

24/05/2013



John McLaren
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Dear John,

Response to open letter seeking feedback on DPP Reset Process

Opening comments

This letter represents Unison's response to the Commission's open letter of 23 April 2013, seeking feedback on the process followed to reset the DPP for electricity distributors. Unison has read and agrees with the comments submitted by the ENA. We have not repeated the views that we share with ENA, but focus on key issues for Unison.

Firstly, we appreciate the Commission taking the opportunity to actively seek feedback on the reset, and we suggest that the Commission continue to do so both formally and informally following major workstreams. Ideally, the closer to the workstream, the better, so that experiences are still fresh in our minds. We would also welcome any feedback that the Commission has for the industry or Unison specifically, so that we can enhance our interactions with you. As far as possible, our aim is to engage constructively with practical solutions or suggestions, and it would be useful to know if there are any aspects we could improve in that regard, or in any other areas.

Secondly, Unison also recognises that the first reset was characterised by unusual circumstances and all stakeholders would learn from the experience. Inevitably there was time pressure on the Commission and submitters as all aspects of the approach had to be developed, which perhaps means some of our comments below may be less applicable in future. Now that stakeholders are familiar with the core reset model used to establish the reset values and how the IMs are to apply, we think that this should lead to smoother processes in future. We would urge the Commission to adopt a high threshold to changing the presentation of the reset model. Where changes are made, it will be important to ensure that there is sufficient time for stakeholders to understand the nature of any changes and make staff available to explain them. We wish to acknowledge that we found the Commission Staff's presentation of the models very useful.

Areas for improvement

Unison's principle area of concern with the process for resetting the DPP was how the model inputs were developed and the Commission's communication of the rationale for adopting particular approaches. Our overall impression is that the Commission did not have a systematic

framework for developing key input variables such as operating expenditure, real revenue growth or input price inflation. We hold that impression because the Commission did not explain the application of such a framework in its draft or final decisions¹, and the development and justification for particular approaches outwardly appeared *ad hoc*, with no obvious (or at least communicated) effort made to assess the likely accuracy of any chosen forecasting approach.²

For example, with respect to forecasting operating expenditure, the Commission's objective was (or at least should have been something like) "to forecast the change in operating expenditure over the regulatory period", which was what the Commission had to use the model for. Once the reset process restarted following the Court-induced delays, the Commission's analysis appears to have very quickly focussed on an econometric model that explains the variation in operating expenditure in proportion to particular scale variables *across* EDBs, which was then refined through the consultation process.

But:

1. Why was this the preferred model, since it did not focus on measurement of changes in operating expenditure over time? The more obvious starting point for developing a model that seeks to explain changes in operating expenditure with respect to changes in scale would have been to use first differences, rather than absolute values. Did the Commission undertake such analysis?
2. What other models did the Commission consider and reject, and on what basis?
3. What checking was done to establish that the model would be effective in forecasting changes in opex over time, e.g., through in-sample forecasting?

At the end of the process, we were left with an impression that the Commission had developed a model which provided a satisfactory outcome, rather than a model which could be shown to provide the best prediction of future operating expenditure requirements, given data and modelling limitations. If Unison is wrong in forming these impressions then we would be delighted to receive from the Commission the outputs of a wider piece of analysis.

From a procedural perspective, we would like to see the Commission commit to a more rigorous and transparent process for developing its models, including making Commission Staff available to answer questions on the analysis done. Alternatively, the Commission could consider modelling work-shops, where Commission Staff, stakeholders and experts could debate the merits of particular approaches or develop an agenda for further analysis. At the end of the process, Unison submits that there should be high visibility that:

1. There were clear criteria that would apply to selecting the forecasts for use in the reset;
2. All reasonably available options for forecasting were considered and analysed;

¹ Setting aside the Quantitative Analysis Guideline on the Commission's website, which we are unsure was applied, or consistently applied.

² While there was extensive testing of the econometric model used to explain operating cost variation *across* the sector, as caused by scale differences, there was no obvious testing of how well the model performed in explaining variation in operating expenditure *over time*, which was what the model was used for.

3. The results of the analysis are transparent;
4. The criteria have been applied to determine the best available forecast.

By following such an approach, Unison submits that there would be increased investor confidence that the DPP reset approach would deliver rigorous outcomes within the confines of the DPP framework.

Unison also recommends that the Commission revisit the level of justification provided with its decisions, especially where they address non-trivial or contentious matters. For example, at paragraph J30 of the Final Decisions Paper, the Commission states with respect to the discount rate applied to claw-back:

We have decided that the cost of debt is a more appropriate discount rate than the cost of capital for the following reasons. This is because the cost of capital reflects the cost of equity, which in turn reflects exposure to systematic risk. However, there is no systematic risk associated with the recovery of the claw-back amounts. Conversely,...

But no explanation is provided by the Commission of why there is no systematic risk associated with recovering claw-back amounts, yet this was the very issue that was being debated in submissions. The Commission had received expert reports³ to the contrary that there is systematic risk involved in recovering claw-back amounts where they are recovered in the same way as general revenues, which is indeed how the claw-back amounts are being recovered.

A further example was the Commission's statement at paragraph 5.4.2:

Our modelling of operating expenditure and revenues relies on independent forecasts that are free of systematic bias in either direction.

This was a bold claim, with no ensuing explanation of how the Commission had reached this view, although we recall that submitters had requested that the Commission provide such explanations when commenting on the same statement in the Draft Determination. Unless the Commission can provide supporting information to substantiate such views, Unison submits that statements of this kind be omitted.

Of course, it may be the case that the Commission cannot anticipate where stakeholders would find it useful for the Commission to elaborate. Accordingly, Unison submits that the Commission consider a process (e.g., making Commission Staff or Commissioners available to answer questions following a draft decision or decision, or a further written Q&A process), where submitters could make reasonable requests for additional information. In light of the issue/example we have raised above, Unison would like to request a further elaboration by the Commission on why it considers claw-back amounts are not subject to systematic risk.

Our overall feedback is that there should not be any mystery as to how or why the Commission reached particular decisions. There is much to commend in the information that the Commission

³ E.g., from CEG (2012) *application of claw-back: A report for Vector* para 20

provided with its draft and final DPP decisions, and there was clear evidence of the Commission seeking to refine and improve its proposals, which we wish to acknowledge. However, we think the Commission can go a step further in increasing the rigor and transparency of its decisions, which would ultimately contribute to the long-term success of the Part 4 regime.

Closing comment

In closing, Unison hopes these comments are useful in helping develop the Commission's thinking about its processes and means of communication. As I noted in my introductory comments we would welcome feedback on anything we can do better in communicating with the Commission.

I would be happy to discuss Unison's feedback with you, if that would be of assistance.

Kind regards

A handwritten signature in black ink, appearing to read 'Nathan Strong' with a stylized flourish at the end.

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE