Ref: 21/037
E 6/14

28/05/2021

Andy Burgess
Head of Energy, Airports, and Dairy
Commerce Commission

By email to regulation.branch@comcom.govt.nz

Dear Andy,

OPEN LETTER ON COMMERCE COMMISSION'S PART 4 PRIORITIES AND ISSUES

Unison welcomes the opportunity to submit on the Commission's open letter of 29 April. We have contributed to the development of the ENA's submission and endorse its recommendations.

Overall, Unison agrees that it is timely and important for the Commission to seek input into its prioritisation of ongoing development and implementation of the Part 4 regime. In preparing this submission, we have considered the most pressing element of carrying out the Gas DPP resets, the timetable for the IM review and the open-ended timeframe for amendments to the Information Disclosure Requirements.

The Commission notes that it is particularly interested in emerging issues relating to decarbonisation, the implications of new energy technologies and business models. In this response we take a broader view. While the decarbonisation agenda will have important implications for regulation under Part 4, there are other factors which are likely to have significant impacts on EDBs, which we think will need to be carefully considered in the IM review and in the way in which DPPs and CPPs are struck.

A key theme of the present environment is volatility and uncertainty

When the Commission made its Electricity Distribution DPP3 decisions in November 2019 this was in a pre-COVID world. Among other matters, in the COVID world:

1. Supply chains are heavily disrupted and tight;
2. Markets (financial and physical) are being heavily distorted by massive fiscal and monetary stimulus;
3. Skill shortages are biting heavily as migrant inflows to New Zealand have dried up;
4. Housing/rental markets are supply constrained across New Zealand, reducing workforce mobility (compounding skill shortages);
5. Inflation expectations are rising (CPI, producer prices and labour costs); and
6. There is an infrastructure boom associated with "shovel-ready" projects and local authorities coming to the realisation that they can no longer defer their "three-water" infrastructure investment deficits.

While IM/DPP regulation was intended to provide high levels of certainty, best practice regulation also provides for a degree of adaptability. The factors above have highlighted that the IM/DPP regime has very limited ability to adapt to changing circumstances, unless there is resort to a CPP. We think a key issue to address is the balance between regulatory certainty and adaptability.

Outside of COVID-driven factors impacting on the industry, as the Commission has identified, the Climate Change Commission has crystalised the significant challenge and path that New Zealand needs to take to meet its emissions abatement commitments. Albeit with high levels of uncertainty, we can expect that decarbonisation of transport and heat production will drive significantly higher levels of electricity use. The industry's challenge is to meet rising demand in an efficient manner, balancing affordability, security and reliability. A significant challenge to address under DPP/CPP regulation is how to manage a much wider range of forecast uncertainty. We know the direction of travel will be more electricity use, but how fast and how much will be very difficult to establish. Consequently, the risks of forecast error in setting DPPs and CPPs is likely to be much greater than in the past.

In this wider context, electricity distributors will need to be at the "top of their game", supported by a regulatory environment that encourages investment and innovation. From that perspective EDBs will need to have the fundamentals covered, including:

- Strong asset management capabilities (which in our view should be supported by a well-implemented asset management system);
- Effective resilience capabilities, including emergency preparedness and response capabilities (including information (cyber) security));
- Effective customer engagement models to ensure effective understanding of customer preferences.

We think that Part 4, generally, incentivises good quality asset management and there is scope for further improvement through reliability incentives (e.g., in setting quality standards and incentives), but it is unclear how the latter two points above are effectively promoted.

Specific Input Methodology Issues

Even without the backdrop of COVID and the decarbonisation agenda, in Unison's view the DPP/IM regime is becoming increasingly unsustainable under current settings. We hold this view for the following reasons:

1. We now think there is sufficient evidence to confirm that there is bias in CPI forecasts;

2. There are significant risks placed on equity investors under the RAB indexation approach associated with forecast inaccuracy in CPI forecasts. In the low WACC environment, these risks have high consequence;

3. Operating expenditure forecasts that have been used for DPP forecasts are largely backwards looking and provide no allowances for a changing environment. The DPP3 reset made allowances for scale-related drivers of increased expenditure requirements, assumed that productivity growth would be zero, but made no allowance for new non-scale related expenditure requirements. The Commission's DPP3 assumption that the measured trend decline in apparent productivity would simply cease lacked any proper evidential basis. We noted the Commission's statement in its recent levy consultation that:

   > Electricity distributors have to deal with an ever-increasing range of complex issues, including those related to new technologies, energy affordability, cybersecurity, health and safety, climate change and decarbonisation, often involving diverse stakeholder views. In particular, distributors are grappling with how to best manage long-lived assets built many decades ago, while taking into account the opportunities and risks associated with emerging technologies. (para 79)

   Despite recognising these issues, under the Commission's prevailing DPP/IM philosophy, the only way an EDB can recover costs associated with these types of activities is to incur the costs, suffer an opex IRIS penalty as a deemed inefficiency, but ensure these costs are included in baseline opex in the penultimate year of the regulatory period to at least allow future recovery. Such an approach is a barrier to EDBs effectively addressing the issues. While opex forecasting is a DPP issue, given the Commission's historical approach to forecasting, we believe an IM needs to be considered to allow greater adaptability of DPP revenue allowances if opex forecasts are to continue to take a backward-looking view.

4. Investment in new connections beyond the forecast level is considered an inefficiency that investors must bear a proportion of through IRIS penalties.

5. We remain doubtful that the IRIS mechanisms achieve their stated objectives, especially the unproven concept that substitution of capex and opex are NPV neutral.

6. The re-opener provisions are narrow and cumbersome (for example, for a regulatory change that causes higher costs, every EDB must apply for a re-opener).

In our view "set and forget" revenue cap regulation in an environment of significant volatility and uncertainty is no longer in the interests of consumers or investors. The IM review will need to give careful consideration to how revenue allowances should adapt in response to a more dynamic environment, where EDBs are required to take a leading role in supporting New Zealand's climate change adaptation.

For example, if EDBs make investments in enabling new platforms to allow consumers to realise value from their DER, how are EDBs to be compensated for these investments? Particularly problematic is that if EDBs make investments in infrastructure and platforms that enable non-network alternatives, these platform investments are treated as an inefficiency (unless they were included in 2019 AMPs), but because non-network alternatives provided by third parties may not provide a RAB asset to the EDB, the EDB cannot benefit from an avoided investment if future

AMPs anticipate the avoidance of a network investment. Accordingly, we think a key issue that needs to be addressed in the IM Review is how enabling investments in infrastructure and platforms to support consumers' DER investments can be recovered. The investments EDBs are currently making in enabling infrastructure (e.g., LV monitoring systems) are being made in spite of regulatory disincentives, not because such investments are being promoted by a supportive regulatory environment. This is not a sustainable position.

Overall, Unison's submission is that the IM Review is likely to be critical in ensuring Part 4 can be a sustainable regulatory regime. While there will be many technical aspects of the current IMs that are likely to be very stable, and therefore require minimal review, there are likely to be complex considerations associated with achieving a better balance of certainty and adaptability. The current IMs provide little adaptability to changing circumstances, which is likely to be a significant barrier to EDBs contributing effectively to New Zealand's decarbonisation commitments. Starting the IM Review with sufficient time to allow for rich analysis of these issues will be critical.

We think an effective IM Review process will involve:

1. Identifying at an early stage the key issues to be addressed;

2. Efficient forums to carry out in depth discussions of the issues. In our experience, smaller forums with knowledgeable experts are likely to be far more effective than large stakeholder events that involve "going round the room" to solicit views; and

3. Sufficient time to develop and test detailed implementation proposals. In particular, the codification in IMs is an important step that needs sufficient time for consultation to avoid the risk of unintended consequences.

Unison submits that priority issues for the IM review should be:

1. Adaptability mechanisms to address a more complex and uncertain environment;

2. WACC with particular focus on:

    a. Establishment of the risk-free rate and debt risk premium;
    b. Update of the MRP;
    c. Its implementation in DPPs and CPPs via cashflows and indexation of the RAB; and
    d. Finance-ability in a low interest rate environment.

3. Incentive mechanisms, including IRIS and innovation allowances.

4. Incentives for industry consolidation. Gains that could be achieved via industry consolidation are not incentivised under Part 4: EDB owners would take significant transaction risks and costs on consolidation, which are not compensated with sufficient

rewards. There has been no EDB consolidation under Part 4, but this may be an important means of realising efficiencies and capability in future.

These are our top-of-mind issues, but we appreciate that the Commission will undertake a formal process to ensure a comprehensive list of critical issues is developed.

Electricity DPP4 reset

The Open Letter is silent on the Electricity DPP4 reset. Although the DPP4 Determination is more than three years away, Unison submits that the Commission should consider a project which seeks to identify key data issues for the reset, particularly where a track record of data is required to make informed decisions. A particular area to address is reliability-related information which would be required to deliver an enhanced reliability regime. We think that we are already at risk of being unable to make enhancements in DPP4 for lack of consistently measured and reported data.

Information Disclosure

The open letter identifies that there is no fixed timing for the targeted ID review. We appreciate that the Commission has to prioritise its resources across all its activities given available funding. Nevertheless, good regulation relies on good information. As noted in the preceding section, given the critical importance of the DPP resets in delivering on the Purpose of Part 4, we think that putting some foresight into the DPP4 reset and desirable information requirements should drive targeted elements of the ID Review. We submit that the Commission should place the targeted ID review relatively high in its list of priorities as it is an enabler for effective regulation.

Closing Comment

Once again, we appreciate the Commission taking the time to seek stakeholders' views on its Part 4 priorities.

Yours sincerely

Nathan Strong
GENERAL MANAGER COMMERCIAL