20/037
E6/14

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Commerce Commission
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Dear Dane,

DPP RESET – UNISON FEEDBACK ON THE DPP RESET PROCESS

Overview

In this letter Unison sets out its feedback on the DPP3 reset, including comments on the process and concerns about aspects of the decision. We have contributed to the preparation of the ENA's submission and have sought to avoid repeating the feedback contained in its submission.

Working within the constraints of DPP regulation

In providing our feedback we take as a starting point that DPP regulation is intended to be low-cost. This has been taken to mean that there should be limited customisation or consideration of individual company circumstances and that methods for setting expenditure forecasts should have general applicability. If the DPP is unsuitable for an EDB, then the effective 'appeal' is to apply for a customised price path (CPP). However, for most EDBs a CPP is a prohibitively costly exercise. The outcome therefore is an EDB will live within the constraints of the DPP even if it leads to sub-optimal outcomes, such as lower than desirable expenditure levels or acceptance of risks that do not manifest in day-to-day reliability issues (e.g., lower expenditure than efficient on resilience to high impact, low likelihood events).

This places pressure on the DPP process to ensure that revenue allowances are sufficient to cover an EDB's efficient expenditure requirements, create realistic service quality and reliability targets and are effective in identifying and allocating risks between EDBs and their consumers.

Overall characterisation of the DPP reset

It was clear that the focus for the Commission in the reset was on improving the quality and reliability standards. While we think that this has been achieved to a material degree and the Commission clearly expended significant effort in analysing historical reliability data to identify improvements (which we highly commend), there remains significant work to be done to develop a more fulsome approach that addresses a wider set of measures than SAIDI and SAIFI.

Use of a wider set of quality and reliability measures had been identified in the DPP2 reset, but both the Commission and EDBs failed to action the steps necessary to enable further improvements in DPP3. The lesson therefore is that we need to take the time between resets to identify data requirements and develop models to advance desired improvements. It will be important for the Commission and industry to reconvene in 2020 to identify the data required for a wider approach to quality to be used in DPP4. We also think it would be useful for the Commission to consider reliability in a wider sense (e.g., resilience to cyber-attacks, climate change etc) so that expenditure allowances include provision for increased costs to manage such risks).

With respect to the approach to establishing the BBAR and MAR, Unison submits that much less effort appeared to be expended on further developing the models that had been used in DPP2. Of particular frustration to Unison is the Commission's approach to forecasting operating expenditure. While we recognise that the Commission is challenged in using AMP opex forecasts as the basis for forecasting opex, the framework for opex forecasting creates a systematic bias towards under-forecasting EDBs' reasonable operating expenditure requirements. This issue is the principle focus for Unison's submission.

Forecasting opex

The Commission's high-level approach to forecasting opex was set out in Box A1[1] as follows:

Box A1: Formula for calculating opex

$$
\begin{aligned}
\text{opex}_t = \text{opex}_{t-1} \times \\
&(1 + \Delta \text{ due to network scale effects}) \times \\
&(1 + \Delta \text{ input prices}) \times \\
&(1 - \Delta \text{ partial productivity for opex}) \pm \\
&\text{step changes}
\end{aligned}
$$

Absent use of forward-looking operating expenditure forecasts (e.g., in AMP forecasts), the Commission continued with the model developed for the DPP2 reset, as set out in Box A1 above. The model takes as a starting point expenditure in the penultimate year of the forecast, and rolls this forward with the various adjustment terms. What was evident from inspection of the formula is that there is no allowance for changes in non-scale related costs, unless they meet the threshold for a "step-change allowance".

A number of EDBs nominated various categories of expenditure where "step changes" in expenditure may occur. Categories included rising cyber-security costs (a non-scale related variable), rising costs of traffic management resulting from more stringent requirements, and

1 *Reasons Paper, page 151*

increasing impositions from the Electricity Authority, etc. The Commission rejected providing any allowances for these new or increased costs, principally on the basis that the costs did not meet tests for significance or were not robustly verifiable. Accordingly, EDBs have been provided with no allowances for any non-scale related activities that drive increases in costs. Although not explicit, the Commission essentially took the position that there will be no changes in the operating environment (unrelated to changes in network scale) that will drive increases in opex. To Unison this is not a realistic or plausible position to take: for example, there are new and rising costs associated with managing cyber-security risks (which are not driven by changes in network length or numbers of consumers). These will not meet the criteria or thresholds for reopeners, but will cumulatively impact on EDBs' expenditures over the regulatory period.

Absent any step-change allowances, EDBs argued that the opex forecast model needed to include a term to allow for non-scale related changes in opex. The ENA engaged NERA to examine the historical trends in expenditure growth, after allowing for scale-related factors. Estimated as a residual, NERA identified that EDBs had experienced non-scale related cost growth of around 3% per annum historically. This 3% growth represented the net effects of changes in non-scale-related costs and changes in industry productivity. It is impossible to decompose this combined term into the separate elements of productivity and non-scale effects, because we do not have measurable drivers of non-scale related costs. Accordingly, numerous submitters recommended that the Commission recognise this practical reality and restate its model as follows:

$$\begin{aligned} \text{opex}_t = \; & \text{opex}_{t-1} \times \\ & (1 + \Delta \text{ due to network scale effects}) \times \\ & (1 + \Delta \text{ input prices}) \times \\ & ((1 - \Delta \text{ partial productivity for opex}) \times (1 + \Delta \text{ due to non-scale effects})) \end{aligned}$$

ENA and others recommended that the Commission estimate the last, composite, term based on NERA's analysis of long-term trends in non-scale-related expenditure growth.

The Commission rejected the proposition that productivity factor could be negative (which was not what EDBs were asking for) and took the view:

> A152 We consider improvements in productivity are achievable due to:
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> A152.1 evidence of positive productivity in electricity distribution sectors across the world, including productivity studies which take non-scale variables such as quality of outputs into account;
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> A152.2 evidence of positive productivity in comparable sectors within New Zealand; and;
>
> A152.3 a changing policy environment with a greater focus on innovation and technology.

Based on judgment the Commission set the productivity factor at 0% and made no allowance for any new or increased non-scale related costs. In responding to EDB submissions that the model needed to make allowance for non-scale costs in a composite residual term, the Commission stated:

> A162 All distributors who responded to the draft decision opposed the productivity factor being set at 0% and thought we should allow for non-scale factors that they consider will drive higher opex in DPP3.
>
> A163 Many of these distributors recommended a negative productivity allowance based on historic evidence from NERA which showed a negative long-term trend of productivity. Several distributors supported NERA's suggestion of reframing the productivity factor as the 'residual opex factor.' This suggests a negative productivity factor does not necessarily mean negative productivity growth. Instead it is caused by the growth of unmeasured outputs such as resilience or quality, offsetting any productivity gains. For the reasons set out above, we do not consider it is appropriate to use historic performance to set the partial productivity factor.
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> A165 ENA's cross-submission asks for clarity over what the partial productivity factor allowance is for. We address this in our analysis.

Unison makes the following points:

1. The model for establishing opex forecasts establishes an impossible standard for EDBs to meet. The Commission rejected all the non-scale factors that EDBs nominated would increase costs during the DPP3 period. It appears that EDBs would have to forecast the costs associated with non-scale related factors for these to be potentially subject to a step-change allowance. Additionally EDBs would need to have some process in place for the Commission to accept these as sufficiently significant, and in some way independently verified. This is inconsistent with the low-cost DPP approach, as well as the Commission's view that an EDB's actual opex forecasts cannot be used in a reset;

2. The Commission makes no allowance for any non-scale related factors that drive increased business costs, despite being fully aware that bodies such as the EA and Climate Change Commission are considering or on the cusp of implementing new requirements on EDBs (e.g., the new Default Distribution Agreements with retailers);

3. The setting of a 0% percent productivity factor appears to be nothing more than a guess, or a hope, rather than a figure derived from any robust analysis applicable to New Zealand EDBs;

4. While we would agree that historical trends need to be considered for ongoing applicability, the evidence from NERA shows a persistent long-term trend of increasing expenditure requirements on EDBs after allowing for scale effects. The Commission should have good justification and evidence to support the cessation of such a long-term trend, particularly when incentive regulation has been operating on the non-exempt EDBs since 2013. If the Commission considers that EDBs are not seeking to improve productivity and efficiency, then it begs the question about the worth of DPP regulation.

The net effect of the Commission's approach is that EDBs must, in fact, increase productivity and efficiency to offset increases in non-scale related factors driving increases in operating expenditure. The purpose of Part 4 requires that efficiency gains be shared with consumers. However, the Commission's approach essentially requires that EDBs use productivity and efficiency gains to meet the costs of higher non-scale related costs (there is no sharing: consumers are effectively to receive it all!). The productivity assumption is not 0%, but a likely materially positive number due to increasing impositions or expectations on EDBs that do not relate to changes in the scale of the network.

Unison recognises that the points above principally address the quality of the Commission's decision on opex. But from a process perspective, the Commission's dismissive approach to the comprehensive report from NERA, signals to EDBs that it was a waste of our financial resources to procure such a report. The Commission made a draft decision to adopt a zero-productivity factor. From the cursory discussion included in the Final Reasons Paper there appeared to be no serious engagement on the valid issues raised concerning absence of non-scale-related adjustments to opex in the NERA report and EDB submissions. We are thus left with the strong impression that the consultation process was not an open and inquiring investigation of the issues raised. This has raised serious concerns about the process for establishing reasonable operating expenditure forecasts. The consequence of the decision is that it now leaves us in a position where, for the DPP3 period, we face little choice but to oppose changes (particularly regulatory changes) that create new or higher operating expenses, even where we consider such changes would be beneficial. There is simply no allowance for them, unless they exceed the 1% re-opener threshold.

An implication of the Commission's approach of not providing for any step changes or changes in non-scale related opex is that consideration will need to be given to DPP re-openers in the coming IM Review. In particular we think that the threshold would need to be lowered for adding opex allowances when there are changes in regulatory settings affecting EDBs. For example, if the Authority makes Code changes that place new or increased costs on EDBs, mandatory provision for those costs to be included in revenue allowances, unless they are truly de minimus.

In summary, the NERA report raised serious and credible issues with the Commission's approach to forecasting non-scale-related changes in opex. We had expected that the Commission would, in kind, engage with those issues in a substantive manner, including if necessary engaging further expert analysis to assess NERA's analysis. That did not occur and has undermined our confidence in the process. NERA's 40+ pages of analysis was addressed with 16 paragraphs in the Final Reasons Paper of weakly reasoned analysis. Notably the response did not even address the substantive point that the Commission's approach provides no allowance for non-scale related factors that drive changes in opex.

Consultation process

Aside from our very significant reservations about the decision quality and process for setting opex allowances, overall, Unison found most aspects of the consultation process itself reasonable. In particular most aspects of the process were timely, there was use of workshops on targeted issues and Commission Staff were available to discuss aspects of the draft decision (e.g., the attendance of Commission Staff at an ENA working group meeting).

We found the workshop late in the process to discuss some particular aspects of the quality and reliability draft decisions a very useful engagement with Commission Staff. It was an effective engagement because there were a limited number of knowledgeable participants discussing detailed issues. The earlier workshops were much less effective, which we put down to having too many people at the workshops and discussions happening at too high a level. Nevertheless, we endorse the Commission trialling such workshops - and respect the intent - but we do not think they generated a rich dialogue on important issues. We acknowledge that the Commission must provide for workshops to be open to interested stakeholders, but it is also important that detailed technical issues can be discussed in a way that can lead to effective resolution with EDBs' experts.

As has been traversed in the ENA submission, the consultation on the IM change to address operating leases was not considered effective and should have taken place prior to the commencement of the DPP3 reset process to allow for more accurate, timely consultation.

Lessons for the future

Overall, we felt (and believe the Commission recognises too) that the DPP3 reset was more a handle turning exercise (especially with respect to the financial models) than an exercise in thoughtfully considering the likely environment for EDBs during the DPP3 reset period, and designing an approach that will be resilient to the demands being placed on EDBs. Our sense was that the Commission was much more focussed on other regulatory processes (e.g., setting Fibre IM's) and the DPP reset was not a high focus area for the Commission.

While we recognise that the Commission made efforts to address issues raised by EDBs (such as neutrality of opex/capex incentives, innovation allowances), we think moving into DPP4, there will be even more importance on reconsidering the design of DPP regulation. Such consideration is required to ensure that EDBs are incentivised to adapt to changing circumstances and the DPP4 regulatory mechanisms can be adapted during the regulatory period. Despite COVID-19 being the biggest catastrophe to strike New Zealand in a life-time, it appears that the Commission has very limited or no ability to adapt the DPP3 regulatory settings, even where this may be necessary to enhance the long-term benefits to consumers.

More generally, we have real doubts that five-year, set-and-forget, resets are appropriate in a more dynamic environment. Unison submits that the Commission and EDBs will need to carefully consider greater use of incentive frameworks and off-ramps to address issues that arise during the regulatory period. The rest of the industry and consumers expect EDBs to provide more than a conveyance service in future, but the current DPP approach essentially remains focussed on the provision of a one-way conveyance service. Currently there is no recognition or reward for EDBs to offer new services (including provision of information to stakeholders), which will likely prove detrimental to the advancement of New Zealand's electricity sector and the long term interests of consumers. Other aspects of improvement, such as expanding measures of quality and reliability, moving to a totex regime, will require a long lead-in time.

Ultimately Unison, as a consumer-owned EDB, is highly vested in supporting regulatory approaches that provide EDBs with appropriate financial rewards and incentives that deliver benefits to our consumers. We look forward to continuing to engage with the Commission on important issues confronting EDBs and the wider electricity market. We appreciate the opportunity to provide feedback and welcome discussion on any of the points raised in this submission.

Our final comment is that time should be invested this year in considering the framework that is necessary to support effective outcomes at DPP4, including the consistent collection of data on which to make robust decisions.

Yours sincerely

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GENERAL MANAGER BUSINESS ASSURANCE