

Submission to: Ministry for Economic Development

Submission on: Review of Commerce Act 1986, Part 4, Part 4A and Part 5
Relating to Regulatory Control Provisions

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1. **Review of the Commerce Act 1986 - Terms of Reference**

Waitaki Power Trust **supports** the decision by the Ministers of Commerce and Energy to review the regulatory control provisions under the Commerce Act 1986.

However, Waitaki Power Trust considers that if the review is to provide robust information to the Ministers then the objectives or terms of reference for the review will need to be comprehensive and the review process, sound.

Objectives of the review include:

- To ensure that regulatory control is consistent with providing for the long-term benefit of consumers within New Zealand.
- To consider whether amendments to the Act are necessary to reinforce Government's objectives concerning infrastructure investment.
- To recommend expanding the scope of regulatory provisions.
- To see feedback from affected businesses on characteristics which MED considers to be desirable features of a regulatory regime (see Discussion Document (DD), 2007, p. 8-13.)
- To promote improvements in the quality of regulations that shape the business environment in order to minimise the compliance burden and provide as much certainty and flexibility as possible (DD, 2007, p. 14).

Waitaki Power Trust contends there is a glaring omission from the objectives of the review identified above.

Nowhere in the Discussion Document is it acknowledged that there may be circumstances where **exempting** a business or businesses from regulation could better provide for the long-term benefit of consumers compared with requiring the business to comply with regulatory provisions.

The same shortsighted approach has shaped the discussion relating to options for change. Various proposals for change are put forward and evaluated by Ministry for Economic Development officers, but no attempt has been made to identify criteria which, if met would exempt businesses from compliance with the regulatory provisions of the Commerce Act 1986.

Waitaki Power Trust contends that the robustness of the review process will be compromised unless viable options for change are identified and open for discussion. These range along a continuum from strengthening the status quo to proposing criteria for exemption from regulation.

The latter alternative is obliquely referred to in a summary of current regulatory provisions.

*The Commerce Act provides for regulatory control under Part 4 and a thresholds regime for electricity lines businesses under Part 4A. Implementation powers for control are provided under Part 5..... there are no powers in the Act to implement other lighter-handed forms of regulation. Thus, if an alternative regulation was found to offer net benefits compared to control (**or no regulation**), implementation powers would need to be provided for through legislative amendment” (DD, 2007, p. 39, Waitaki Power Trust emphasis.)*

Likewise, it follows that if exemption from regulation was found to offer stronger net benefits to consumers than regulatory compliance, then power to implement that option would need to be provided for through legislative amendment.

Such a proviso clearly shows that exemption from regulatory compliance is a legitimate option for change.

Issues relating to this conclusion will be identified and discussed in Sections 5, 6 and 7 below.

2. Philosophical Basis of the Commerce Act 1986 – Fallacies and Phobias

The Commerce Act 1986 enshrines in legislation the key tenets of free market economic theory. The purpose statement of the Act states:

*The purpose of this Act is to **promote competition** in markets for the long-term benefit of consumers within New Zealand (DD 2007, p. 21 fn 5, Waitaki Power Trust emphasis.)*

In simple terms, the fundamental assumptions on which the Act is based include:

- a. That a ‘free’ or ‘unregulated’ market will produce the strongest net outcomes and ensure long-term economic benefit for New Zealand consumers.
- b. That competition is the most potent and effective tool for influencing the economic behaviour of businesses in the market place with respect to price and quality of goods and services.

But markets, which are serviced by well-justified ‘natural monopoly’ businesses, do not fit the ‘free’ market paradigm. Hence, ‘natural monopolies’, for instance, electricity distribution companies that provide an essential service, operate in a market where the basic dynamic of competition is absent.

Since 1986, a succession of governments have bought into the phobic argument that in the absence of competition

A natural monopolist will have the incentive and scope to raise price and restrict the quantity and/or quality of the good or service offered... This is especially true in the case of ‘essential services’ such as electricity, where

electricity lines businesses have strong natural monopoly characteristics.
(DD, 2007, p. 21).

Accordingly, in 2001 the Commerce Act 1986 was substantially amended to include generic economic control provisions, and further, provisions which allow the Commerce Commission to place electricity lines distribution businesses under regulatory control if they breach price or quality thresholds set at 5 yearly intervals by the Commission.

The belief is that

economic regulation, if implemented, would 'mimic' in a market with little or no competition, the outcomes that would occur in a market with workable competition (see DD, 2007, p. 21).

Waitaki Power Trust rejects as fallacious the assumptions on which the 2001 amendments to the Commerce Act 1986 were based.

First, it was assumed that competition is the **only** tool that can influence the behaviour of businesses in the market place with respect to price, quantity and quality of goods and services. Hence, in the absence of competition the **sole** option is to provide for economic regulation (see DD, 2007 pp 22-23).

The second assumption is that regulating for price control in order to prevent natural monopolies, in this case electricity distribution network companies, from generating excessive profit would provide for the long-term benefit of consumers within New Zealand.

The second assumption is neither true *a priori* nor from experience.

Waitaki Power Trust is confident that the Minister of Energy, in particular, is well aware that regulating for the level of price increase which electricity distribution line companies can charge has created the situation where a number of line companies now do not have the financial capacity to undertake essential replacement and upgrade work. This outcome clearly does not provide for the long-term benefits of consumers.

In adopting the first assumption government has failed to perceive that the free market principle of competition and its proxy, economic regulation, are not the only 'tools' which are capable of influencing price setting and quality of service by natural monopolies which provide essential goods and services.

This point too, will be elaborated in later discussion.

3. Sector Approach to Economic Regulation

Issues relating to the design of regulatory control parameters are canvassed in MED's Discussion Document, 'Review of Regulatory Control Provisions under the Commerce Act 1986'. Chapter 9.2 considers the pros and cons of sector regulation versus regulating for individual firms within a sector (DD, 2007, p. 50.)

Waitaki Power Trust **accepts** that there is a need to clarify whether the Act empowers the Commerce Commission to

*Recommend that a sector (with natural monopoly characteristics) be placed under economic regulating **without needing to establish that regulation is justified for each and every firm individually** in the sector (DD, 2007, p. 50).*

But, the Trust **strongly rejects** MED's *modus operandi* of first

assum(ing) that it is possible to regulate a sector and not just individual firms within a sector (ibid, p. 50)

and then proceeding to identify subsequent regulatory issues at sector level alone.

Waitaki Power Trust further contends that there are cogent reasons as to why a broad-brush sector wide approach won't do.

A sector wide basis for economic regulation:

- Fails to recognise that not all electricity lines businesses would be incentivised by the absence of competition to charge excessive prices and/or cut back on quality of supply and that there are sound reasons why this is the case.
- Violates the basic social concepts of fairness and fair play since regardless of differences in financial practices all lines distribution businesses are regarded as being the same.
- Incurs direct financial costs to all electricity lines companies due to the need to devote resources to administering and complying with regulation.
- Forces all electricity lines distribution businesses into the same unsustainable position with respect to replacement and upgrade work regardless of whether company financial practice and service levels would differ significantly under the current economic regulations compared with exemption from regulation, an outcome that is detrimental in every way to the long-term interests of consumers, and
- Requires directors on the Board of some electricity lines businesses to make decisions, which can meet two sets of requirements.

On the one hand are the regulatory control provisions of the Commerce Act 1986 and on the other, are annual profit and service levels **plus** a programme of maintenance, replacement and upgrade work signed off on following negotiations between directors and consumer representatives, that is, a Trustee/Shareholder Board.

Waitaki Power Trust considers that the **disadvantages** of a sector wide approach to economic regulation significantly outweigh purported gains associated with that approach (see *ibid*, p. 50).

Recommendation

Trustees recommend that for lines companies as natural monopoly businesses a **company (firm) specific approach is adopted with the objective of:**

- a. recognising differences in financial practices between electricity lines businesses captured by Part 4A of the Commerce Act 1986, and
- b. establishing whether full, lighter-handed or exemption from regulatory options, apply for each company.

A customised approach would introduce the flexibility necessary to establish **company specific** economic regulation criteria and control processes and also allow for flexibility with respect to compliance levels required of businesses operating under different circumstances within a sector.

4. Regulatory-Specific Purpose Statement

Waitaki Power Trust **supports** the proposal that Part 4 of the Commerce Act 1986 be amended to include a regulatory-specific purpose statement.

Trustees consider this type of amendment is particularly important.

A clear statement of the purpose for including in Part 4 generic provisions for economic regulation across the current range of natural monopolistic sectors would, *ipso facto*, serve two important functions.

A regulatory-specific purpose statement would not only provide guidance on interpretation and application of the provisions within Part 4, Part 4A and Part 5 of the Act, but also it could act as a bridging principle to normalise the inclusion of regulatory control provisions within an Act, the over-arching purpose of which is to promote **competition** in the market place for the long term **benefit** of New Zealand consumers.

Waitaki Power Trust agrees that a regulatory-specific purpose statement needs to include reference to both economic efficiency and consumer protection.

If economic efficiency and consumer protection are construed respectively in terms of 'net public benefit' and 'net acquirer's benefit) then, the added advantage is that the purpose of regulatory control provisions would align with the over-arching purpose statement of the Commerce Act 1986. Such an outcome would resolve the current tension within the Act, which arises because the whole concept of regulatory control does not sit comfortably with other provisions designed solely to promote competition in the market place.

Waitaki Power Trust therefore **strongly supports in principle** the regulatory-specific statement which is proposed in the Discussion Document, on the assumption that it would precede clauses in Part 4 of the Act and state:

The purpose of this Part is, in markets where there is little or no competition or prospect of competition, to provide for economic regulation for the long-term benefit of consumers of New Zealand. Any regulation under this Part should seek to ensure that suppliers:

- a. are limited in their ability to earn excessive profits;*
- b. have incentives to improve efficiency and provide services at a quality that reflects consumer demands;*
- c. share the benefits of efficiency gains with consumers, including through lower prices; and*
- d. have incentives to innovate and to invest, including in replacement, upgraded and new assets and in related businesses.*

Waitaki Power Trust considers that a regulatory-specific purpose statement along the above lines will be effective with respect to:

- clarifying the intent of Part 4, Part 4A and Part 5 provisions of the Commerce Act 1986;
- removing uncertainty as to when **and** how economic regulation is to be imposed; and
- incentivise businesses within a natural monopoly sector to maintain, replace and upgrade infra-structural assets, which provide and/or supply essential goods or services.

Waitaki Power Trust considers that over time sub-part (d), if implemented in a reasonable manner, would enable monopoly suppliers of essential services, electricity lines companies, in particular, to address ‘quality’ and ‘quantity’ issues which are directly due to current regulatory control of lines companies price path/revenue stream threshold caps.

5. Protecting Consumer Interest: Economic Regulation versus Consumer-driven ‘Tools’

Must it be assumed that in the absence of competition and its proxy, economic regulation, natural monopoly providers of essential goods and services will invariably act in the manner predicted by ‘free’ market economic theory? That is to say, will all natural monopolies, especially those providing essential goods and/or services

- seek inflated prices;
- restrict the quality and/or quantity of goods or services provided;

- endeavour to generate excessive profit to be either retained, or returned to shareholders as a windfall on their investment, at the expense of maintaining and up grading the infrastructure that provides the goods and/or services?

Waitaki Power Trust concedes that the above scenario can be true of some businesses in certain situations. But Trustees are **adamant** that economic theory predictions relating to the behaviour of unregulated natural monopolies **do not apply** across the board. There **are** exceptions and these need to be accommodated by the Commerce Act 1986.

The first step in that direction can be put in terms of a question:

- are the four objectives of the proposed regulatory-specific purpose statement able to be achieved **if and only if** monopolist suppliers of essential goods and/or services are legally required to comply with government legislation? or,
- are there alternative, **non-regulatory ‘tools’** available, which can function *inter alia*, to achieve the same objectives?

The crux of the matter is whether there is less need to regulate some natural monopolist suppliers than others. The issue is obliquely referred to in MED Discussion Document, Chapter 10. But, for reasons that are unclear, the Ministry has chosen to consider only one example – small Community Trust owned businesses (DD, 2007, p. 62).

Waitaki Power Trust contends the Ministry has advanced a straw-man argument. None of the issues raised in opposition to exempting Community Trust owned businesses from regulation apply in the case of **100% Consumer Owned Trusts**.

Waitaki Power Trust is confident that the non-regulatory tools available for influencing and modifying the economic behaviour of a number of Consumer Trust owned electricity lines businesses can, and currently do act, as far as is possible under regulatory control, not only to achieve the regulatory-specific objectives set out above, but also to protect and enhance consumer well-being in the wider sense.

6. Consumer Trust Owned Lines Businesses, Non-regulatory Tools and Regulatory-specific Objectives

The question of whether 100% Consumer Trust owned line businesses need to be regulated has recently been considered and commented on in various forums.

For example, almost eighteen months ago during a presentation to those attending an Energy Trusts of New Zealand conference the Minister of Energy, the Honourable David Parker, mentioned in passing that he was not convinced that Consumer Trust owned lines companies need to be regulated. A number of Trustees listening to his address held similar views. More recently, the former head of Britain’s electricity regulatory body, Professor Littlechild also questioned whether it is necessary to regulate Consumer Trust owned lines companies at a Vector policy forum. Significantly, Professor Littlechild was echoing similar thoughts raised by Richard Meade from New Zealand’s Institute for the Study of Competition and Regulation.

There is no doubt that consumers have a significant influence albeit indirectly on the economic behaviour of Consumer Trust owned businesses with respect to price/revenue and the service levels they require. Consumers elect Trustees who wear two hats. Consumer Power Trusts were established to hold the shares in electricity lines companies on behalf of the consumer-owners.

Wearing their shareholder hat, Trustees are empowered by the Energy Companies Act 1992 to require directors of the company to provide them with a copy of the company's draft Statement of Corporate Intent not later than 1 month after the commencement of each financial year of the energy company. Trustee/Shareholders are then required by law to approve the company's Statement of Corporate Intent. In similar vein, at the end of each financial year, Trustees as Shareholders, monitor and assess the performance of the directors of the company by comparing the company's annual report with the company's Statement of Corporate Intent for that year. And, at the Annual General Meeting of the Company, Trustees can and do exercise shareholder rights on behalf of the consumer owners, to ensure that directors of the company have a clear understanding of consumer needs and requirements.

Given the robust system of checks and balances in place with respect to 100% Consumer Trust owned lines businesses, it should come as no surprise that the objectives of consumers, Trustee/Shareholders, company directors and management echo the objectives of the proposed regulatory-specific purpose statement to be included in the Commerce Act.

Acting on behalf of the consumer-owners Trustees as Shareholders seek to ensure that the company

- a. is limited in its ability to charge excessive prices and earn excessive profits;
- b. improves efficiency by minimising costs, extending and providing quality services that reflect consumer demand;
- c. shares the benefits of efficiency gains with consumers through lower prices **and** returning to Consumers in their capacity as owners, the benefits of ownership of the shares in the Company;
- d. protects the financial investment the consumer-owners have in the company, by investing in maintenance, replacement, upgrading and network development to meet consumer demand; and
- e. has incentives to innovate and invest in related businesses.

It is noteworthy that while (a) and (c) are natural consequences of 100% Consumer Trust owned lines company businesses, the current regulatory regime which **all** lines businesses must comply with acts as a barrier to full achievement of (b), (d) and (e). No matter how sensible or reasonable shareholder recommendations and company decisions may be the risk of breaching the price path threshold set for the company by the Commerce Commission is always present and takes priority when investment decisions are made.

Waitaki Power Trust contends that the work of Trustees as shareholders, focussed as it is on achieving and protecting consumer well being and the long long-term interests of consumers replicates to a large extent, the current role of the Commerce Commission.

But there are a number of extremely important differences.

- a. The Commerce Commission's role is a top-down approach – the Commission monitors compliance with price path and quality thresholds the Commission has set. Shareholders of Consumer Trust owned lines businesses also exercise a watchdog role with respect to price and service levels. But theirs is a bottom-up approach – acting directly on the basis of consumer requirements and needs.
- b. Commerce Commission decisions generally are subject only to judicial review through the High Court. Trustee/Shareholders as elected consumer representatives are fully held to account through the Trustee election process.
- c. Accountability only at judicial review level does not allow a lines company to question substantial issues and the Commission's rationale behind the decision itself. To that extent, Commerce Commission decisions are seen as arbitrary. Recommendations by Trustee/Shareholders are put forward for discussion and/or negotiation between Trustees/Shareholders and Directors. The actual level of company revenue or profit to be returned each year to consumer-owners for example is generally decided as the result of 'constructive engagement', a process which is far from arbitrary;
- d. Trustee/Shareholders as on the ground consumer representatives, are far better placed than the nationally based Commerce Commission with its focus on compliance issues, to exercise a degree of flexibility in exercising a watchdog role when circumstances require it. An extreme weather event, last winter's snowfall, highlights the effect of inflexibility and the role that regulating price/revenue caps has on electricity lines business decisions.

The snowfall forced several South Island electricity lines companies to significantly revise budgets and planned work programmes. The threshold regimes effectively limited the work that could be done. In this situation decisions based primarily on compliance issues served no gainful purpose. Furthermore, revising planned work programmes to accommodate compliance requirements can act to reduce economic and productive efficiency, neither of which advance the best long-term interest of consumers.

It is clear that the business and planning environment in which electricity lines companies operate can change for a number of legitimate reasons. Being constrained by a control regime to the degree of inflexibility as currently exists because of economic regulation, is not in the long-term interest of any consumers.

The situation is even more critical when consumers have 100% ownership of the electricity line company business. The flow on effects of economic regulation and inflexibility on economic and productive efficiency act to undermine the long-term viability of a business which consumers own.

The problem in a nutshell, is that in a number of cases and more especially 100% Consumer Trust owned electricity lines businesses, economic regulation and its elaboration in terms of threshold regimes in Part 4A of the Act are **not** consistent with, and in practice, actually work against providing for the long-term benefit of consumer-owners. The need to comply with a set of rules, and the threat of investigation and penalty if they are breached, unnecessarily constrains and frustrates decision makers whose primary objective **is** to act in the best long-term interests of the consumer-owners.

Trustees as shareholder representatives of the consumer-owners can be confident about the Board's focus and objectives, that without the constraints of regulation company decisions will reflect the best interest of consumers. After all, Trustees as shareholders not only appoint but also have authority to remove directors should the situation require that step to be taken.

Waitaki Power Trust is adamant that if regulation serves no gainful purpose then provision needs to be made under the Commerce Act 1986 for the businesses involved to be exempt from regulation.

7. Providing for Exceptions – Recommended Amendments to the Commerce Act 1986

Waitaki Power Trust has given cogent reasons for extending the scope of the current regulatory control provisions under the Commerce Act 1986 beyond the range of options presented by MED in the Discussion Document of April 2007.

There is danger in continually stating the basic premises of 'free' market economic theory, that in the absence of competition the only instrument available for modifying the economic behaviour of natural monopolies is regulation. The danger consists of the fact that it is well recognised by international psychological research that the more times something is repeated, the stronger the belief that what is said is true.

This may explain why MED's Discussion Document is strangely silent on considering **exemption from regulation** as a very real and indeed necessary, option for change.

Recommendation

Waitaki Power Trust recommends that Part 4, Part 4A and Part 5 of the Commerce Act 1986 be amended as necessary, to make provision for the following matters:

- a. A regulatory- specific purpose statement including objectives a – d as proposed.

- b. A business-specific approach within the electricity lines business sector currently captured under the one-size-fits-all approach of Part 4A of the Act with the objective of:
 - recognising differences in financial practices between electricity lines companies, and
 - establishing whether full, lighter-handed or exemption from regulatory options apply in the case of each company.
- c. More light-handed regulatory provisions, the objective of which is to minimise regulatory control and the degree of regulatory intrusiveness and reduce business compliance costs.
- d. Criteria to guide decision makers of conditions under which light-handed regulatory control provisions apply; and
- e. Criteria to guide decision makers of conditions under which 100% Consumer Trust owned businesses, electricity lines companies in particular, can be exempt from regulatory control provisions under the Commerce Act 1986.

Recommendation of amendments along the lines proposed is consistent with the generally agreed position acknowledged in the Discussion Document

that regulation should only be considered where market power is significant and sustained and cannot be more effectively addressed by other means (DD, 2007, p. 31).

Furthermore, as the Discussion Document points out, it is worth noting that

in most jurisdictions overseas the decision on whether a firm or sector should be subject to economic regulation has already been determined and is set in legislation (DD, 2007, p. 30).

Waitaki Power Trust endorses these sentiments and urges that they be reflected in changes to the Commerce Act 1986.

8. Summary

Waitaki Power Trust endorses the need to review the regulatory control provisions under the Commerce Act 1986.

Trustees are not alone in the view that the strict terms of economic regulation relating to electricity lines businesses under Part 4A of the Act are not providing for the long-term benefit of New Zealand consumers. Every time that like-minded people meet at national level, the so-called 'wall of wire' situation is a topic for discussion.

The purpose of regulatory control provisions needs to be clearly spelled out to remove ambiguity, uncertainty and debate over interpretation of policy.

Electricity lines businesses should not have to second-guess how the Commerce Commission and its consultants might interpret information and assess compliance because of legislative gaps.

Waitaki Power Trust has suggested ways that these issues can be resolved.

The Trust has also made recommendations of amendment directed at avoiding the inefficient use of human, financial and technical resources that occurs

- under a sector wide approach to regulatory control;
- when the watchdog role relating to the same electricity lines business is legally required to be carried out by two separate organizations with different agendas, the Commerce Commission monitoring compliance with a set of rules and Trustee/Shareholders acting directly in the best interests of consumers; and
- when electricity lines company businesses are inappropriately captured under regulatory control provisions which are unnecessary because the same objectives can be achieved by non-regulatory tools acting directly to meet consumer requirements.

Waitaki Power Trust sincerely requests that the Ministers of Commerce and of Energy give serious consideration to the points that have been made by this submission.

Appendix I: Article, Otago Daily Times, 3 July 2007 “Network returns \$1.7m surplus”

> Waitaki

Network returns \$1.7m surplus

OOT
3/7/07

Continued growth boosts result

By SALLY RAE

NORTH OTAGO power lines company Network Waitaki has returned a surplus of just over \$1.7 million for the financial year ending March 31.

Chairman Lindsay Malcolm said continued revenue growth based on increased and electricity use by consumers helped improve annual returns.

Against that, significant unbudgeted costs associated with last year's severe winter storm raised operating costs to high levels.

In addition, large increases in transmission charges over which the company had little control had occurred.

The consumer trust ownership brought benefits for consumers of lower line charges, profits rebated back to consumers and capital development that would strengthen existing services and allow for new community developments.

More importantly, policy control of the company remained firmly in local hands, Mr Malcolm said.

"There are some who would view what we own as consumers as something to be acquired for the purpose of siphoning away your assets, profits and reserves for their own use in other areas. As a community, we must be mindful of the value of the business we all share in as consumers here in North Otago," he said.

Chief executive Graham Clark said growth in demand for electricity was expected to continue. Rural areas had been experiencing the greatest growth, driven by the change in farming practices from predominantly dryland farming to more intensive farming resulting from the



Lindsay Malcolm

development of irrigation schemes.

Growth was making it more difficult to maintain quality and security of supply in times of planned maintenance on both the transmission and

distribution networks.

Those issues were being addressed by capital expenditure on the distribution network and consulting Transpower on how it might resolve its issues in that area.

There were local projects, including the proposed Holcim cement plant at Weston and stage two of the North Otago irrigation scheme, in various stages of planning that would have significant requirements for electricity.

Those requirements, should all the projects proceed, would place significant demands on Transpower's transmission system, Mr Clark said.

It was important for Network Waitaki to keep Transpower informed of potential developments so that Transpower could plan for the likely increase in demand.

Network Waitaki had operating revenue of \$12.278 million, compared with \$10.891 million for the 2005-06 year.

Operating expenses were \$8.792 million compared with \$7.663 million for the previous year. The surplus after tax was \$1.753 million (\$1.392 million in 2005-06). The company paid out a discount to its customers of \$1.642 million during the financial year.