

31/03/2015



Keston Ruxton
Manager, Market Assessment and Dairy
Regulation Branch
Commerce Commission

By email regulation.branch@comcom.govt.nz

Dear Keston,

UNISON RESPONSE TO OPEN LETTER ON SCOPE, TIMING, FOCUS OF REVIEW OF INPUT METHODOLOGIES

Opening comment

1. The Commerce Commission (Commission) released the an open letter¹ to interested parties seeking input on the scope, process and timeframes for the review of the IM's, which (mostly) were published on 20 January, 2011.
2. Unison has read and contributed to the ENA submission and supports its conclusions and recommendations. In this submission we focus on key matters to Unison, and seek to avoid duplication of points made by the ENA.

Unison's submissions

3. We welcome the Commission's early engagement on what will be a key regulatory process before the review gets formally under-way. We understand that the Commission would particularly value feedback on the potential scope of the review, so that it can commence focussing resources on key areas of research. The open letter requests feedback on three key areas:
 - a) Which input methodologies would be included in the review at this stage;
 - b) The process that would be followed; and
 - c) The proposed timeframes for the review, including when it should start and finish, with the Commission indicating that it may be useful for gas consumers to have the review completed by December 2016, prior to the gas DPP resets.
4. Unison's principle submissions concern the process that should be followed for the review. While we understand the Commission's desire to confirm scope as soon as possible, it is essential that

¹ Commerce Commission, Open letter on our proposed scope, timing and focus for the review of input methodologies, 27 February 2015

the process follows an orderly approach, with the full scope of the IM's to be reviewed defined following three key preliminary steps, which we discuss below.

5. The IMs are intended to be a cornerstone of the Part 4 regime. They were intended to provide investors with confidence that key regulatory rules and processes would not be subject to frequent change, and that there would be some external accountability on setting and changing the IMs through merits appeal.
6. Given the experience to date, it is not evident to Unison what role the Commission considers the IMs play, in reality. Our general impression, formed through the out-of-schedule review of the WACC IM, which considered percentile issues only and no other matters raised by the High Court, the Commission's reluctance to consider a "Starting Price Adjustment IM" as well as other changes and introduction of new IMs, is that the Commission would generally prefer to have flexibility when setting price paths to make policy changes. It is not evident to us whether the Commission has any particular criteria or thresholds that it applies when considering whether to change or introduce new IMs, but this is an important part of establishing the credibility of the IMs in creating a stable environment for investors in regulated goods and services.
7. To be clear, Unison does not expect the IMs to stay the same for ever – the regime clearly contemplates that IMs should be reviewed after a reasonable elapse of time, and may be changed. However, there should be a degree of predictability about how the IMs might change in light of changing circumstances or information about the performance of the IMs in achieving the Part 4 objectives: it is important that investors have confidence not just in the IMs themselves, but the process and criteria for when they may change.
8. Accordingly, Unison considers that the IM review process should commence with:
 - a) Establishing a formal process for the review;
 - b) Establishing a clear framework for the review, including the decision-making process in light of the economic and legal framework of Part 4, development of criteria and thresholds for any changes to existing IMs or introducing new ones, and the best means of utilising expertise (for example, would a panel of experts – "hot-tub" approach be a more efficient and effective approach). The original IM setting process involved the use of conferences where the Commission could explore parties' views further – their potential role and efficacy would need to be considered; and
 - c) Establishing a clear sense of the issues confronting EDBs directly or indirectly. This "environmental scan" should consider what has changed since 2011 and what have we learned about the performance of the existing IMs? The implications of disruptive technologies would feature quite strongly in that analysis, but also factors such as the rise in electricity prices, and demographic and social shifts etc that impact on derived demand for our services. The experience of Orion's CPPs and the DPP resets would also feature in considering the effectiveness of IMs, as well as the ad hoc development and changes to IMs. This would set the context and potential full scope for the review: not just of existing IM's but whether there should be others.

In relation to the impact of disruptive technologies, it would be useful to consider the literature on the economics of decision-making and investment under uncertainty. The current regulatory model is based on a paradigm where EDBs are assumed to be

monopolies over assets' physical lifetimes, but economic lives could be much shorter in future. It may be more appropriate for network prices to track the declining costs of disruptive technologies, with relatively higher prices in the short-term and declining over time, for example.

9. Development of the items above could proceed concurrently, but released for consultation as they are completed.
10. Unison submits that once these aspects of the IM review have been completed, only then could the full scope of the review be established.
11. In terms of the timeframe for the review, Unison's principle concern is that there is adequate time from start to finish to conduct an effective review that does not become rushed because of time constraints. While we believe that it would be worthwhile commencing the review shortly, we are not convinced that targeting the completion of the review by the end of December 2016 is feasible, or that the gas DPP resets should drive the timeframe for completion. The Commission should map out the process and related Part 4 work to ensure that consultation can take place in an orderly manner, with adequate time at each consultation step to enable considered responses. We would also strongly urge careful planning of the technical drafting and consultation stage, as this has sometimes proved insufficient to enable accurate translation of policy intent into technical drafting.
12. While we believe that an environmental scan needs to be completed prior to defining the full scope of the IM review, we consider that the list of items raised in paragraphs 31.2 to 31.6 of the Open Letter would likely be included in the final scope of the review. However, we are not persuaded that there is a need to put any material focus on considering a split cost of capital. As far as we are aware the introduction of a split cost of capital would be unprecedented and on MEUG's suggestion that a lower WACC could apply to sunk assets and a higher WACC to future investments would send a strong signal to investors of regulatory opportunism, which would be inimical to investment. In Unison's view, the Commission is not obliged to consider, in any detail, options which are so extreme that they could not possibly hope to satisfy the Part 4 objectives.
13. An area of the IMs that we also consider should be reviewed is the IRIS IMs. While we understand that the IRIS mechanisms are intended to ensure EDBs face time-constant incentives over the course of a regulatory period to improve efficiency, they exist because of the five-year regulatory period construct and focus on opex and capex separately. We have some concern that they may conflict with longer term incentives that EDBs should ideally face in ensuring efficient investment in their networks over time. Smart grid approaches typically involve significant opex to deliver systems that deliver savings in capex over a longer term. The IRIS mechanisms do not consider the interplay between capex and opex under smart grid approaches and may therefore create barriers to their introduction.
14. Once again, we appreciate the Commission's early engagement on the forthcoming IM review and would welcome further opportunities to discuss the process for the review.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Nathan Strong', written in a cursive style.

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE