7/07/2019

Dane Gunnell
Manager, Price-Quality Regulation
Regulation Branch
Commerce Commission

By email regulation.branch@comcom.govt.nz

Dear Dane,

UNISON SUBMISSION ON DPP INPUT METHODOLOGY AMENDMENTS

This letter represents Unison's submission on the consultation paper: *Proposed amendments to input methodologies for electricity distributors and Transpower New Zealand Limited – Reasons Paper.* Unison has read and contributed to the ENA's submission and supports its recommendations. Rather than repeat the ENA's submission's, Unison focusses on more narrow points of direct interest.

Change to the definition of operating costs.

The Commission proposes to include a new exclusion to the definition of operating expenses ("opex") by excluding **pecuniary penalties.** The Commission asserts that this is a clarification of the existing definition of opex. We are unsure on what basis this assertion has been formed.

The Commission states:

> 2.53 While we consider the current definition does not allow such costs to be passed through to consumers (via a DPP or CPP reset and via the IRIS), the exclusion is implicit, and so making this explicit through a proposed IM amendment better promotes the IM purpose in s 52R of the Act.

The definition of costs is set out in the Input Methodologies

operating cost means a cost incurred by the EDB in question relating to the supply of-
(a) regulated services alone; or
(b) regulated services and one or more unregulated service,
and excludes-
(c) a cost that is treated as a cost of an asset by GAAP;
(d) amounts that are depreciation, tax, subvention payments, revaluations or an interest expense, in accordance with their meanings under GAAP;
(e) debt issuance costs;
(f) pass-through costs;

(g) recoverable costs; and
(h) distribution of profits to consumers;

Pecuniary penalties are clearly a cost incurred by the EDB that relates to the supply of regulated services (they do not occur for unrelated reasons) and the current list of exclusions does not implicitly include pecuniary penalties. The Commission's proposal is clearly a policy change, not a clarification.

In that respect, we agree with the ENA's submission that the policy change needs to be considered in relation to the costs and benefits that the change brings. We note that the change alters the benefit-cost ratio between the costs of controls relative to the avoided costs of better managing business compliance risks. Under the opex IRIS scheme under the current policy setting, businesses may weigh-up the costs of additional business controls at the current IRIS incentive rates (both capex and opex IRIS impacts as many controls will involve capex) relative to the avoided costs of pecuniary penalties also at the equivalent opex IRIS incentive effect. Under the Commission's proposal, businesses would incur 100% of the pecuniary penalty, because there would be no opex IRIS relief. There is also potential to distort in-sourcing / out-sourcing decisions. A contractor is unlikely to pass-through the costs of pecuniary penalties to a principal, but include a margin in prices to cover this risk. An EDB's internal division, however, would bear 100% of the same pecuniary penalties.

Unison agrees with the ENA that most businesses would operate very low risk tolerances for breach of laws and regulations, although there is always more that can be done to strengthen controls. We consider that from a public policy perspective, on balance, although there is a distortion in incentives if pecuniary penalties are excluded from opex, we support the change in definition of opex to exclude pecuniary penalties, but only those in respect of Part 4 breaches. This change would need to be reflected in weighing up any future changes to the cost of capital, as the risk of breach of laws and regulations has an asymmetric effect on returns, unless the Commission is happy to finance excessive risk aversion on the part of EDBs to eliminate all risks of breach.

Unison submits that this change should apply from the commencement of the next disclosure year (i.e., from 1 April, 2020). We strongly disagree that the change is a "clarification" and therefore be applied retrospectively. This would represent poor regulatory policy – businesses cannot go back and change their control environment to reflect the changed cost-benefit assessment.

Moreover, making such a change retrospectively would give rise to broader concerns about other potential "clarifications" that might have adverse retrospective impacts on the EDBs. For example, it is not obvious that the Commission has explicitly contemplated "fraud risk" and who bears the risk of fraud. Again, although most businesses would operate very low tolerance for fraud and have numerous controls to reduce the risk, there are some fraud risks that are very difficult to detect. Is this a risk that EDBs should bear, or is this risk shared between consumers (which we believe it would be under the current definition of opex)?

From Unison's perspective, we consider there would be a significant erosion of our confidence in regulatory certainty and predictability if this change was characterised as a "clarification" and applied retrospectively. It plainly is not a clarification, but a change to the definition of opex.

Yours sincerely

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE