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Submission on productivity in EDB DPP4 reset

24 April 2024

1 Submission and contact details

Consultation	Submission on productivity in EDB DPP4 reset
Submitted to	Commerce Commission
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2 Confidential information

There is no confidential information provided in this submission. This submission can be publicly disclosed.

3 Supporting submissions

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to submit a response to the Commerce Commission (**Commission**) on the CEPA EDB efficiency study. This response will refer to the study as the '**The CEPA Paper**'.

Along with the other five large distribution networks, we have commissioned NERA to respond to The Paper. The joint submission has been provided as a separate submission. This response will refer to this submission and the '**NERA Paper**'.

The Electricity Network Association (**ENA**) has also provided a submission and a supporting study by Frontier in response to the CEPA Paper. WELL is a member of the ENA and participated in the submission development. This response will refer to this submission and the '**ENA Paper**'.

This submission should be read in conjunction with the NERA and ENA Papers.

4 Unmeasured productivity and implicit productivity improvements

The NERA and the Frontier reports generally agreed with the findings of the CEPA Paper in regards to *measured* productivity¹. The NERA and the Frontier Papers also agreed with CEPA's observations and comments about the limitations of the study – specifically, that in complex industries like electricity distribution, it's difficult to capture productivity in a small number of output variables. The CEPA report provided the example of EDBs changing their work practices to improve workplace safety. Changed work practices include de-energising some work activities and providing more extensive traffic management which increases delivery costs. The cost increases do not provide a subsequent improvement in the measured productivity measures and therefore make the measured productivity worse.

The NERA Paper highlights the difficulties in capturing productivity and provides unmeasured outputs not captured in the CEPA study². The ENA Paper highlights the improvement in EDB staff safety compared to other industries.

Importantly, NERA highlights that the costs of providing unmeasured outputs are not funded by the regulatory allowances and networks are having to find savings or incur IRIS penalties to fund the new costs. To avoid a large IRIS penalty, EDBs would have to make implicit (implicit because it's not captured in the *measured* productivity improvements) productivity improvements to fund the cost increases.

The increase in insurance costs on the Wellington network provides a good example of this because the Information Disclosures report insurance costs separately and they can be reliably tracked (noting that insurance is just one example and there is a range of other unmeasured outputs). WELL's operating expenses since Information Disclosures were first provided in 2013³, net of inflation and network growth factors. During this period, real opex costs decreased by \$1.1m or 4% and real insurance costs have increased by \$0.8m or 74%⁴.

¹ Noting that the Frontier report did highlight some errors and suggested improvements. However, the impact of these changes was not material.

² Section 3.2 of the NERA Paper.

³ The 2023 opex figure is based on WELL's draft Information Disclosure data.

⁴ WELL's insurance coverage also decreased slightly in 2020.

The yellow line in Figure 1 shows opex costs including the full insurance cost and the green line shows opex excluding the above inflationary increase in insurance (the amount not provided for by the allowances). The difference between the lines shows the savings WELL has had to find to avoid the 24% IRIS penalty on every dollar spent over allowances. Figure 2 Provides the insurance cost increases that we have had to find savings for each year. These costs are the above inflationary increases that the regulatory allowances do not fund.

Figure 1 – WELL’s real operating expenditure

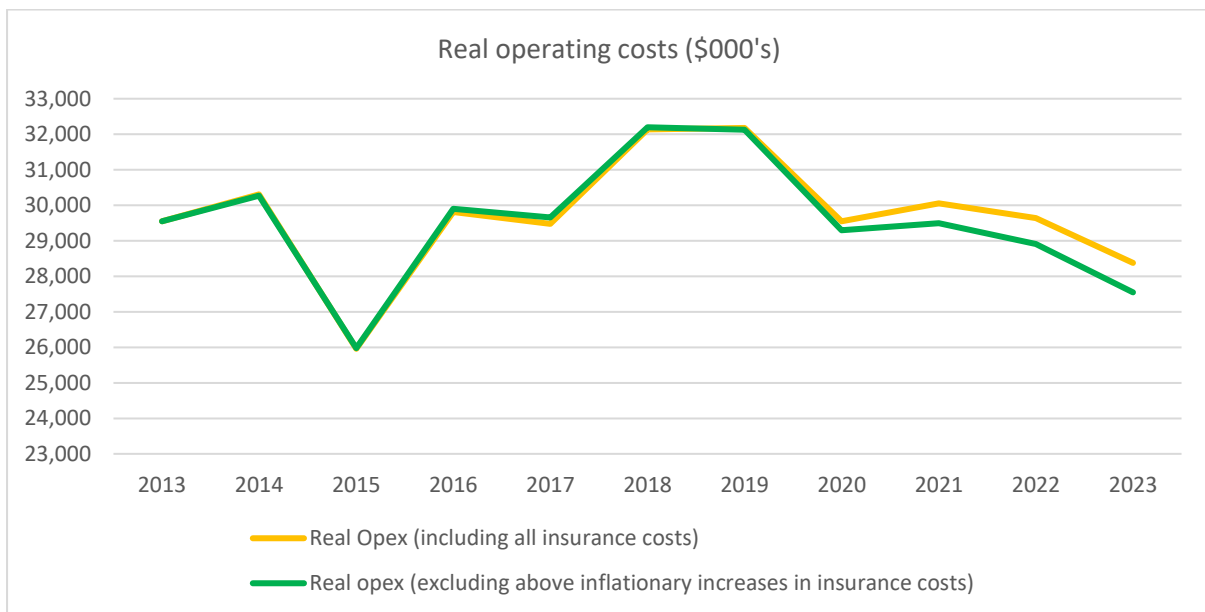
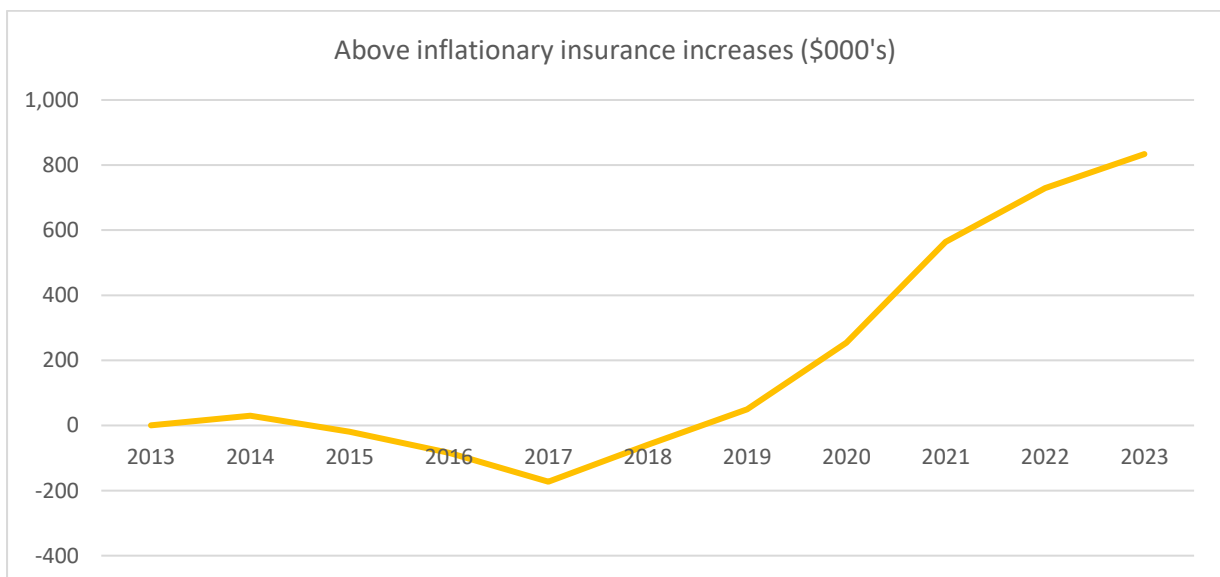


Figure 2 – above inflationary insurance increases



The IRIS combined with an allowance which isn't adjusted for new costs provides an implicit type of productivity incentive. The DPP framework has very strict criteria for providing opex step changes, none were provided in DPP2 or DPP3. The IRIS provides strong financial incentives to manage expenditures within the regulatory allowances. A 24% penalty on any opex overspend makes maintaining a real return difficult. WELL's management and Board closely monitor its cost expenditure because of the IRIS's impact on its financial performance.

5 Setting a productivity factor

WELL notes the ENAs conclusion that the findings of the CEPA paper support the retention of a zero productivity factor [refn]:

- CEPA recognises that while overall measured productivity is declining, this could be because of the modelling approach taken. The report highlights the difficulty in trying to capture all productivity outputs and provides examples of the types of costs that the model would not capture⁵.
- The analysis shows productivity has been flat over the past decade⁶. Most of the measured decline in productivity was in the period from 2008 to 2013, before the current regulatory framework with strong cost-saving incentives and tight control of allowances for new operating costs was introduced.

Supporting this conclusion:

- The ENA and NERA reports provided examples of unmeasured productivity improvements like staff safety improvements⁷.
- The ENA report showed that economy-wide productivity trends also declined at a similar rate. Productivity for the electricity, gas, water and waste services sector has decreased by more than the EDB sector over the same period. This suggests that similar infrastructure entities may also be subject to new costs that do not improve the traditional productivity measures⁸.

⁵ Section 2.3 of the CEPA Paper.

⁶ Figure 14 from the CEPA Paper showing the total productivity factor over time.

⁷ Section 3.2 of the NERA Paper and page 2 of the ENA Paper.

⁸ Page 1 of the ENA Paper.

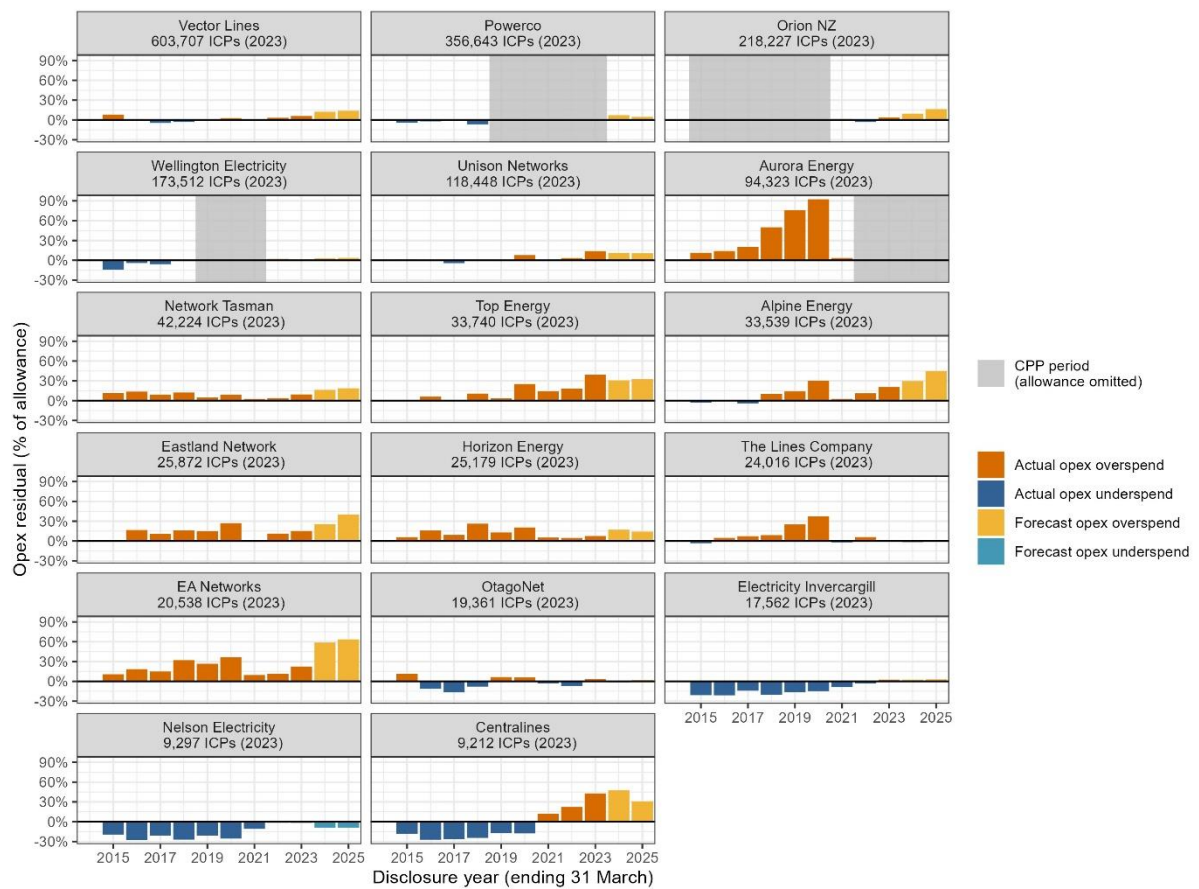
We would agree that a zero PPF would be appropriate if DPP allowances are set at a level which will allow a network to deliver consumer/stakeholder quality expectations (both the explicit quality target reflected in the quality path and implicit service levels like good customer service and safe staff working environment). However, if DPP allowances aren't capturing all of the costs that networks are exposed to then a negative PPF factor may be appropriate to capture costs missed by the allowances. Conversely, if the DPP allowances are adjusted for every new cost (i.e. the step change criteria were loosened) then applying a positive PPF could incentivise productivity improvements while still maintaining appropriate service levels.

6 Variability between networks

One possible use of the CEPA Paper is to inform the Commission's decision on EDBs' opex allowances for DPP4, including whether to apply a productivity target in the form of a partial productivity factor (PPF). Care must be taken as to how the networkwide productivity measures are interrupted and applied to individual networks. The NERA Paper examined opex expenditure for each non-except network. Figure 3 is from the NERA Paper (Figure 4.2) and shows that there was significant variability between networks and that some networks (especially the larger networks) have managed their opex costs in line with allowances – including finding savings to offset any new costs.

Applying a networkwide positive PPF would mean that networks that have potentially been providing implicit productivity improvements will have to find further savings at a time when they need to grow their capability to meet the expected step change in demand from electrification. It may not be in the long-term interest of consumers to incentivise further cost-cutting as at some point networks may not be able to provide the services customers want. The first thing that an EDB will cut is any innovation or service development which will impact the long-term quality of the network.

Figure 3 – Opex residual as a % of allowed opex for the 17 non-exempt EDBs (individually), 2015-2025



Source: Information disclosure schedules 6 and 11b; and DPP2/DPP3 opex projections. Only non-exempt EDBs that are subject to price-quality regulation are included. Only DPP allowances are included. We exclude the years in which an EDB went on a CPP. Forecast opex is as of the 2023 disclosures.