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### **Submission on Starting Price Adjustment Update Paper – industry-wide assumptions**

1. Vector welcomes the opportunity to provide this submission on the industry-wide assumptions section of the Commerce Commission's ("the Commission") consultation paper *2010-15 DPP Starting Price Adjustments and Other Amendments Update Paper* ("Update Paper").
2. We also attach a report by CEG (*Industry-wide forecasts and default price paths*), which highlights two issues with the Commission's starting price adjustment model. We recommend that the solutions put forward by CEG are implemented by the Commission.
3. As discussed in our previous submission, section 54K(3) of the Commerce Act 1986 ("the Act") permits the Commission to re-set the DPP to account for the new input methodologies only to the extent required by the input methodologies had they applied in April 2010. In Vector's view, the input methodologies do not permit the Commission to adjust the starting price. This submission, which contemplates the use of forecasts for making a starting price adjustment, is without prejudice to that view.
4. In our previous submission<sup>1</sup>, Vector commented on the Commission's proposed starting price adjustment ("SPA") methodology and put forward our own proposed alternative methodology. However, we did not comment in detail on the use of industry-wide forecasts or the forecasts chosen by the

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<sup>1</sup> *Vector Submission on 2010-15 DPP Starting Price Adjustment and Other Amendments Update Paper*, 16 May 2011.

Commission. This submission comments on the Commission's forecasting approach.

### *Regulatory framework*

5. The Commission proposes to make starting price adjustments as provided by section 53P of the Act. Section 53P provides that
  - (3) The starting prices must be either–
    - (a) the prices that applied at the end of the previous regulatory period; or
    - (b) prices, determined by the Commission, that are based on the current and projected profitability of each supplier.
6. The Commission clearly intends to set starting prices under section 53P(3)(b) and its SPA model is an attempt to set prices based on the current and projected profitability of each supplier.
7. Vector notes the reference in section 53P(3)(b) to "each supplier". This could be interpreted to mean that the Commission should use supplier-specific information to set starting prices for each EDB and avoid the use of industry-wide assumptions.
8. However, we consider that this is an unduly narrow interpretation of the section given the wider context of the Act and, in particular, default/customised price-quality regulation. Section 53K provides that:

The purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.
9. The difficulty that the Commission faces in setting supplier-specific forecasts arises from inherent asymmetry in access to information – i.e. the electricity distribution business ("EDB") will generally have better information about its business than the Commission. If the Commission were to adopt an EDB-specific approach to assessing the current and projected profitability of each supplier, the Commission would be likely to need substantial amounts of information from each EDB in order to develop robust forecasts.
10. Even if the Commission did not require additional information, EDBs would be likely to seek to provide additional firm-specific information to the Commission to build a case for a different starting price adjustment. The Commission would then need to evaluate and verify the information (and in particular consider if any other information should be required to balance the information pro-actively provided).

11. We consider that the likely investigation and analysis that would be necessary in such an approach would be comparable to a CPP application and inconsistent with a low-cost DPP.
12. Vector considers that the Commission's approach of forecasting the projected profitability of each supplier based on industry-wide assumptions is an appropriate element in determining appropriate starting prices in the context of the legislative directions regarding relatively low-cost regulation. However, as stated in our previous submission, we believe that there must also be a mechanism to cater for the inherent errors in any industry-wide forecasts in that such forecasts:
  - will not be reliable forecasts of industry-wide performance; and
  - will not be reliable forecasts of EDB specific performance.
13. Furthermore, any approach to determining appropriate starting prices must have regard to the purpose statement in section 52A and, in particular, to the need to incentivise investment through an ex ante expectation of earning at least the regulatory cost of capital.

*Commission's proposed approach*

14. In the Update Paper, the Commission's proposed SPA Methodology involves forecasting EDBs' costs and revenues over the regulatory period by applying assumptions in respect of movements in real revenue growth, operating expenditure and capital expenditure.<sup>2</sup>
15. As noted above, Vector supports the Commission's attempt to derive a low-cost method of forecasting the projected profitability of EDBs by means of industry-wide forecasts.
16. However, the Commission's proposed methods for deriving industry-wide assumptions are insufficiently robust. They appear to be arbitrarily chosen, with weak linkages between the proxies being used (for revenue and opex growth) and based on an unstable data-set.
17. Fundamentally, the Commission's data does not demonstrate that the relationship between the proxies and the forecast metric are clear or stable over time.
18. The Commission should therefore take a cautious approach to making and placing reliance on these forecasts. A band mechanism, as proposed by

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<sup>2</sup> The Commission also uses an assumed forecast of CPI growth. Vector's comments on the Commission's CPI forecasts were set out in our submission of 16 May 2011 and we will not repeat those points here.

Vector and others in previous submissions on the Update Paper, is one way of addressing the uncertainty in the forecasts.

19. We note that, in the Update Paper, the Commission advises that it intends to further develop the forecasting assumptions. We welcome this commitment. However, if the Commission plans to develop a different set of forecasting assumptions, stakeholders must be given an opportunity to review and comment on the further refinements before the draft decision stage. Further, for reasons provided, while we support further development of forecasting assumptions, this in itself will not remove the need for a mechanism to cater for the errors inherent in any forecasting information.

#### *Sources of information*

20. The Commission's industry-wide assumptions were developed using historical trend information, independent forecasts and, for capital expenditure, forecasts taken from the Asset Management Plans of non-exempt EDBs. Sources of information utilised by the Commission were data from Statistics New Zealand and the Reserve Bank of New Zealand as well as data set out in a review of total factor productivity of the New Zealand electricity distribution sector by Economic Insights.
21. Vector considers that the sources of information used by the Commission are appropriate. We welcome the Commission's reliance on already-available information as this is in line with the low-cost nature of a DPP. However, greater reliance could, for example, be placed on Asset Management Plans of EDBs.

#### *Real revenue growth forecasts*

22. For real revenue growth, the Commission considered historical trends of real revenue growth as shown by Economic Insights. However, the Commission noted that real revenue growth over the 2010-15 regulatory period may differ from historically observed trends. Vector agrees with the Commission that this is plausible as the effects of the global financial crisis are still being felt and New Zealand's economic performance has yet to recover to the growth rates of the past decade.
23. The Commission proposes to forecast real revenue growth as the forecast GDP growth minus 1% (which the Commission considers is the historical average difference between EDB total output and GDP). Vector is not convinced by this approach.
24. In our view, the relationship between revenue growth and GDP seems highly sensitive to the choice of base year. Depending on the time series chosen, the difference could be 0.6%, 0.1% or -0.5%. In addition, real GDP

contracted during the recent recession but total output growth continued along essentially the same trend as previously.

#### *Operational expenditure growth forecasts*

25. For operational expenditure, the Commission chose to set an opex forecast as equal to the sum of the industry-wide real revenue growth forecast and the economy-wide CPI forecast.
26. Vector considers that the assumption that there is a close relationship between total output and opex is fairly tenuous. The concerns raised above regarding the real revenue growth forecast also apply here.
27. We consider the alternative approach considered by the Commission of using an opex price assumption based on the labour cost growth for the electricity, gas and water (EGW) sector of the economy may have greater merit.
28. Alternatively, the Commission could make use of the forecast maintenance costs as set out in EDB Asset Management Plans, in a similar manner to its proposal to make use of Asset Management Plans when setting capex forecasts. However, if the Commission did rely on this it would need to be mindful of the comments we make below that Asset Management Plan forecasts tend to become increasingly under-stated as they project further forward due to the difficulties of forecasting expected future expenditure.

#### *Capital expenditure growth forecasts*

29. For capital expenditure, the Commission proposes to take the average forecasts of capital expenditure from the Asset Management Plans of all non-exempt EDBs as the industry-wide forecast for all EDBs.
30. Vector considers that this is appropriate. Reliance on each EDB's individual capital expenditure forecast would create unfortunate incentives for EDBs that should be avoided. However, the way this has been applied creates notable concerns. These are discussed below.
31. Firstly, the Commission is using real capex forecasts to derive a nominal capex growth rate. EDB Asset Management Plans include capex forecasts in real terms, which is consistent with the 2008 Information Disclosure Requirements. The capex growth rate derived from this data is applied as a nominal growth rate in the Commission's SPA Model. It does not take into account capex price inflation and, as a result, is understated.
32. Importantly, capex forecasts decline over time due to the difficulty of forecasting projects in future periods. The likelihood of future forecasts being too low is not necessarily a problem for EDB planning because Asset Management Plans are updated on a regular basis. However, in this context it is problematic as the current forecast will underestimate the capex trend to

2015. It would be even more of a problem in future resets where the forecasts will need to be applied to a full five year regulatory period.

*Section 54(K(3))*

33. Finally, for clarification Vector makes the following further comments in relation to the application of section 54K(3). These comments should be read together with Vector's submission of 16 May 2011.
34. As Vector has submitted, section 54K(4) enables changes to the DPP only to the extent required by the input methodologies that are subsequently published. Vector notes that the published input methodologies, if applied, could result in various changes to the DPP (either the price path of other aspects of the DPP determinations). The Commission has set out list of such amendments in Table 4 of its Update Paper. In relation to this Table, other than the proposed CPI adjustment for the increase in GST, Vector submits that:
- it is not apparent that any of the proposed changes, if applied at April 2010 would have been material;
  - even if they had been material, the DPP may only be amended to the extent of the change; and
  - the position remains that none of the changes referred to would have resulted in a different starting price (unless the SPA methodology is retrospectively applied), that is, adjustment of the starting price is not permitted under section 54K(3).

*Contact details*

35. Thank-you for considering this submission. If you require further information please contact me on 09 978 8340 or at [allan.carvell@vector.co.nz](mailto:allan.carvell@vector.co.nz).

Yours sincerely,



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