance of security of supply, the common good nature of electricity transmission and the countervailing market power that Transpower's customers have in relation to Transpower, argue for regulation specifically tailored to electricity transmission.

Transpower considers that the desirable characteristics of regulation should possibly be given greater prominence in the regulatory scheme.

While the CC is required to give effect to the Purpose Statement, no weight is required to be placed on the desirable characteristics of regulation, yet regulatory failure may occur because the regulator acts in a way that is inconsistent with these characteristics. This problem might be addressed by requiring the inclusion of desirable regulatory characteristics in rules and regulation.

As the Discussion Document notes, there is potential inconsistency between the various desirable regulatory characteristics and between those characteristics and the regulatory purpose. Weighting or prioritising the desirable characteristics/purpose could help resolve this problem.

The Discussion Document notes it has 'attempted to assess proposed amendments to the regulatory provisions against the above characteristics'.²¹ Transpower applauds this attempt, but notes that the analysis has not been explicit, which makes it difficult to assess the extent to which the proposals would give effect to the desirable regulatory characteristics.

Chapter 3: Potential issues with the current regime

1. Does the above list capture the main issues with the current regulatory regime?

Yes (in relation to Part 4 and Part 4A).

²¹ MED, Discussion Document, April 2007, p 13.

2. *Are these issues adequately identified and described?*

Yes.

3. *Are there any other issues with the current regime that are not listed above and should be considered as part of this review?*

Transpower notes it also has concerns with the regulatory constraints applying under the Electricity Act and the overlapping jurisdiction of the EC and the CC (see sections 2 and 5).

The Discussion Document has focussed on the regulatory regime. However, consideration should also be given to examining the behaviour of the regulators when implementing regulatory requirements. The way in which regulatory arrangements are implemented can be as important as the design of those arrangements. The adoption of merits reviews should help to address this concern.

Chapter 4: Objectives of economic regulation

1. *Do you agree that a regulatory regime needs to be available to address issues in markets with monopoly characteristics?*

Yes. It is common practice for monopoly businesses such as electricity lines businesses to face some form of regulation. Better specification of how these businesses should be regulated would improve certainty.

As noted in Section 2, market power concerns are not the primary reason for regulating Transpower. Transpower considers that it should be regulated for the following reasons:

- To enable Transpower to establish legal relationships with its customers;
- To enable Transpower to obtain payment for its services and secure its revenue;
- To enable investment in and payment for interconnected assets, which have the characteristics of 'public' or 'club' goods;
- To test the efficiency of Transpower's investment and operating activities; and
- To ensure that Transpower is able to earn a commercial return on its assets.

2. *Do you consider that the sole or primary objective of a regulatory regime should be economic efficiency or consumer protection (distribution), or do you consider that both should be taken into account?*

Transpower believes that the primary objective of regulation should be to ensure economic efficiency, with consumer welfare treated as a secondary objective. An efficiency objective is particularly relevant to Transpower. A regulatory regime for electricity transmission is required to enable Transpower to establish legal relationships with all of its customers and to secure a return on its investment in the interconnected grid. Without security of revenue, under-investment may result. This is an efficiency concern. Further, Transpower recognises that the regulatory regime provides it with

some degree of revenue certainty and it would therefore also be appropriate to test the efficiency of its investment and operating activities.

Chapter 5: Purpose statement

1. In your opinion, is a regulatory-specific purpose statement desirable?

Yes. A purpose statement would provide important guidance for the rule setters. The overall purpose statement for the Commerce Act is not relevant for markets where competition is unlikely to emerge.

2. If so, do you agree with the proposed regulatory-specific purpose statement, or do you prefer an alternative formulation? If so, please suggest specific wording.

Transpower discusses a possible purpose statement for regulation of transmission in section 7 of its submission.

Chapter 6: The decision on whether to impose regulation

1. Do you agree with the proposed criteria for deciding on whether regulation may be imposed?

As discussed in the body of this submission, Transpower believes that some form of regulation is required to enable the electricity transmission business to function effectively. Consequently, Transpower has focussed on the preferred form of that regulation.

2. If you agree that one of the tests for whether control may be imposed should be where the long term benefits to acquirers exceed direct and indirect costs, do you consider that such benefits should (a) 'substantially' or (b) 'clearly' exceed costs, or should there be some other guidance on weighting?

Transpower notes that 'substantially' could relate to the amount by which benefits are to exceed costs and 'clearly' could relate to the certainty to which benefits are to exceed costs so that both terms could be relevant.

As noted above, Transpower would prefer economic efficiency to be the predominant test of whether regulation is required. If the test is based on the net benefits to acquirers, then, given the uncertainty associated with cost benefit analysis, the benefits should 'substantially' exceed the costs, to allow a significant margin for possible error.

Providing guidance in advance is desirable as this provides businesses with some degree of certainty that would otherwise not exist.

3. If you agree that one of the tests for whether control may be imposed should be where the long term benefits to acquirers exceed direct and indirect costs, should those benefits be considered regardless of whether acquirers acquire the goods and services directly or indirectly, or should it be necessary to establish that benefits will be passed on to end users (or consumers or end-acquirers)?

Transpower would prefer the test to be predominantly based on economic efficiency considerations. Determining whether different income distributions improve welfare is problematic, and one reason why Transpower prefers a standard based predominantly on economic efficiency.

4. *Should the current provisions in the Act allowing control to be imposed in the interests of suppliers (to a monopsonist) be retained?*

Yes.

5. *Do you agree that there should not be a legislative test for when regulation should be imposed?*

In some cases, such as for electricity transmission, specifying the need for regulation in legislation may promote business certainty, reduce compliance costs and help enable the business to operate effectively. Retaining 'flexibility' where regulation is required to enable the business to operate effectively simply increases uncertainty, adds to compliance costs and makes it difficult for the business to invest.

6. *Do you agree that the Minister should remain the decision-maker on whether control should be imposed under Part 4, but that the Minister must receive a report and recommendation from the Commerce Commission before making a decision?*

Yes, for industries and situations where the justification for regulation is not clear. Transpower considers that for its own regulation, the legislation should specify how regulation will apply.

7. *Do you agree that the decisions on whether and, if so, how to regulate should be undertaken simultaneously rather than sequentially?*

Yes. Transpower supports allowing the CC to consider the form of control when it is considering whether to impose control. This would simplify the CC's analysis, allow it to specify more clearly the key assumptions of its analysis and provide greater certainty to businesses that there will be consistency between the decision to impose control and the form of control itself.

Chapter 7: Types of economic regulation

1. *Do you agree that it is desirable to widen the scope of the Commerce Act by providing for regulatory options other than control, specifically:*

- *negotiation/arbitration; and*
- *price monitoring/information disclosure?*

Yes, more flexibility is generally a good thing. Transpower believes that regulation should, to the extent possible, be appropriately tailored to the magnitude of any problem that it seeks to address. Allowing more regulatory options should achieve this.

Whilst increasing options increases flexibility, it should not be at the expense of certainty.

However, the limitations of these approaches should be recognised. For example, Transpower found that negotiation was unsuccessful in enabling investment in the interconnected grid, given its 'public' or 'club' good characteristics.

2. *Do you consider that specific, easier tests should be provided to determine whether lighter-handed types of regulation, such as information disclosure, may be imposed, such as:*

- *meeting the competition criteria only; or*
- *requiring qualitative (rather than quantitative) cost-benefit analysis?*

Transpower notes that 'light-handed' regulation can still impose significant costs on businesses, so it remains important to ensure that analysis leading to such regulation is robust.

Chapter 8: Key input decisions

1. Do you see value in having key input decisions set as a stand-alone process in advance of an inquiry and recommendation to regulate? If so, should they be set for a specific sector once an inquiry has been initiated, or set generically irrespective of whether or not an inquiry has been initiated?

Transpower agrees with the proposal that input methodologies should be set in advance of any inquiry and concurs with the advantages noted in the Discussion Document. Transpower agrees with the Discussion Document that the CC's ability under the current arrangements to make methodological decisions 'as it goes' has caused significant uncertainty.

Transpower believes that the key advantage of setting input methodologies in advance is improved decision making and greater certainty.

Ideally input methodologies should be set generically regardless of whether an inquiry has been initiated or not.

Transpower also agrees with the Discussion Document's suggestion that if the CC is responsible for setting the input methodologies, its decisions should be subject to merits review.

Transpower notes that its preferred regulatory structure would have a separate regulatory body setting the rules, including the input methodologies.

2. Is it practical, or possible, to set generic methodologies that could apply to all potentially regulated sectors?

Transpower believes that it is both practical and possible to set generic methodologies for the inputs listed in paragraph 131 of the Discussion Document. The principles underpinning natural monopoly regulation are largely common. It will be important to ensure the methodologies are able to handle variations within the natural monopolies being regulated, and to ensure some flexibility for special circumstances. For example, issues to consider that may affect a methodology include the size and nature of the customer base, position in the capital expenditure life cycle and ownership.

3. Do you consider that input methodologies should be set:

- *as guidelines by the Commerce Commission;*
- *as Rules by the Minister following a recommendation from the Commission; or*
- *another option (please specify)?*

Transpower would prefer a separate independent body to set the input methodologies. Decisions by such a body should be subject to merits review.

In Transpower's view there are significant advantages to having a separate rule maker including, transparency and quality decision making (as noted in the Discussion Document). Transpower's views are discussed in more detail in section 5 of the submission.

Chapter 9: Regulatory control design issues

1. Should specific provision be made (e.g. in Part 5) to allow the Commerce Commission to use comparative benchmarking as a methodology for setting control terms?

Transpower opposes the use of comparative benchmarking, at least in relation to electricity transmission, and notes that it is problematic for other industries as well. Benchmarking is not appropriate for setting control and it is debatable for thresholds. Benchmarking requires robust normalisation for different operating circumstances such as customer density, network geography and climate. It is very difficult to do this in a robust manner.

2. Should specific provision be made to allow the Minister to request the Commission to consider whether economic regulation may be imposed on a sector as a whole (rather than each individual firm within a sector) and if so, should provision be made for cost benefit analysis on this matter to be undertaken in qualitative (rather than quantitative) terms?

In Transpower's view, electricity transmission should be subject to separate regulation based on a full analysis of the relevant regulatory problems. This could be undertaken without any need for the Minister to refer the issue to the CC.

In general, however, it would be reasonable for the legislation to allow for regulation to be imposed on a sector as a whole (rather than individual firms within a sector) and for the Minister to request the CC's assistance when making such a decision. Imposing sector regulation is common practice overseas and in many circumstances it is appropriate. However, it is important to ensure that the regulatory regime is flexible enough to target those companies that are most in need of regulation and that the regulation imposed is itself appropriate.

Whether or not sector regulation is imposed is a significant issue for any regulator to consider. In Transpower's view, the importance of the issue requires robust analysis which means that unless there are very good reasons not to do so, quantitative analysis should form the basis of any decision.

3. Is there value in allowing firms to propose their own control terms for the Commission's consideration ('propose/respond' model)?

Transpower believes that allowing businesses to propose their own control terms is a positive step forward. Transpower has proposed significant change to the regulatory regime for electricity transmission, at the heart of which is the conventional regime found in Australia and the UK. A core component of those regimes is a propose/respond model. Further details are outlined in section 4 of Transpower's submission.

4. If firms are able to propose their own control terms, should the Commission be required to accept proposals that meet pre-set criteria? Do you have any comment on the proposed 'reasonableness criteria'?

Transpower agrees with the Discussion Document's proposal and believes that the CC should be required to accept proposals that meet pre-set criteria. This would provide much needed certainty to the regulatory regime.

5. If firms have the ability to propose their own control terms, should this proposal take place before or after declaration of control by the Minister (note that in section 9.3 the paper proposes different sequences for control of individual firms compared to sector control)?

Transpower believes that businesses should be able to choose whether they propose control terms or whether they follow threshold regulation and if they accept threshold regulation, only move to control upon an inappropriate breach of the thresholds.

Chapter 10: Possible packages of 'how to regulate'

1. With regard to the Part 4A thresholds regime do you favour:

- retaining the threshold regime and making it more generic (that is, applicable to sectors other than electricity lines businesses), or*
- repealing Part 4A and amending Part 5 to allow the Commerce Commission to use comparative benchmarking to set terms and conditions for control while allowing firms to seek customised control terms.*

Transpower does not support either proposed approach. Both approaches appear to advocate benchmarking as a central tool and as discussed earlier, Transpower has strong misgivings about the appropriateness and usefulness of benchmarking.

Transpower also believes that the thresholds approach is not appropriate for Transpower. Transpower's views are discussed in more detail in section 2 of its submission.

2. In your opinion, are there other options for addressing the issues with the Part 4A thresholds regime?

Transpower's preferred regulatory regime for the transmission industry is discussed in sections 3 and 4 of its submission. Its preferred regulatory structure is considered in section 5.

3. Are small businesses within a sector likely to be disproportionately affected by the requirements of the regulatory regimes proposed in this document? What are the likely incremental costs of complying with the current Part 4A and proposed alternative regimes? How could these costs be minimised?

Ensuring that small businesses are not given an unnecessarily heavy regulatory burden should be a key aim of the regulatory regime.

4. Should local community owned trusts be subject to a different regulatory regime than larger non-trust electricity lines businesses?

Yes. These businesses should not be subject to threshold or control based regulation. As the Discussion Document notes, regulation is unlikely to have a positive net benefit even if transfers between producers and consumers are taken into account as community owned trusts have common customers and owners.

Chapter 11: Processes for amending and enforcing control terms

1. Do you agree that control terms should not be re-opened within a specified control period, other than under exceptional circumstances? If so, do you agree with the exceptional circumstances suggested in this Chapter?

Transpower agrees that the opportunity to reopen control terms should be limited. However, as discussed in section 4, under the conventional regulatory approach as implemented in Australia, a number of circumstances may justify reopening. These include:

- Easements tax change event;
- Insurance event;
- Regulatory change event;
- Service standard event;
- Tax change event; and
- Terrorism event.

2. Are the current provisions relating to penalties in the Act for breaches of control terms (s70C) satisfactory or should additional guidance be provided?

At the moment the CC is rule setter, prosecutor and judge and there is no appeals process. These functions should be separated as discussed in more detail in the body of this submission.

Chapter 12: Accountability mechanisms

1. Do you consider that it is desirable to provide for merits review of regulatory decisions or does judicial review provide sufficient constraints on regulatory decisions?

Transpower supports merits reviews of both the CC's and the EC's decisions. This is discussed in section 6 of Transpower's submission.

2. Do you agree with the document's conclusions that, if merits review is provided for, it should only apply to control decisions made by the Commission and be limited to the form of 'appeals by way of re-hearing' where new evidence can be introduced only if it is fresh and material and it could not have been submitted at the original decision-making stage?

Transpower agrees that a merits review should be by way of a rehearing. Transpower believes that merits review should be wider than just control decisions. Input methodologies should be reviewable if they amount to binding rules.

3. What is your preferred composition of any merits review body, taking into account New Zealand's small size and limited resources?

Transpower would prefer a specialist body consisting of at least one judge (or equivalent legally trained person) with specialist experience in regulatory/competition law, an economist, and a person with industry expertise. The body could be established as a specialist tribunal or as an arm of the High Court.