

10 April 2015

John McLaren
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By email: regulation.branch@comcom.govt.nz

Dear John,

UNISON RESPONSE TO OPEN LETTER ON FEEDBACK ON PROCESS FOR RESETTING DEFAULT PRICE-QUALITY PATHS FOR ELECTRICITY DISTRIBUTORS

Opening comment

1. The Commerce Commission (Commission) released an open letter¹ to interested parties seeking feedback on process for resetting default price-quality paths for electricity distributors.
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 strongly support the Commission seeking feedback on key processes to ensure that lessons can be incorporated in future processes. We also agree with the Commission's assessment that a number of improvements were made in the second DPP reset that generally made the process smoother, including (and especially) the use of technical working groups.
4. Unison submits that there are three areas where improvements in the process could be achieved:
 - a) While we appreciated the early release of the financial model and its consistency (albeit in different form) with what had been used in the 2013 reset, we were surprised with the release of so many supporting models, which took considerable time to assess and to understand their impacts in affecting the principle financial model. We recommend that, as far as possible, the Commission retain the model structure used in the 2015 reset and

¹ Commerce Commission, *Feedback on process for resetting default price-quality paths for electricity distributors*, 27 February 2015

clearly explain any changes made. Supporting models should also be released with early versions of the main financial model;

- b) Ensuring that the process is long enough to allow for adequate responses. Our experience was that over-lapping consultation, with the simultaneous WACC percentile review and IRIS IMs, meant that we were not confident that we fully understood all the issues, resulting in a focus on what we perceived to be material matters. While we supported the improvements being sought in this DPP reset, including significant changes to the quality framework, IRIS and energy efficiency incentives, in retrospect, this put too much pressure on the consultation process. We recommend that in future resets, the Commission should ensure that there is sufficient time to allow for meaningful consultation on all aspects of the decision; and
 - c) Of critical concern to Unison is that the DPP reset has *increased* uncertainty about outcomes from future resets because the Commission's decision-making framework and criteria are not transparent. We elaborate on this point further in the paragraphs below.
5. In making its decisions on the IM appeals, the High Court emphasized that certainty would not be achieved at an absolute point in time, but would be achieved over time with the collective weight of the Commission's IM decisions and when price paths were set and reset. Unison accepted at the time of the 2013 reset that there was inevitably limited time and information on which to make the initial reset decisions, but that this should improve in future resets. We expected to see more rigour in the analysis and a clearer decision-making framework in the second reset. In our feedback on the 2013 reset we stated:

“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 decisions², 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.³

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:

² Setting aside the Quantitative Analysis Guideline on the Commission's website, which we are unsure was applied, or consistently applied.

³ 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.

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.

...

“At the end of the process, Unison submits that there should be high visibility that:

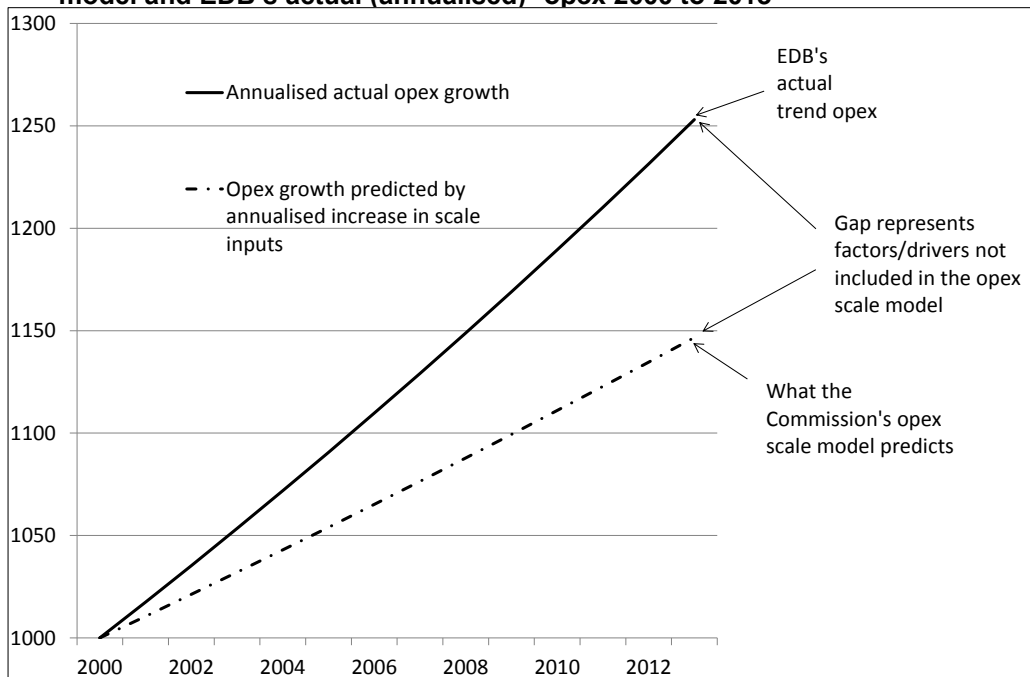
1. There were clear criteria that would apply to selecting the forecasts for use in the reset;
2. All reasonably available options for forecasting were considered and analysed;
3. The results of the analysis are transparent;
4. The criteria have been applied to determine the best available forecast.

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.”⁴

6. Unison remains concerned that these recommendations were not followed in developing critical elements of the reset forecasts.
7. One of Unison’s key submissions on the 2015 draft reset decision was that the model for forecasting opex, based on the use of scale drivers performed very poorly in explaining past changes in operating expenditure. We demonstrated, quite powerfully we thought, that the scale models systematically under-estimate changes in operating expenditure and that there would therefore need to be compensating mechanisms to address the wedge between the forecasting model and actual changes in opex observed over time.
8. The significant variance between the opex forecasting model and actual sector-wide changes in opex was demonstrated in the following figure:

⁴ Unison (2013) Letter to John McLaren *Response to open letter seeking feedback on DPP Reset Process*, 24 May

Figure 5: Gap between (annualised) opex predicted by Commission's scale adjustment model and EDB's actual (annualised)⁵ opex 2000 to 2013⁶



9. What concerns Unison from a process perspective is that this empirical evidence presented was not obviously addressed in the Commission's final decision. While the Commission may not be able to address every single point raised in every submission, forecasting accuracy of the opex forecasting model is critical to the Commission's reset decisions, so we would have expected the Commission to analyse these findings and either modify the approach or produce further evidence to support the model's use. While the Commission engaged Professor Jeff Borland to critique its econometric models, his analysis seemed to focus on the performance of the models from a statistical point of view – did the model fit the cross-section data? – rather than assess whether the model was fit for purpose as a forecasting model.

10. Unison's empirical analysis of the opex forecasting model had important implications for the interpretation of the "productivity" analysis conducted by EI and PEG, both of whom calculated negative rates of "opex partial productivity growth" for EDBs over extended periods. As Unison highlighted in its submission, in our view these negative rates of partial opex productivity growth were likely to be an indicator of the fact that the productivity models are poorly specified and fail to account for other, non-scale factors systematically driving increases in costs (or that our outputs are far more complex than just ICPs served and MVA-kms or circuit length). The Commission ultimately appears to have set aside the empirical analysis of trends in "productivity" (or whatever it is really measuring) in adopting the much smaller -0.25% partial productivity growth factor. But in light of these severe deficiencies in the opex forecasting models, it was important that the Commission not discard the trend analysis, without undertaking an explicit analysis of what factors might be driving the results and whether or not those factors would continue to drive trends.

⁵ For convenience, we have used the annual average change in scale variables and opex to show the results. The same end-point would be reached if we used the actual year on year variances.

⁶ Source data is from EI's Productivity Study and Commerce Commission network and non-network scale elasticities.

11. Unison's key point is not to relitigate the rights and wrongs of the opex forecasts, but highlight that from a stakeholder perspective the process has left us with:
 - a) Significant unaddressed concerns that the Commission has adopted an opex forecasting model and assumption for opex partial productivity growth that have not been robustly justified, and yet seem to us to have clear deficiencies. This does not provide us confidence or certainty about future reset processes and the rigor of analysis underpinning crucial and complex decisions. If models cannot adequately the past, how can the Commission or stakeholders have confidence that the models will be accurate predictors of the future; and
 - b) Uncertainty about the Commission's decision-making process, because there were no clearly stated criteria or principles expressed for when empirical analysis would be set aside for "regulatory judgement," nor is there transparency around how "regulatory judgement" is exercised – numbers cannot simply come out of the air, based on unspecified qualitative considerations. It was concerning that in the Process and Issues Paper⁷ the Commission indicated that any recent decline in partial productivity would likely be seen as temporary. However, the analysis indicated that partial productivity decline has been a persistent trend since the early 2000's after structural separation of lines and energy. From a process perspective the Commission did not consult on or provide any evidence to under-pin a departure from trend. In that light, we are left with an uncomfortable impression that the Commission found the results of the empirical analysis incompatible with a pre-conceived view of productivity growth, and selected a value that it preferred. We would be delighted to receive additional information from the Commission that demonstrates a more thorough process was undertaken than is presented in the Commission's final reasons.
12. The Commission does a very good job of plainly presenting *what* the decisions are, and the models that have been used to arrive at the decisions, but we continue to hold that significant improvements need to be made in explaining in detail the basis for some of its decisions. Unison submits that certainty and confidence would only be built as much by transparent documentation of *how and why* decisions have been reached, particularly for complex, contentious and material components of the building blocks models.
13. While we do hold concerns that the Commission's decisions do not contain enough reasoning, we would not want those comments to detract from endorsement that the Commission:
 - a) clearly put significant effort into engaging with stakeholders;
 - b) presented its decisions in an accessible manner to a range of stakeholders; and
 - c) made improvements to the wider framework to promote consumers interests' in incentivising quality improvements and having incentives to pursue energy efficiency.
14. We think the Commission has laid a good platform for ongoing improvements to DPP resets and look forward to engaging on developments in the inter-reset period. I trust that these comments are helpful in informing future reset processes.

⁷ Commerce Commission (2014) *Default price-quality paths from 1 April 2015 for 17 electricity distributors: Process and issues paper*, p17

Yours sincerely

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

Nathan Strong

GENERAL MANAGER BUSINESS ASSURANCE