



**Submission to Commerce Commission on
2010-15 DPP Starting Price Adjustment
and Other Amendments Update Paper**

16 May 2011

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INTRODUCTION

1. Vector welcomes the opportunity to provide this submission to the Commerce Commission ("**Commission**") on the Update Paper *2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments* ("**Update Paper**").
2. On 21 April 2011, the Commission specified an amended process for responding to the Update Paper with submissions on all parts of the Update Paper for except industry-wide assumptions due on 16 May 2011 and submissions on industry wide assumptions due on 23 May 2011.
3. This is Vector's first submission of the consultation process, addressing all issues other than industry-wide assumptions. We will provide further submissions in line with the rest of the process.
4. Vector's contact person for this submission is:

Allan Carvell
Group General Manager Regulation and Pricing
Tel: 09 978 8340
Email: allan.carvell@vector.co.nz

STRUCTURE OF SUBMISSION

5. In this submission:
 - (a) Part A refers to the requirement of section 54K(3) and the reasons why it is not open to the Commission to adjust the starting price under this section on the basis of the published input methodologies.
 - (b) Part B:
 - i. assesses the Commission's proposal against the legal requirements and sets out why, in Vector's view, the Commission's proposed SPA methodology is not consistent with the legal requirements and / or is based on incorrect assumptions; and
 - ii. identifies other issues in the Commission's approach, for example, in relation to undue model sensitivity.
 - (c) Part C set outs Vector's alternative proposes approaches to the Commission's SPA methodology.
 - (d) Part D addresses other matter (including the basis for and likely the impact of claw-back).

EXECUTIVE SUMMARY

6. As a first matter, Vector submits that the Commission is not permitted to make a starting price adjustment under section 54K(3). Any change to the DPP must be limited to changes that would have occurred had the input methodologies been in place as at 1 April 2010. In the current circumstances, section 54K(3) permits the Commission to amend only the CPI component of the current default price quality path set on 1 April 2010 ("**1 April DPP**").
7. Without prejudice to this position, Vector submits that the Commission's proposed methodology for determining starting price adjustments ("**SPA methodology**") is inconsistent with the Part 4 Purpose and the purpose of default / customised price-quality path ("**DPP / CPP**") regulation.
8. Under section 52P(3)(b) the Commission is required to adjust starting prices on the basis of current and projected profitability. However, the information that informs this assessment is inherently highly susceptible to error. Specifically, under the Commission's proposed approach this information is:
 - (a) based on limited data series and is not statistically robust; and
 - (b) not reflective of individual Electricity Distribution Business ("**EDB**") circumstances (it is based on industry or economy wide data).
9. The Commission initially addressed this uncertainty by way of an ROI band approach. The Commission has now abandoned that approach in favour of a SPA methodology that makes no allowance for regulatory error.
10. In relation to the Commission's revised approach, Vector agrees with the greater emphasis on projected profitability. Vector also agrees that the issue of EDBs moving away from an ROI point over time (due to their initial circumstances) needs to be addressed. However, Vector submits that the Commission has erred in failing to make any allowance for regulatory error, relying instead on the CPP mechanism.
11. The Commission's revised position is largely based on its assumption that the CPP is low-cost for suppliers and can and will be used by suppliers as an error correction mechanism. Vector submits that this reasoning is fundamentally flawed. Specifically, the Commission's reasoning takes no account of the fact that:
 - (a) EDBs will be put to significant cost when applying for a CPP (the Commission has misunderstood the nature of EDB information and processes required when preparing for a CPP);

- (b) EDBs face considerable risks when applying for a CPP and, in reality, will be reluctant to apply;
 - (c) EDBs will be exposed to the risk of a lower WACC under a CPP;
 - (d) without allowance for error correction, at least ½ of the EDBs will likely need to apply for a CPP in order to earn a normal rate of return;
 - (e) many of these suppliers will remain on suboptimal DPP (given the risks and costs associated with a CPP); and
 - (f) the potential long term impact on consumers of suppliers remaining on control terms that are too tough is likely to be greater than any negative impact arising from alternatives such as a band approach.
12. Vector notes that the Commission suggests the 75th percentile for WACC accounts for uncertainty when adjusting starting prices (because it is biased towards suppliers). Vector strongly disagrees. The 75th percentile is intended to address WACC model error and cannot be credibly used to address error in the information used in the starting price adjustment process.
 13. In short, neither the CPP nor the 75th percentile provide appropriate or effective error correction mechanisms. This means that, in effect, the Commission's proposed SPA methodology assumes the industry-wide forecasts are perfect and makes no allowance for forecast error.
 14. Further, CPPs were primarily intended to provide a mechanism for enabling abnormal investment. In Vector's view it is not credible for the Commission to now suggest, contrary to its position in December 2010, that Parliament intended CPPs to address run of the mill forecast errors (noting that the policy material underlying the Act provides no support for the Commission's position).
 15. Vector submits that the Commission's approach is, therefore, clearly contrary to the Part 4 purpose statement (including the long term interests of consumers) and the intended operation of the DPP / CPP framework. As the Commission has previously acknowledged, the long term consequences of setting control terms too low are more severe than the consequences of setting control terms that are too high (and therefore dynamic efficiency should always be favoured). Further, contrary to incentives to invest, the Commission's approach fails to provide suppliers with an expectation of earning at least normal returns over the regulatory period (the Commission's focus being on eliminating rather than limiting excess profits).
 16. Vector is also concerned that aspects of the Commission's approach do not address model sensitivity or promote price stability.

Recommendations

17. Vector first submits that the Commission should amend only the CPI component of the 1 April DPP in accordance with the requirements of section 54K(3).
18. Without prejudice to this position, Vector submits that the Commission should elect to maintain current starting prices under section 53P(3)(a). Vector considers this would be the most stable and least disruptive option, given that only a portion of the first regulatory period remains and given the legal challenges currently underway.
19. If this is not agreed, Vector proposes an alternative SPA methodology which Vector submits is consistent with Part 4 and based on a sound analysis. This proposal combines elements of the ROI-band and industry-wide forecasting approaches into a SPA methodology that avoids the downside of the previous approaches. Under this approach there is less risk of a starting price adjustment being unsuitable and of suppliers being forced to apply for a CPP and / or remaining on a suboptimal DPP. Most importantly, it promotes dynamic efficiency and minimises the risk of under-investment.
20. A summary of Vector's proposed SPA methodology is set out below.
 - (a) Vector's proposed SPA methodology would rely on:
 - i. the most recently reported actual results restated to reflect the input methodologies, i.e. 2010 disclosed information updated in line with the Commission's information request;
 - ii. the Commission's industry average forecast approach and the assessment of suppliers' initial conditions to provide a representation of forecast profitability over the regulatory period; and
 - iii. the Constant Level model as developed by Thomson and van Zijl (with any necessary modifications suggested by Economic Insights) to establish a starting point for EDBs.
 - (b) Vector's recommended approach is to use these data to set an ROI-band with the lower limit at the 75th percentile WACC estimate and the upper limit at 2 standard deviations (using the Thomson and van Zijl Constant Level statistical approach) above the 75th percentile WACC estimate. This would place the upper control limit at 0.84% above the 75th percentile WACC estimate (i.e. 9.61%).
 - (c) Vector's recommended approach is to then make starting price adjustments for EDBs to ensure that their ROI does not exceed the

top of the band or fall below the bottom of the band on the basis of the EDBs' projected profitability slope.

- (d) The result of this approach will be that the ROIs of all non-exempt EDBs will remain within the band throughout the regulatory period (with limited exceptions).
- (e) Importantly, this approach provides for an *ex ante* expectation for all EDBs that they will earn at least the regulatory WACC.
- (f) Vector's recommended band is asymmetric to reflect the greater social costs of setting price paths too low. We note that it is smaller than the 1-1.25% band previously proposed by the Commission.

Other matters

21. Vector makes the following recommendations in relation to other matters addressed in the Update Paper:

- (a) *Claw-back*: The Commission should not apply claw-back to any perceived over recovery of revenues in the 2010/11 and 2011/12 regulatory years. This would be consistent with suppliers' incentives to invest during 2012-2015, and would avoid retrospectively penalising past pricing decisions.
- (b) *Alternative rates of change*: The Commission should permit EDBs to demonstrate financial hardship across their group operations. This would reflect the way in which firms with multiple business units operate.
- (c) *Price path compliance formula*: The Commission should adopt a 3 year (rather than 5 year) NPV equivalent approach to starting price adjustments.
- (d) *Other amendments to the 2010 - 2015 DPP*: Vector supports the Commission's proposed *ex post* process for approving avoided transmission costs, provided that the only evidence required will be evidence of the value of the avoided transmission investment. Vector assumes that this proposal also applies to new investment contracts.
- (e) *Actual revenue impacts not clear*: Vector requests that the Commission provide a worked example demonstrating how the SPA model outputs would be translated into a price path adjustment for an EDB. This is necessary for EDBs to determine the likely impact of the starting price adjustment approach.

PART A: DPP RESET UNDER SECTION 54K(3)

Overview

22. The Commission is required to set starting prices for default price paths to apply to non-exempt EDBs at the commencement of each regulatory period. Section 53P(3) requires the Commission to either use the prices that applied at the end of the preceding regulatory period (section 53P(3)(a)) or to determine starting prices that are based on the current and projected profitability of each supplier (section 53P(3)(b)). Adjusting prices under section 53P(3)(b) requires the Commission to develop and then apply a starting price adjustment methodology ("**SPA methodology**").
23. The Commission elected to set starting prices for the regulatory period commencing on 1 April 2010 by adopting the prices that applied at the end of the preceding regulatory period (i.e. under section 53P(3)(a)).
24. The Commission may reset the DPP before the end of the current regulatory period under 54K(3) if, had a published input methodology applied in 1 April 2010 when the DPP was reset, it would have resulted in a materially different path being set ("**section 54K(3) test**").
25. In this section Vector:
 - (a) sets out the requirements of the section 54K(3) test; and
 - (b) explains why the Commission's proposal to adjust starting prices under section 54K(3) is unlawful and not permitted under the Act.

Section 54K(3) test

26. A key objective of the Part 4 reforms was to improve regulatory certainty. To achieve certainty, DPPs are expected to remain in place for the duration of a regulatory period. While a section 52P determination can be amended following consultation, the limited circumstances in which a DPP determination can be re-opened are set out in the published input methodologies (noting that relevant input methodologies must be applied to DPP regulation under section 52S).
27. In relation to the 1 April 2010 DPP reset, there was a likelihood that the reset would happen in advance of the publication of the input methodologies. Parliament addressed this timing issue in section 54K(3). However, rather than include a provision that simply enabled the Commission to reset the DPP in accordance with section 53P(3), limited circumstances for revisiting the 1 April 2010 DPP were carefully prescribed. Specifically, section 54K(3) provides that:

(3) If an input methodology is published after 1 April 2010 and if, had that methodology applied at the time the default price-quality paths were reset as required by subsection (1), it would have resulted in a materially different path being set, then the Commission may reset the default price-quality paths in accordance with section 53P and may apply claw-back, despite section 53ZB(1).

28. Key features of the section 54K(3) test are as follows:

- (a) The section enables input methodologies that apply to DPP regulation to be applied retrospectively, as at 1 April 2010. This is an express departure from the general principle against retrospectivity and, in this context, the limits prescribed by Parliament must be given proper effect.
- (b) Importantly, the section enables the retrospective application of input methodologies only. It is not open to the Commission to use this section to retrospectively apply rules and processes determined after 1 April 2010 but which are not input methodologies.
- (c) The test is objective and must be determined as a matter of fact, that is, Parliament did not provide for a reset on the basis the Commission "is satisfied" or "considers" that a materially different price path "is likely to" result. The test requires an assessment to be made to determine the price path that would have applied had the relevant input methodologies applied as at 1 April 2010. It is only by determining this price path that an assessment can be made of whether or not the price path would have been materially different.
- (d) If the test is satisfied in relation to a specific input methodology, the DPP should be reset only to the extent that that input methodology would have resulted in a material change. It would undermine the intended limits in section 54K(3) if one change in relation to say, CPI (which relates to rates of change only), enabled the Commission to then implement unrelated adjustments to starting prices which would not have been made if the input methodologies had applied as at 1 April 2010.¹
- (e) Section 54K(3) requires that the reset of the DPP is "in accordance with section 53P". This means only that the Commission must comply with the requirements in section 53P to the extent relevant to the reset being undertaken. For example, if only rates of change were

¹ Also see section 53ZB which is similarly worded. Specifically, section 53ZB provides that the Commission must reset the DPP in accordance with section 53P where an input methodology changes on appeal and where, had that input methodology applied at the time the DPP was set, a materially different price-quality path would have been set. This section is clearly intended to limit the extent of any change to the extent it is required by the new input methodology.

materially affected by a retrospective application of the input methodologies, this must be in accordance with section 53P(5) - (7). The Commission would also be required to consult with interested parties (section 53P(2)) in relation to the proposed change.

Adjustment of the starting prices not permitted under section 53K(3)

29. In the Update Paper the Commission states that the published input methodologies would have resulted in a materially different path being set.² Accordingly, it intends to proceed with the reset under section 54K(3) including adjusting starting prices.
30. However, the only input methodology that may have resulted in a materially different path had it applied as at 1 April 2010 is the Commission's rules and processes input methodology (specification of price) which excludes the increase in the CPI resulting from the October 2010 goods and services tax (GST) increase.³
31. The other input methodologies, as a matter of fact, would not have resulted in a materially different price path as at 1 April 2010. In particular, they would not have resulted in any change to the starting price. This is because:
 - (a) the Commission had no process in place as at 1 April 2010 for determining adjustments to price paths. A method for resetting thresholds under the previous regime was never finally determined, nor was it applicable given the Commission must adjust prices on the basis of current and future profitability;
 - (b) the SPA starting price methodology has not been determined as an input methodology and cannot therefore be retrospectively applied under section 54K(3); and
 - (c) the published input methodologies, such as asset valuation and the weighted cost of capital, do not give any indication about how or whether a different price path would have applied in 2011.
32. It is notable that the Commission has not explained how input methodologies other than the adjustment to the CPI would result in a materially different price path. Rather, the Commission notes that the changes cannot be fully quantified until EDBs have completed the information requests but that it "expects" that the changes to some price-quality paths resulting from the input methodologies "are likely to be"

² Commerce Commission, *2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments: Update Paper*, April 2011, para 1.11.

³ Even then it is questionable whether the Commission can seek to retrospectively apply a change based on an event not envisaged as at 1 April 2010. Vector also questions whether it was appropriate to include this CPI adjustment in an input methodology rather than as a change to the DPP determination at the next reset.

material (1.12). The problem remains that this analysis can only be undertaken by the Commission seeking to retrospectively apply its SPA methodology.

33. Further, the Commission considers that the change to the CPI in itself enables it to adjust the starting price by backdating its SPA methodology. As set out above, in Vector's view, this is beyond the intended scope of section 54K(3) and is unlawful. Section 54K(3) was not intended to trigger a wholesale reset of the DPP unless the retrospective application of the input methodologies required this.
34. The fact that the SPA methodology rather than the input methodologies are driving material changes to the price paths is demonstrated by the very different outcomes resulting from the two SPA methodologies proposed by the Commission to date. Under the ROI band approach, many EDBs would have seen no price change at all. Conversely, under the industry-wide average forecasting approach most EDBs will face a price change and those EDBs that would have faced a price change will face a larger price change.
35. Vector agrees with the ENA submission where it notes that:
 - (a) the section 54K(3) test envisaged a repopulation of an existing starting price adjustment model using the input methodologies only (Vector notes also that a SPA methodology could be retrospectively applied if it had been properly developed as an input methodology); and
 - (b) the Commission's approach, however, provides the Commission with a wide discretion to construct a model and backdate its application to the initial reset. This is particularly problematic in the context of a provision which gives the Commission the power to apply claw-back to excessive profits as measured by the price path that would have been set had the input methodologies applied.

Recommendation

36. On the basis of the above, Vector submits it would be unlawful for the Commission to seek to reset the DPP under section 54K(3) other than in relation to the identified CPI adjustment (which does not concern starting price adjustments).

PART B: ASSESSMENT OF THE COMMISSION'S SPA METHODOLOGY

Overview

37. In this section Vector first summarises the Commission's proposed approach.
38. Vector next explains why, in its view, the Commission's failure to make allowance for uncertainty and error in its revised SPA methodology is contrary to the relevant statutory requirements. Specifically:
- (a) in relation to Part 4 purpose, the Commission's approach:
 - i. does not promote long term benefits for consumers;
 - ii. does not promote incentives to invest; and
 - iii. misapplies section 52A(1)(d) which expressly refers to limiting rather than removing excess profits;
 - (b) in relation to section 53K and the intended operation of the DPP / CPP framework, the Commission's position:
 - i. is based on incorrect assumptions regarding the likely cost of a CPP for suppliers and the cost and benefits for consumers;
 - ii. takes no account of the risks faced by EDBs in applying for a CPP; and
 - iii. takes no account of the significant risk that suppliers will remain on a suboptimal DPP.
 - (c) in relation to allowance for regulatory error:
 - i. assessment of current and future profitability is inherently inaccurate and must be catered for; and
 - ii. the 75th percentile estimate for WACC does not address error.
39. In relation to section 53P(3), Vector points to the requirements of 53P(4) should the Commission seek to apply claw-back over more than one statutory period.
40. Finally, Vector outlines aspects of the Commission's approach which Vector considers are inconsistent with best regulatory practice / certainty (in relation to, for example, model sensitivity and price instability).
41. Vector's submissions are without prejudice to Vector's view that the SPA methodology cannot be applied to the 1 April 2010 DPP.

Summary of the Commission's proposed SPA methodology

42. The Commission has abandoned its earlier proposed SPA methodology (first signalled in June 2009 and developed into a formal proposal in August 2010) of a SPA methodology that used historical data to forecast future returns on investment and which included a band around the 75th percentile WACC point estimate to address uncertainty in the forecasts.
43. The Commission now proposes a SPA methodology that makes no allowance for corrections of forecasting error. The Commission considers an allowance for uncertainty is not required because suppliers can apply for a CPP.
44. The Commission considers that its SPA methodology meets the low cost purpose of DPP / CPP regulation because the CPP will be largely costless to suppliers (the cost will be passed through to consumers) and that the benefits to consumers resulting from a CPP will outweigh the likely costs.
45. The Commission suggests that a band approach would be generous to all EDBs but costly to consumers (notwithstanding it promoted a band approach in its previous papers). By way of demonstration it states that a one percent increase in ROI is equivalent to \$20.7 million increase in opex for Vector.
46. The Commission's new proposal starts with current ROI (using one year's data) and forecasts it forward based on a series of assumptions. More specifically, the Commission's proposed SPA methodology involves the following stages:
 - (a) Each EDB's initial conditions are estimated using data from a single disclosure year (2009/10), including each EDB's return on investment and assets commissioned during the year.
 - (b) Industry-wide forecast estimates of revenue growth, opex growth and capex growth to the end of the regulatory period are developed.
 - (c) An economy-wide forecast estimate of CPI is developed.
 - (d) These industry-wide forecasts and the CPI forecast are applied to the initial conditions of each EDB to develop a forecast of each EDB's business over the regulatory period.
 - (e) The methodology then identifies the necessary changes to the prices of each EDB in order for each EDB's forecast rate of return over the regulatory period to equal the Commission's estimate of WACC.
47. If any EDB finds that, due to their actual circumstances differing from the industry-wide forecasts, the EDB is not achieving at least a normal rate of

return under the Commission's approach, that EDB is expected to seek to achieve efficiency gains and/or apply for a CPP.

Commission's approach must be consistent with Part 4 purpose

Requirements of Part 4

48. The SPA methodology must be consistent with the purpose of Part 4 (section 52A). This requires the Commission to promote the long-term benefit of consumers by promoting outcomes that are consistent with workably competitive markets such that suppliers:
- (a) have incentives to innovate and invest;
 - (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands;
 - (c) share with consumers the benefits of efficiency gains; and
 - (d) are limited in their ability to extract excessive profits.
49. Relevant to the determination of the SPA methodology:
- (e) In relation to section 52A(1)(a), a key change sought by the Government in the Part 4 reforms was in relation to the relative importance afforded to incentives to invest. Specifically, Parliament intended that more weight should be placed on incentives to invest than previously. Vector refers to its submission on the Commission's Electricity Distribution and Gas Pipeline Services Input Methodology Draft Reasons paper dated 23 August 2010. This sets out in detail the policy objective underlying the Part 4 of the Act and the additional weight expected to be placed on incentives to invest in order to improve the regime.⁴

The emphasis on incentives to invest in the Act reflected the focus of the 2006 Government Policy Statement.⁵ Indeed the 2006 GPS was withdrawn last year on the basis that its objectives were now reflected in Part 4.⁶

⁴ Vector, *Submission in response to the Commerce Commission's Draft Reasons Paper for Electricity Distribution Businesses and Gas Pipeline Businesses: Asset Valuation*, 23 August 2010, Part A.

⁵ Minister of Commerce, *Statement to the Commerce Commission of Economic Policy of the Government: Incentives of regulated businesses to invest in infrastructure*, 7 August 2006.

⁶ See http://www.med.govt.nz/templates/MultipageDocumentTOC_21483.aspx. The policy statement was revoked on 1 November 2010 because "the expectations in this statement are now included in Part 4 of the Commerce Act".

- (f) In relation to section 52A(1)(d), Parliament deliberately referred to limiting (rather than eliminating) excess profits in order to avoid too tough control terms. The reasons for this policy position were explained as follows:⁷

The costs of regulatory error tend to be asymmetric (i.e. the cost of errors leading to too-tough control terms and under-investment are likely to outweigh the costs of errors allowing higher than normal rates of return).

50. Further, the Commission must consider these objectives in the context of the long-term interests of consumers. A key factor when considering the long-term interests of consumers is the asymmetric risk of regulatory error. This was recognised by the Ministry of Economic Development when developing the Part 4 framework as set out above.
51. The asymmetric risks associated with regulatory error are well recognised in economic theory and practice. As explained by Synergies Economic Consulting, in a report for Vector provided in the input methodologies consultation process:

From an economic perspective, the adverse impact on consumers from prices being marginally higher than the regulator believes is optimal (allocative inefficiency) in the short term are not large relative to the long-term costs associated with under-pricing of infrastructure assets and the consequential under-investment in those assets (dynamic inefficiency). This asymmetry is important for resolving the tension that arises from the inherent imprecision of regulatory parameters.⁸

...

The costs of regulatory error are widely acknowledged to be asymmetric, since under-investment in infrastructure (which might be expected if regulatory returns were too low or investors perceive a credible threat that they may be too low) can, in general, be expected to have more severe consequences for the economy than excessive or otherwise inefficient investment that might occur if regulatory returns are too high.⁹

...

⁷ Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007, paragraph 75.

⁸ Synergies Economic Consulting, *Selected Issues Arising from Commerce Commission's Input Methodologies Discussion Paper: An expert statement*, August 2009, page VII.

⁹ *Ibid*, section 2.1.1, page 6.

The manifestation of under-investment in infrastructure can be very subtle and take a long period of time to materialise.¹⁰

52. The Commission itself has endorsed this economic view, noting that in a regulatory setting involving constraining pricing to end users, the social costs associated with underestimation are likely to outweigh the short-term costs of overestimation.¹¹
53. Accordingly, it is not controversial that promoting the long term benefit of consumers requires the Commission to take account of the asymmetric consequences of regulatory error. It is implicit in the Act that the Commission should err on the side of caution when undertaking regulatory assessments. This is particularly critical in the case of the approach to the SPA, given the inherently high risk of uncertainty and likely error in the information used. In particular, while Vector accepts the need to develop a process for addressing projected profitability, the forecasting information used requires allowance for potential error as:
- (a) it is based on limited data series and is not statistically robust; and
 - (b) industry and / or economy wide data is not reflective of individual EDB circumstances (or supported by EDB data analysis, New Zealand statistics, regional data etc).

Commission's approach will not promote the long term interests of consumers

54. Contrary to the purpose of Part 4, the Commission has taken no account of the asymmetric consequences of regulatory error. The Commission says that this is because suppliers can and will apply for CPPs to address DPP error. For example, the Commission states that "given that the regime provides for an alternative price path in the form of a CPP, the discontinuation of an investment as a direct result of regulatory decisions on starting prices under the DPP is unlikely to be an observed outcome."¹²
55. Vector considers that this assumption is simply wrong (given the significant risk that suppliers will remain on sub-optimal DPPs, as explained at paragraph 106 below) and that the Commission's approach is contrary to the long term benefit of consumers.

¹⁰ Ibid, section 2.3.1, pages 13 - 14

¹¹ See for example Commerce Commission, *Input Methodologies EDB-GPB Reasons Paper*, paragraph H1.31. Also Commerce Commission, *A Guide to Regulatory Decision Making by the Commerce Commission for the Telecommunications Sector - Discussion Paper*, 31 July 2009, para 135, where the Commission states, "where a tension exists between short-term allocative efficiency and long-term dynamic efficiency, the Commission will give greater weight to the promotion of the latter", recognising that "...innovation and efficient investment over time can deliver significant long-term benefits to end-users, and the adverse consequences of deterring or delaying such investments may be substantial".

¹² Commerce Commission, *2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments: Update Paper*, April 2011, footnote 76.

56. Vector notes that the Commission has adopted a policy approach which is the reverse of that underlying Part 4. Specifically, the Commission states that, taking into account the optional CPP available suppliers "the consequences of an underestimate of a supplier's actual profitability are therefore more serious than that of an overestimate in terms of the probability that the error will have a detrimental impact".¹³ This proposition is based on a short rather than long term view of consumer benefit and on the Commission's erroneous view that the CPP mechanism can be and will be used by suppliers as an error correction mechanism.
57. As a result, the Commission's proposed approach effectively assumes the industry-wide forecasts are perfect and makes no allowance for forecast error (as further explained in paragraphs 108 to 109 below).
58. Finally, the Commission provides a table which shows Vector's operating expenditure increasing by \$20.7 million under a 1% point increase in ROI and then suggests that removing the band will result in excess profits for suppliers. Vector notes that this opex figure bears no direct relationship to the extent to which excess profits may or may not be earned under a band approach. In any event, and more importantly, no account is taken of the long term impact on consumers of under-investment by EDBs. Further, the Commission's approach to excess profits misapplies the section 52(d) objective as explained below.

Commission's approach contrary to section 52A(1)(a)

Investment requires an expectation of earning at least normal returns

59. Section 52A(1)(a) requires that regulated suppliers have incentives to invest. It is the ability to expect to earn at least (i.e. above) a normal rate of return that incentivises investment in network businesses.¹⁴ As the Commission notes in the Input Methodologies Reasons Paper, "in workably competitive markets suppliers expect to earn at least a normal rate of return over time".¹⁵ Vector agrees that, in light of the range of investment opportunities open to investors, investment in regulated assets is better promoted when the ex ante expectation is that the EDB will earn at least the regulated cost of capital over the regulated period.
60. Vector notes the Commission's previous acknowledgement that "the WACC provides a measure of the return on capital that a supplier is anticipated to require over a given future regulatory period in order for it to be

¹³ Ibid, para 4.62.

¹⁴ See, for example, *ibid*, paras X.3, 2.10, 2.23.

¹⁵ Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, December 2010, paragraphs 2.6.28, 4.2.24.

appropriately compensated (i.e. achieve a normal economic profit) for the systematic risk that a supplier bears in providing regulated services.”¹⁶

61. Despite the above, the Commission’s current proposal is to aim specifically for a WACC return and no higher. Under its approach:
- (a) starting price adjustments are made so that each supplier can be expected to earn normal returns over the regulatory period;
 - (b) due to the different circumstances of each supplier, the Commission's approach is likely to mean that some suppliers will start with a return above WACC and drop below the WACC over the regulatory period, and other suppliers will start below WACC and move above the WACC over the regulatory period; and
 - (c) overall each supplier would be expected to earn a return only equal to WACC over the regulatory period. Importantly, they would not have an *ex ante* expectation that they would earn, on average, a return *at least* equal to WACC over the regulatory period.
62. The Commission is incorrect to distinguish between an *ex ante* expectation of earning normal returns and an *ex post* opportunity to earn above normal returns due to efficiency gains. The opportunity to make above normal returns (for a period) is the incentive to make efficiency gains. The returns implicit in this cannot also be the returns that are at least equal to (i.e. can be above) the normal return that provides an incentive to invest. It is the *ex ante* expectation of earning above normal returns that drives network investment. While efficiency gains may lead to above normal profits over time, there is no *ex ante* expectation that efficiency gains will be achieved.

A high risk of suppliers earning less than normal returns under the DPP

63. Further, there is considerable risk of error / uncertainty in the forecasts used and, accordingly, each EDB faces a significant risk that it will earn less than a normal return.
64. The Commission considers that EDBs can and will simply apply for a CPP to correct regulatory error. As set out below, this view is not based on any evidence, only misconceived assumptions regarding the costs and risks of CPP applications. Contrary to the Commission's position, under its approach a considerable number of EDBs are likely to remain on suboptimal DPPs and under invest to avoid being placed in this position (as explained below).

¹⁶ Commerce Commission, *Starting Price Adjustments for Default Price-Quality Paths: Discussion Paper*, 5 August 2010, para 4.8.

Commission has misapplied section 52A(1)(d)

65. As set out above, section 52A(1)(d) expressly requires that regulated suppliers are limited in their ability to extract excessive profits. It does not require the Commission to remove any prospect of earning above normal returns. This drafting was deliberate in order to avoid the negative long term consequences of too-tough control terms.¹⁷ Vector notes also the limitation on profits is already largely achieved through the price cap mechanism.
66. The Commission is misapplying the objective in section 52A(1)(d) by seeking to remove any ex ante expectation of earning above normal returns without sound basis (the CPP option is not a sound reason for seeking to remove any expectation of above normal profits) and without regard to the long term implications for consumers.

Commission's approach not consistent with workably competitive market outcomes

67. The ability to earn and expectation of earning above normal returns is also essential for delivering outcomes consistent with workably competitive markets.
68. The Commission's approach essentially asks EDBs to invest with an expectation of NPV=0. This outcome is based on the theory of perfect competition and is contrary to the workable competition approach endorsed in the Act.

Commission's approach contrary to sections 52A(1)(b) and (c)

69. Section 52A(1)(b) requires that suppliers have incentives to improve efficiency. The Commission's proposal does not incentivise efficiency improvements, as the Commission is effectively requiring them to be given away immediately (see discussion of section 52A(1)(c) below).
70. Section 52A(1)(c) requires efficiency gains to be shared with consumers. However, the Commission's proposal effectively requires efficiency gains to be given away entirely. Where an EDB needs to make efficiency gains just to achieve a normal return, this implies a 100% transfer of efficiency gains to consumers from the day the efficiency gains are achieved.

¹⁷ Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document, April 2007*, paragraph 75.

Commission's approach must be consistent with section 53P

71. The Commission's approach does not seek to recover profits from previous regulatory periods. However, if claw-back were to be applied and smoothed over time (for example as a result of adjustments to the regulatory investment value) there is a risk that prices set for the 2015 reset could seek to recover excessive profits from this regulatory period. In our view, that outcome would be inconsistent with the Act.
72. The Commission's approach uses some data that is relevant to the current profitability of suppliers and forecasts the projected profitability of suppliers over the regulatory period. The data relating to current profitability is one year's data only. This has consequences for the methodology of projecting supplier profitability and determining starting price adjustments.

Commission's approach must be consistent with section 53K

Requirements for the effective operation of the DPP / CPP framework

73. Vector has previously provided detailed submissions to the Commission on the statutory requirements in relation to the DPP / CPP framework.¹⁸ Vector's key arguments are repeated again below.
74. Section 53K sets out the purpose of default / customised price-quality regulation as follows:

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.

75. The DPPs and CPPs are intended to work together to provide a regime that is low cost overall (and there would be no purpose in a low cost DPP regime if most suppliers were incentivised to apply for high cost CPPs because DPPs were too harsh). This is reflected in:
- (a) the stated policy concern that "a large proportion of firms [might] propose customised terms, thereby undoing the cost-effectiveness benefits of [default paths]";¹⁹ and

¹⁸ Vector, *Submission in response to the Commerce Commission's Input Methodologies Draft Reasons and Determinations for Electricity Distribution Businesses and Gas Pipeline Businesses: Cost Allocation, Regulatory Tax, Pricing Methodology, Rules and Processes*, 9 August 2010, paras 211 - 220; Vector, *Submission in response to the Commerce Commission's Input Methodologies Draft Reasons and Determinations for Electricity Distribution Businesses and Gas Pipeline Businesses: Customised Price-Quality Paths*, 25 August 2010, paras 26 - 46.

¹⁹ Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007, para 163.

- (b) Parliament's stated objective to "tailor the regime to New Zealand's small size (with small firms and limited resources)".²⁰
76. Specifically, the effective operation of the DPP / CPP regime requires that:
- (a) CPP proposals are the exception to the rule. To achieve this, DPPs must be set in a way that meets the needs of most suppliers. If DPPs are too tough in their application:
- i. suppliers will be forced to apply for a CPP in order to receive satisfactory outcomes (and any more than a few CPP applications in one regulatory period is likely to undermine the intended low cost nature of the regime); and
 - ii. given CPP proposals are risky, expensive and time consuming, it is also possible that some suppliers will be forced to choose to remain on a defective DPP and receive sub-optimal returns which they would not receive if suitable DPP rules and processes were in place.
- (b) CPPs are available to suppliers to accommodate their specific circumstances due to, say, a step change in investment that better meets consumers' demands. This is reflected by the stated policy objectives that:
- i. a key weakness of the previous regime was that it did not provide an ability for firms to seek *ex ante* approval of "major capital expenditure" or "abnormal investment";²¹ and
 - ii. accordingly, CPPs would be expected to relate to "significant capital expenditure (that is, of a different level and character than in the recent past, e.g. 10 years) required in order to meet customers' quality expectations and requirements."²²
77. This policy position is further evidenced in the First Reading Debate on the Commerce Amendment Bill, then Minister of Commerce Lianne Dalziel said:²³

Suppliers may apply to the commission for a customised price-quality path if they have special requirements, such as needing to make significant new investments...

²⁰ Explanatory Note to the Commerce Amendment Bill 2008, page 3.

²¹ Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007, paragraph 49; Cabinet Paper, 22 January 2008, para 40.

²² Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007, para 171.

²³ Parliamentary Debates (Hansard) for Thursday, 10 March 2008.

The replacement of Part 4A is expected to provide much more certainty for businesses, including giving them an upfront opportunity to get approvals for customised price-quality paths to cover the cost of a step change in investment requirements, for example.

78. Further, as recently as December 2010 the Commission has stated that “step changes in future expenditure for a particular supplier relative to its historical expenditure is expected to be a key reason for CPP applications being made.”²⁴ Vector agrees that this is an appropriate circumstance for a CPP application.
79. The Act further envisages CPPs as the exception rather than the rule where it has deliberately included a number of requirements that add risk for the supplier.²⁵ Specifically:
- (a) a supplier is limited to only one CPP proposal during a regulatory period and may not make a proposal within 12 months of a DPP reset (section 53Q(3));
 - (b) the proposal cannot be withdrawn (section 53R(a));
 - (c) the regulated supplier must bear the costs of making the proposal (section 53Y(1));
 - (d) the Commission may claw-back once the price path is set (section 53V(2)(b));
 - (e) the Commission may set a CPP that it considers appropriate (section 53V(1)). In particular, section 53V(2)(a) and (b) provides that the Commission may:
 - i. set a CPP which is lower or otherwise less favourable to the supplier than the DPP that would otherwise apply; and
 - ii. if it sets a lower or a higher price than applied under the DPP, apply claw-back;
 - (f) the supplier is bound by any CPP set by the Commission for the regulatory period to which it applies (section 53R(b)); and
 - (g) the Commission can set different starting prices for the DPP when a supplier transitions back from a CPP to a DPP.

²⁴ Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, December 2010, paragraph 9.3.11.

²⁵ Ministry of Economic Development, *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document*, April 2007, paragraph 163.

80. In addition, the Commission is required to deal with only four CPP applications a year and CPP applications cannot be made in the final year of a DPP regulatory period.
81. The DPP / CPP framework is also a key mechanism for ensuring the regime is better at promoting incentives to invest than the previous regime.²⁶ Investment will be deterred if suppliers are forced to remain on a defective DPP (and / or where suppliers defer investment that would place them in a position of making sub-normal returns).

Commission's approach inconsistent with DPP / CPP framework

82. The Commission's position in relation to the likely operation of the DPP / CPP framework is as follows:
- (a) Any supplier facing subnormal returns under a DPP will apply for a CPP, and therefore the actual cost of setting starting prices below normal returns is the cost of a CPP application, not that investment will be deterred.²⁷ On the other hand, there is no mechanism for correction of above normal returns earned under a DPP.
 - (b) A CPP application will be essentially costless to an EDB, because verification costs can be passed through and all other data should already be held by the EDB.²⁸
 - (c) There will be benefits resulting from a CPP, such as a step change in investment, that will outweigh the cost to consumers of a CPP application.
83. On this basis the Commission concludes that, given the availability of a CPP, "the consequences of an underestimate of a supplier's actual profitability are more serious than that of an overestimate in terms of the probability that the error will have a detrimental impact".²⁹
84. As Vector explains in detail below, the Commission's position in relation to the likely operation of the DPP / CPP framework is fundamentally flawed. Specifically, the Commission's approach:
- (a) is not supported by any evidence and is based on incorrect assumptions in relation to the likely cost of a CPP and the nature of EDB information; and

²⁶ See, for example, Cabinet Paper, 22 January 2008, paragraph 54.

²⁷ Commerce Commission, *2010-2015 Default Price-Quality Path Starting Price Adjustments Update Paper*, 11 April 2011, paragraphs 2.9 and 4.59.

²⁸ Ibid, para 4, where the Commission states that the majority of incremental costs of a CPP application are recoverable and are therefore incurred by a supplier's consumers rather than the supplier.

²⁹ Ibid, para 4.62.

- (b) takes no account or no proper account of:
 - i. the risks to EDBs in applying for a CPP;
 - ii. the number of CPP applications that would likely be made under its approach compared to alternative approaches; and
 - iii. the very real risk that suppliers will remain on suboptimal DPP.

Commission's assumptions re costs not supported by evidence and based on a misunderstanding of information held by EDBs

85. The Commission views CPP proposals as largely costless for EDBs, although we note that the Commission has provided no evidence or reasoning to support its view. The Commission's position is based on its view suppliers may recover the cost of independent verification. It then concludes that most (if not all) of the other information necessary to prepare a CPP proposal should be readily available to a supplier, whether or not it is applying for a CPP.³⁰
86. Vector submits that this assumption is incorrect. Specifically, reasonable and prudent operators would not (and EDBs do not) retain all of the information the Commission is likely to require for a CPP application. A CPP is not an accurate proxy of standard decision-making, particularly in relation to the five-year CPP forecast period. Specifically:
- (a) In normal business circumstances, decisions can be changed on the basis of new information where required. As a result, even firms in industries characterised by long-term contracting arrangements tend not to make final decisions about investment projects five years in advance (so material is not collated in this way).
 - (b) By way of example, Vector understands that the Commission is currently seeking cost forecasts from Transpower (in relation to its Individual Price-Quality Path) to within 5% for projects to be undertaken across Transpower's regulatory period (i.e. up to seven years in advance). Vector has some doubt as to whether this is practically achievable given the difficulty of forecasting costs of labour and materials over such a timeframe. However, no sensible business would incur costs by planning that level of detail that far in advance as, if information and plans change, resources will have been wasted.
87. Considerable cost and resources will be involved in preparing the information in an application and ensuring it is compliant with the CPP requirements. In particular:

³⁰ Commerce Commission, *2010-2015 Default Price-Quality Path Starting Price Adjustments Update Paper*, 11 April 2011, paras 4.64 - 4.65.

- (a) Collating internal business information into a coherent proposal consistent with the broader CPP requirements, such as explicit consideration of the Part 4 purpose statement, is a significant and costly task and the required information is unlikely to be readily available.
 - (b) Existing policies, procedures and plans may not be documented in a manner suitable for external review (albeit they may be suitable for internal operational requirements and Board scrutiny). For example, in many cases the information has not been developed to auditable standards. Accordingly, the audit process will add time and cost to the usual business operations of a regulated supplier.
 - (c) Vector expects that all EDBs would need to invest time and resources into formalising their written documentation to fully support their CPP application information to ensure it complies with the CPP input methodology. This is not an indication of poor procedures. It simply reflects the manner in which businesses operate.
 - (d) Prudent governance will require that any information sent to the Commission is subject to additional review given the information will be fixed once it is submitted and will form the basis of the price path for the five-year CPP regulatory period. Suppliers will therefore need additional assurance that the information, and its underlying assumptions, is robust. No prudent business would release information in those circumstances without an additional and comprehensive review.
 - (e) The requirement for directors to certify the CPP application will require an additional level of governance and quality assurance.
 - (f) Both the independent verifier and the Commission are likely to pose further questions to EDBs on the basis of making CPP applications and responding to such requests will also involve time and resources.
88. The processes outlined above are not only costly for Vector, but also very disruptive for the business. For example:
- (a) Vector had first-hand experience of these processes during the gas inquiry and control process. They were time-consuming, costly and distracted staff and senior management from the standard operations of the business.
 - (b) Vector understands that Transpower considers its interaction with the Commission (in the context of its annual price path setting process) to be extensive and intrusive.

- (c) Vector understands, from discussions with regulated suppliers in other jurisdictions such as Australia, that those suppliers put considerable effort into preparing the information necessary for their revenue authorisation processes (often characterised to Vector as requiring a significant team dedicated to the task for 18-24 months).
89. Vector notes that the Australian Energy Market Commission sought information from suppliers on the costs incurred in preparing a regulatory proposal and participating in the assessment of the proposal. Australian suppliers suggested that the costs they faced were in the order of \$2m to \$5m for each regulatory assessment.³¹
90. Vector is concerned that the Commission's views on the cost and disruption of a CPP application are not consistent with the actual impact of revenue authorisation processes both in New Zealand and in other jurisdictions.
91. Vector notes that there would be no purpose in having a DPP regime if CPPs were truly low-cost. Further, it cannot have been Parliament's intention that "low-cost" regulation meant low-cost only to the Commission.

Commission wrongly assumes benefits to consumers of CPPs will outweigh costs

92. The Commission considers that a CPP will result in benefits to consumers, such as a step change in investment, and that these benefits will outweigh the costs to consumers of applying for a CPP.³²
93. Vector considers that this view has no basis for the following reasons:
- (a) The Commission has no means for assessing the costs of CPPs for consumers. The Commission acknowledges that it has no robust information in this regard.³³
 - (b) The Commission also has no basis for assessing the benefit to consumers and whether this outweighs the costs.
 - (c) The Commission assumes that benefits will arise from CPPs (such as providing for a step change in investment that better meets consumer demand). For reasons given above, under the Commission's approach CPPs will often be sought simply to enable a supplier to earn a normal rate of return (bringing no benefit to consumers). There is therefore no basis for assuming benefits to consumers will, as a matter of course, arise from CPP applications under the Commission's approach.

³¹ For example, see Australian Energy Market Commission, *Perspectives on the Building Blocks Approach: Review into the use of total factor productivity for the determination of prices and revenues*, 30 July 2009, paragraph 3.4.

³² Commerce Commission, *2010-2015 Default Price-Quality Path Starting Price Adjustments Update Paper*, 11 April 2011, para 4.67.

³³ *Ibid*, para 4.66.

- (d) Further, the Commission has taken no proper account of the likely cost of a CPP application to suppliers.

Commission takes no account of the risk to EDBs in applying for a CPP

94. Vector notes that the Commission has taken no account of the reality that EDBs will be reluctant to apply for a CPP because of the risks involved.
95. As identified in paragraph 79 above, the Act has built in a number of risks for suppliers to ensure CPPs remain the exception rather than the rule (for example, more onerous terms can be imposed and clawback may be applied).
96. Further, the CPP evaluation criteria in the input methodologies provide that the Commission must be satisfied any expenditure proposal is "prudent and efficient", and will assess all aspects of a CPP proposal against the Part 4 purpose (with limited additional guidance provided in the Final Determinations). This provides the Commission with considerable discretion in relation to its evaluation of a CPP, adding further considerable uncertainty and risk to a CPP proposal.
97. This should be considered in light of the well documented concerns around the Commission's exercise of its discretionary powers under the previous regime. Specifically, Vector's experience during the Gas Authorisation and the Intention to Declare Control of Vector's electricity distribution business was a series of arbitrary changes of position by the Commission and difficult to justify outcomes. We understand that other regulated suppliers have had similar experiences.
98. We recognise there have been changes in the Commission since that time. However, these are not experiences that build confidence sufficient for regulated businesses to voluntarily expose the full ambit of business decisions to regulatory scrutiny. There seems to be a real risk to governance and accountability processes and, while this may not be the intention of the regulator, they are consequences that suppliers of regulated services will wish to avoid other than in extreme circumstances.
99. During this starting price adjustment process, the Commission has again made major changes fairly late in the process with no advance warning or advance discussion with regulated suppliers as to how new approaches could or should be developed. In such circumstances, suppliers are unlikely to have confidence that the Commission will make a reasonable decision and operate a transparent process when responding to a CPP application. Accordingly, suppliers may choose to under-invest rather than face the inherent risks of a CPP application.

100. Vector also notes that there is relatively limited experience with such regulatory processes in New Zealand that EDBs can look to. However, the process of investment approval by the Electricity Commission for the transmission grid is one such example. This process seemed to result in the Electricity Commission imposing its own technical view of the appropriate solution to grid development needs in place of those of the transmission company.
101. Given the risks outlined above, making a CPP application will be a risky enterprise for an EDB to make and is a step that would not be taken lightly.

Commission takes no account of the fact that EDBs will be exposed to the risk of a lower WACC under a CPP

102. If an EDB applies for a CPP, it is exposed to changes in the risk free rate for the WACC determination. For example, the 75th percentile vanilla WACC for a five year period decreased from 8.77% to 8.05% between 1 September 2009 and 1 September 2010.³⁴
103. Essentially, unless an EDB applies for a CPP at the same time as a DPP is determined (which is not currently possible because of the way the process has developed), it faces an unmanageable risk that the risk free rate will move against it. There is no allowance for this risk under the Commission's SPA methodology. This is a further reason why EDBs will be reluctant to apply for a CPP.

Commission takes no account of risk that suppliers will remain on suboptimal DPP

104. The Commission considers that:
- (a) the consequence of setting starting prices below *ex ante* normal returns may be that some suppliers apply for a CPP;³⁵ and
 - (b) suppliers that remain on a DPP can be assumed to have been afforded a price-quality path that is broadly consistent with them earning at least a normal return over time.³⁶
105. Assuming a normal distribution of error in the Commission's forecasted outcomes for each EDB, the Commission's proposal means that half of the non-exempt EDBs may need to make a CPP application (without considering extreme events). In addition, some EDBs who will be able to earn an at least

³⁴ Commerce Commission, *Explanatory Note on the Cost of Capital Determination*, March 2011 page 2.

³⁵ Commerce Commission, *2010-2015 Default Price-Quality Path Starting Price Adjustments Update Paper*, 11 April 2011, para 4.58.

³⁶ *Ibid*, para 2.9.

normal return under the DPP may need to apply for a CPP in order to fund a step-change in investment.

106. Further, and critically, it is most likely that a number of those suppliers who need to make an application to earn more than normal returns will not make a CPP application. That is, the considerable risks and cost associated with a CPP application (as referred to above) mean there is a very real possibility of suppliers remaining on a defective DPP for a prolonged period of time. As set out above, and as acknowledged by the Commission, this would negatively impact on incentives to invest and the long term benefit of consumers. To address the asymmetric risk of delayed investment, the Commission must err on the side of caution and make allowance for the uncertainty necessarily inherent in a SPA methodology.

Allowance required for uncertainty and error in SPA methodology

107. Given the above, the SPA methodology should make allowances for risk of error and uncertainty notwithstanding the availability of CPPs.

Risk of error in Commission's approach has not been catered for

108. The Commission's SPA methodology involves inherent uncertainties. While to some extent these are unavoidable, the Commission's SPA methodology is flawed in that it makes no attempt to address the uncertainties and the asymmetric risks of providing incorrect starting price adjustments.

109. Specifically:

- (a) The Commission's methodology places 100% reliance for the starting ROI estimate on a single year's data. Vector recognises that the Commission has little choice but to use a single year's data due to the lack of time series data that has been prepared in accordance with the IMs.
- (b) However, the statistical implication of using a single year's data only is that the estimate of current profitability will be much more uncertain (in terms of whether it accurately reflects the underlying ROI of an EDB) than would be the case if a longer series were used. The Commission has made no allowance for this uncertainty. Instead, it assumes that the estimate reflects perfectly an EDB's underlying ROI. This assumption is not credible, particularly as Economic Insights criticised the Thomson/van Zijl approach for placing excessive weight (73%) on the last year in the data series.³⁷

³⁷ Economic Insights, *Review of the Commerce Commission's Analytical Framework for Starting Price Adjustments*, 20 April 2011, page 8.

- (c) In relation to the industry-wide and economy-wide forecasts, these are also uncertain and in some places seem arbitrary. However, the Commission makes no allowance for the risk of error and is effectively, therefore, using the results of these analyses as perfect estimates of each EDB's underlying ROI.
- (d) The Thomson/van Zijl report provides statistical estimates for the dispersion of EDB ROIs over time. Economic Insights' review of this report supported the use of the Constant Level model for estimating ROI forecasts and confidence intervals. The Thomson/van Zijl analysis is the most statistically robust information available for addressing uncertainty in the Commission's forecast. While the Commission makes no use of it, it is incorporated into Vector's preferred approach (described below).

110. Vector will comment further on the industry-wide forecasts in its next submission.

Commission wrong to suggest use of 75th percentile accounts for risk of forecasting error in SPA methodology (it accounts for error in the WACC model only)

111. The Commission takes that view that the uncertainty in the WACC estimate is already accounted for in the use of the 75th percentile and that this estimate is already biased to suppliers. In particular, the Commission in the Update paper states that:³⁸

The proposed approach compares suppliers' forecast profitability with the 75th percentile WACC estimate. Starting price adjustments will therefore be biased in favour of suppliers due to the use of this WACC estimate. The Commission considers that the proposed approach does not need to provide further bias in favour of suppliers, by providing for uncertainty in profitability forecasts.

112. This view is incorrect and, if the Commission acts on it, the Commission will undermine incentives to invest. Vector is concerned that the Commission appears to be moving away from its previous position of "always" favouring outcomes that promote dynamic efficiency.

113. The Commission appears to be suggesting that the use of the 75th percentile in the WACC estimate addresses regulatory error in the SPA methodology. Vector strongly disagrees with this position.

114. The Commission has settled on the 75th percentile WACC as being the appropriate estimate of regulatory WACC to balance the asymmetric risk of

³⁸ Commerce Commission, *2010-2015 Default Price-Quality Path Starting Price Adjustments Update Paper*, 11 April 2011, para 2.27.

over-charging consumers and the risk of underinvestment by EDBs as a result of WACC estimation error.³⁹

115. More specifically, the use of a 75th percentile WACC point estimate is to address volatility in estimates of the WACC parameters by adjusting for potential errors in the selection and estimation of input parameters. It was not intended to address error in the information used in the starting price adjustment process.
116. As is widely recognised, including by the Commission, WACC estimation is prone to error and the social costs of setting a WACC estimate that is too low are greater than the social costs of setting a WACC estimate that is too high. The Commission's previous statements on this matter have been very clear:⁴⁰

The reason for the Commission adopting a cost of capital estimate that is above the mid-point for default/customised price-quality regulation, is that it considers the social costs associated with underestimation of the cost of capital in a regulatory setting involving constraining pricing to end users (as opposed to information disclosure applications and situations involving competition among suppliers), are likely to outweigh the short-term costs of overestimation (i.e. if the cost of capital is set too low, the incentives for suppliers to undertake efficient investments will be reduced, which would be inconsistent with the long-term benefit of consumers). That is, the Commission is acknowledging that where there is potentially a trade-off between dynamic efficiency (i.e. incentives to invest) and static allocative efficiency (i.e. higher short-term pricing), the Commission will always favour outcomes that promote dynamic efficiency. The reason is that dynamic efficiency promotes investment over time and ensures the longer term supply of the service, which thereby promotes the long-term benefit of consumers (consistent with outcomes in workably competitive markets).

117. Vector agrees with that earlier analysis. Further, the WACC represents the minimum rate of return that is necessary to attract debt and equity capital to an investment.⁴¹ In reality, given capital scarcity, a higher rate of return is likely to be required in order to invest sufficiently in a network business. The 75th percentile WACC estimate is therefore the floor of the range of revenues at which EDBs will have sufficient incentives to invest in their businesses.

³⁹ As noted in Vector's previous submissions, the 75th percentile is too low as it is based on a mid-point that is too low, does not allow for error in model parameters other than the debt premium, asset beta and TAMRP, and does not allow for the possibility of regulatory error resulting from model error. See *Vector submission on Draft IM Reasons and Determinations: Cost of Capital*, 13 August 2010, page 28.

⁴⁰ Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, December 2010, para H1.31.

⁴¹ Kolbe, A. L., Tye, W. B., Myers, S. C., *Regulatory Risk: Economic Principles and Applications to Natural Gas Pipeline and Other Industries*, Kluwer: Massachusetts, 1993, pp. 68-69.

118. However, the use of the 75th percentile estimate cannot credibly be used to address difficulties in accurately assessing the current and projected profitability of EDBs and, if acted, will undermine incentives to invest. Vector is concerned that the Commission appears to be moving away from its previous position of “always” favouring outcomes that promote dynamic efficiency.

The Commission has mischaracterised submissions on the ROI-band proposal

119. As a final point, the Commission appears to have misinterpreted previous submissions in the SPA process as opposing the band concept. This was not the case for the majority of submissions. Submissions, including Vector’s, raised concerns about the robustness of the analysis for setting the band limits and for projecting profitability. They argued that further analysis was required and, in particular, that the lower limit should be set equal to the 75th percentile WACC point estimate. However, they did not oppose the band itself.
120. The main concerns with the Commission’s previous approach were that it took a very simplistic approach to any consideration of future profitability. The Commission’s new approach addresses that concern. However, a mechanism to address future profitability is not incompatible with a band approach. In fact, the band is useful precisely because it is used to provide for uncertainty with the estimates of future and current profitability.
121. Submissions on the previous approach were arguing for an improved method of forecasting profitability, not for a removal of the mechanism to address uncertainty in that forecast.

Other issues in relation to the Commission’s approach

122. Without prejudice to Vector's view that the Commission's approach fails to meet the requirements of the Act as set out above, Vector identifies below what it considers to be serious flaws in the Commission's reasoning and approach. In particular, as a matter of good regulatory practice, and in the interests of certainty, the Commission should adopt approaches that:
- (a) are not unduly sensitive to parameter choice;
 - (b) use inflation forecasts that are accurate and consistent with the cost of capital input methodology; and
 - (c) promote price stability.

SPA methodology should not be overly sensitive to parameter choice: CPI impact on outcomes is excessive

123. Economic Insights notes that it is “generally desirable” that starting price adjustments are “not unduly sensitive to parameter choice”.⁴² Vector agrees that the SPA methodology should not be overly sensitive to parameter choice.
124. However, Vector disagrees with Economic Insights that this has been achieved. The proposed model is extremely sensitive to slight changes in forecast CPI and is highly sensitive to changes in forecast revenue growth.
125. It is striking that a 0.1% change in the forecast CPI number in the model leads to an approximately -1% change in the Po adjustment for every EDB. There is a large amount of value resting on very small changes in a single forecast variable that is outside the control of EDBs. In our view, this reduces the credibility and usefulness of the SPA methodology.
126. Vector is also concerned that the CPI element, as it flows through into annual asset revaluations, essentially represents a non-cash return element over the regulatory period but drives real cash flow impacts through its effect on the starting price adjustment. The larger the CPI the larger the adverse impact on EDBs' cash flows. For this reason, the Commission should take a robust and conservative approach to establishing the CPI estimate it will use in setting the starting price adjustments.
127. Without prejudice to Vector's submission that an alternative SPA methodology is required, Vector recommends that the Commission investigate ways to lessen the model's sensitivity to changes in CPI.

The Commission's choice of CPI data and formula is arbitrary

128. The Commission is proposing to use a CPI forecast derived from historical Statistics New Zealand data and forecast data from the most recent Reserve Bank of New Zealand ("**RBNZ**") Monetary Policy Statement. It intends to apply the historic and forecast CPI data in the starting price determination by using the same lagged approach as in the compliance formula, with a GST adjustment.
129. Vector considers that the RBNZ is a credible and commonly used source of CPI forecasts. However, other credible and commonly used sources of CPI forecasts exist and the Commission should consider these. For example, Vector notes that NZIER's most recent CPI forecast⁴³ differs from that of the

⁴² Economic Insights, *Review of the Commerce Commission's Analytical Framework for Starting Price Adjustments*, 20 April 2011, page 3.

⁴³ NZIER, *CPI Forecasts*, March 2011.

RBNZ and, if it were used instead of the RBNZ forecast, would produce an average CPI estimate of 2.0% over the regulatory period, rather than the Commission's 2.3%. This would change the starting price adjustment of every EDB by approximately 3%. This is a material difference that results purely from an arbitrary choice on the part of the Commission.

130. Without prejudice to Vector's submission that an alternative SPA methodology is required, Vector recommends that the Commission use the average of the RBNZ and NZIER CPI forecasts (and any other credible and commonly used source of forecast CPI) when forecasting CPI within the starting price adjustment model. This is a minimum step to reduce the risk of relying on an erroneous or aberrant CPI forecast.

Use of CPI inconsistent with cost of capital input methodology

131. The Commission is being inconsistent in its use of CPI in different parts of the regulatory regime. In the starting price adjustment model it is applying the most up to date actual CPI data available and using the most recent CPI forecast.
132. However, when the Commission set the risk-free rate it used, among other things, inflation expectations as at September 2009. This creates the risk that EDBs will not be NPV neutral over the regulatory period as the inflation forecasts that underpin our rate of return are not equivalent to the inflation forecasts that estimate our input costs. The Commission's approach makes no allowance for this and is therefore inconsistent.
133. Without prejudice to Vector's submission that an alternative SPA methodology is required, Vector recommends that the same inflation forecasts are used to set the risk-free rate and the starting price adjustment.

Promote price stability

134. Vector agrees with Economic Insights that a regulatory regime that promotes price stability for consumers is desirable. However, the Commission's methodology will not deliver price stability. The Commission could achieve price stability by:
 - (a) setting starting prices equal to those that applied at the end of the preceding regulatory period in accordance with section 53P(3)(a);
 - (b) developing an approach that based the input methodologies and settings of the regulatory regime on current prices (such as the "line in the sand approach" to valuing RAB that was discussed during input methodology development); or

- (c) using an ROI-band approach, which would minimise price disruption.
135. The Commission's current approach will not promote price stability for consumers. If the substantial price changes implied by the Commission's illustrative model results are to be implemented, even if smoothed over the regulatory period, then some consumers will see very substantial price changes. These potential changes are then exacerbated by the possibility of claw-back.
 136. If the Commission is concerned about maximising price stability, it should reconsider its starting price adjustment approach.

PART C: VECTOR'S PREFERRED APPROACH FOR SPA METHODOLOGY

Overview

137. Vector's preferred alternative is for the Commission not to make a DPP starting price adjustment until 2015. Vector considers that this would be the most stable and least disruptive option, given that only a portion of the first regulatory period remains and given the legal challenges currently underway (including in relation to the Commission's approach to its SPA methodology). It is open to the Commission to adopt this approach by rolling over prices under section 52P(3)(a). Alternatively, and without prejudice to Vector's position set out in Part A, the Commission could exercise its discretion not to reset the DPP under section 54K(3).
138. If the Commission does not agree to effectively defer the reset until 2015, Vector submits that the Commission should adopt the proposed methodology outlined below. This approach meets the relevant statutory requirements and is materially better at meeting the Part 4 purpose. In particular, Vector's proposal appropriately makes allowance for the high risk of regulatory error and uncertainty associated with assessing current and future profitability.
139. In this section Vector:
- (a) outlines its proposed approach for an SPA methodology (which in effect combines aspects of the Commission two approaches to date);
 - (b) highlights aspects of the Commission's SPA methodology which are agreed and have been incorporated in Vector's proposal; and
 - (c) explains why its approach is materially better at meeting the Part 4 purpose.

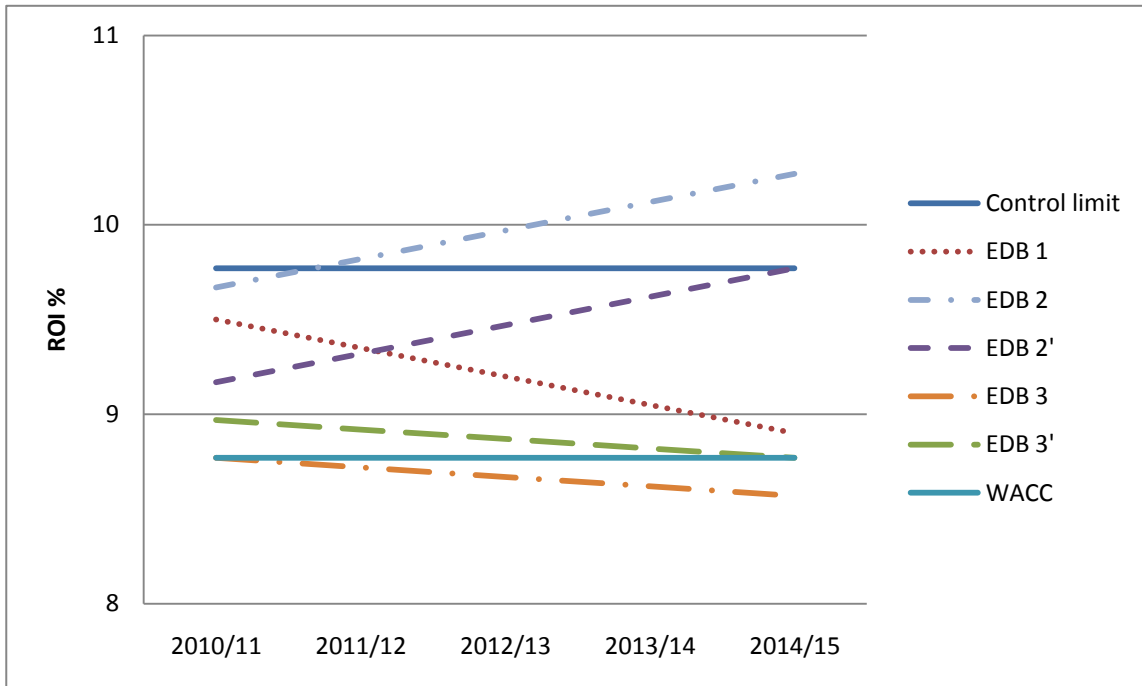
Details of Vector's SPA proposal

140. Vector considers that the methodology for making starting price adjustments that best meets the Part 4 Purpose and other key regulatory principles is as follows:
141. Use EDBs' most recently reported disclosure information restated to reflect the input methodologies, i.e. 2010 disclosed information updated in line with the Commission's information request

142. Use the Commission's industry average forecast approach and the assessment of suppliers' initial conditions to provide a representation of forecast profitability over the regulatory period⁴⁴.
143. Use the Constant Level model as developed by Thomson and van Zijl on behalf of the ENA (with any necessary modifications suggested by Economic Insights) to establish a statistically robust approach to setting a band for the inherent uncertainty in forecasting future profitability.
144. Set an ROI-band with the lower limit at the 75th percentile WACC estimate and the upper limit ("control limit") at 2 standard deviations (established using the Thomson and van Zijl Constant Level model) above the 75th percentile WACC estimate. This would place the upper control limit at 0.84% above the 75th percentile WACC estimate (i.e. 9.61%).
145. Make starting price adjustments for EDBs to ensure that their ROI does not exceed the top of the band or fall below the bottom of the band on the basis of the EDBs' projected profitability slope. It is proposed that the Commission would initially determine starting price adjustments as in their previous (ROI band) proposal based on the reported 2010 ROI, but would then further adjust the starting prices to ensure that in all years the ROI of each EDB does not breach the band's upper or lower boundaries. This would address the issue that suppliers will naturally move away from any point estimate over time due to their initial conditions. This is shown in Figure 1 below.
146. Where EDB's projected profitability slope is too steep to remain within the band across the regulatory period, the EDB should receive a starting price adjustment sufficient to ensure that the EDB never falls below the 75th percentile WACC estimate.

⁴⁴ Vector will suggest refinements to this approach in its next submission on this topic.

Figure 1: Graphical representation of results of Vector’s proposed methodology⁴⁵



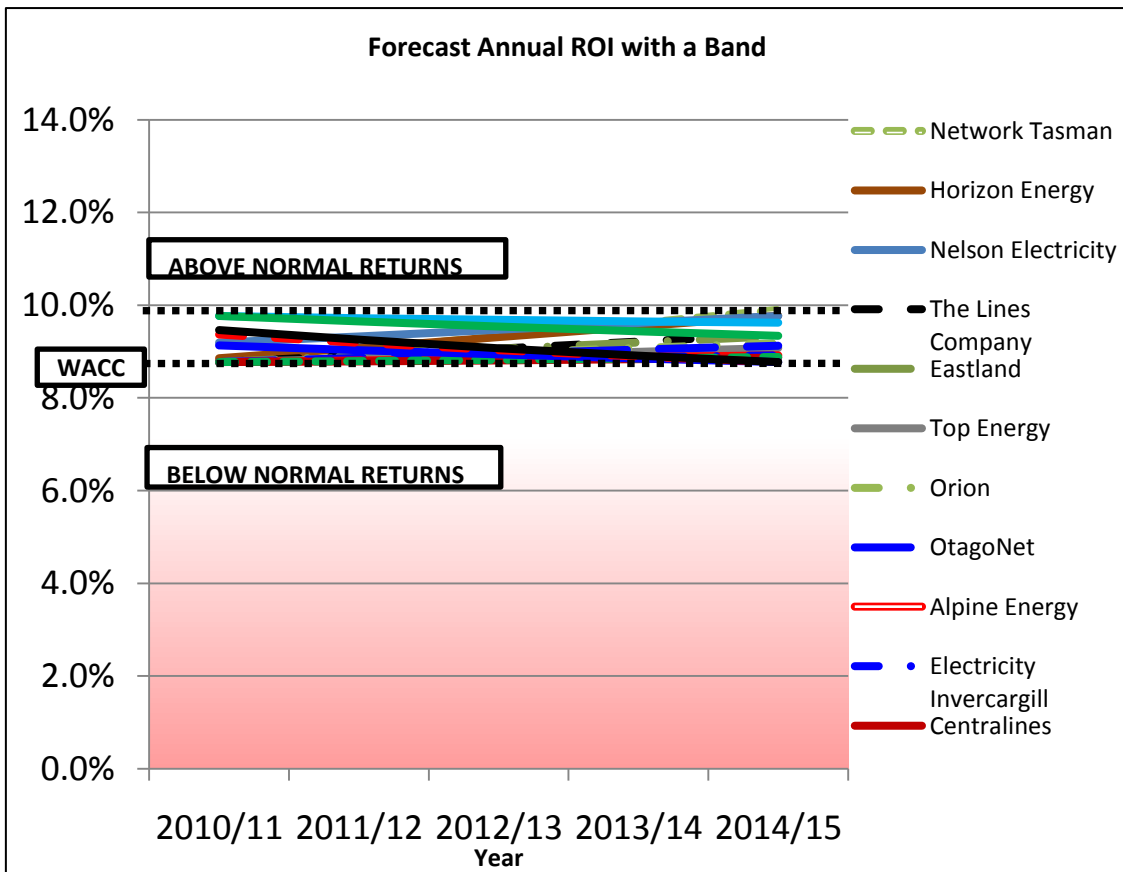
147. In this example:

- (a) EDB 1’s projected ROI is entirely between the control limit and the 75th WACC percentile. EDB 1 therefore has an *ex ante* expectation of earning at least a normal return over the regulatory period and does not receive any price adjustment.
- (b) EDB 2’s projected ROI starts just below the control limit but is projected to increase over time, meaning its *ex ante* expectation is to earn returns in excess of the upper boundary of the band. It would therefore receive a price decrease to bring it to EDB 2’, a position that keeps its ROI between the control limit and the 75th WACC percentile for the regulatory period.
- (c) EDB 3’s projected ROI starts at the 75th WACC percentile, but is projected to decrease over time. EDB 3 therefore receives a price increase to bring it to EDB 3’, where it can expect to earn at least a normal return over the regulatory period.

⁴⁵ Note that the figure sets the Control limit at 1% above the 75th percentile WACC estimate for ease of reference. It does not attempt to model a 1 or 2 standard deviation band above the WACC point estimate as this is unnecessary for illustrative purposes.

148. Applying this approach to the Commission’s model yields the illustrative outcomes shown in Figure 2 (again, using a 1% band for illustrative purposes only).

Figure 2: Forecast Annual ROI with a band between WACC percentile and control limit



Aspects of the Commission’s approach included in Vector’s methodology

149. Vector agrees with aspects of the Commission SPA methodology. For avoidance of doubt, while these aspects are agreed, the Commission’s SPA methodology itself is not agreed as an appropriate or lawful approach.

150. Specifically, Vector agrees that:

- (a) that the issue of EDBs moving away from an ROI point over time due to their initial circumstances (e.g. their capex:depreciation ratio) needs to be addressed.
- (b) In line with the comments made in previous submissions, Vector also agrees there is a need for the Commission to address projected profitability when making starting price adjustments. We will

comment further on the industry average approach in our next submission.

151. These aspects are reflected in Vector's proposed approach above.

Why Vector's proposal is materially better at meeting the Part 4 purpose

152. This proposal combines elements of the ROI-band and industry-wide forecasting approaches into a SPA methodology that avoids the downside of the previous approaches. There is a statistically robust means of establishing the upper limit of the band and the lower limit is the 75th percentile WACC, meaning suppliers should have less risk of a starting price adjustment being unsuitable and being forced to apply for a CPP. Most importantly, it promotes dynamic efficiency and minimises the risk of under-investment.

153. Vector's proposal includes the band mechanism to address the uncertainties inherent in using 2010 data without normalisation and in forecasting EDB ROIs forward using industry-wide and economy-wide assumptions.

154. The two standard-deviation extent of the band in Vector's proposal reflects the range of uncertainties that are being catered for and is smaller than the 1% or 1.25% bands proposed by the Commission in its 5 August 2010 Discussion Paper.

155. Vector recognises that the Commission has responded to requests from some submitters that a greater emphasis on predicted profitability was required. Vector notes that the Commission's *ex ante* profitability forecasts are only one forecast out of a range of possible and valid *ex ante* profitability forecasts at both an industry and EDB specific level. Using these profitability forecasts in the context of a band-approach as Vector has proposed could mitigate the risk of forecast error.

156. Vector considers that our SPA methodology is superior to the Commission's at meeting the following criteria:

- (a) is consistent with the Part 4 Purpose, particularly the requirement to incentivise investment;
- (b) promotes relatively low cost regulation;
- (c) is consistent with the current and projected profitability of suppliers;
- (d) does not seek to recover excessive profits from previous regulatory periods;
- (e) promotes price stability; and

- (f) is not unduly sensitive to parameter choice.
157. Vector's approach best meets the Part 4 Purpose as it is:
- (a) Consistent with Section 52A(1)(a) by providing improved incentives to invest by providing EDBs with an *ex ante* expectation of earning at least a normal rate of return.
 - (b) Consistent with Section 52A(1)(b) by better promoting efficiency gains as EDBs will be able to retain those efficiency gains until the reset rather than potentially lose them to consumers where the gains are required to reach a normal rate of return.
 - (c) Consistent with Section 52A(1)(c) by only requiring the sharing of efficiency gains with consumers (rather than a 100% transfer by some suppliers as they struggle to reach a normal return).
 - (d) Consistent with Section 52A(1)(d) by only limiting the ability to earn excessive profits, rather than eliminating them entirely.
158. In general, Vector's methodology better fits with the objective of the Act (i.e. outcomes consistent with those produced in competitive markets), whereas the Commission's approach aims more to the unrealistic, and generally unobserved, standard of perfect competition.
159. Vector's proposal better meets the purpose of default/customised price-quality regulation. Like the Commission's proposal it, is low-cost to implement. However, it is superior as it is less likely to result in a large number of EDBs needing to apply for a CPP in order to earn normal returns and, potentially, remaining on a defective DPP.
160. Vector's methodology is more consistent with the current and projected profitability of suppliers as it incorporates a mechanism to address the inherent uncertainty in the available data.
161. Vector's methodology better meets the test of avoiding the recovery of excessive profits from previous regulatory periods. It is likely to reduce the magnitude of the starting price adjustments and therefore reduce any incentive to spread the impact of price changes to beyond 2015.
162. Vector agrees with Economic Insights that a regulatory regime that promotes price stability for consumers is desirable. Vector's methodology better achieves the aim of ensuring price stability as it should lead to fewer and more manageable price changes in the near term and, because it aims to maintain projected profitability within the band at the end of the regulatory period, should also mitigate the potential for significant price adjustments at each subsequent reset.

163. Vector's methodology better meets the requirement of avoiding undue sensitivity due to parameter choice as the use of a band mitigates the impact of the input assumptions.

PART D: OTHER MATTERS

Claw-back

164. In the Update Paper, the Commission does not reach a firm view on the application claw-back of earnings in the 2010/11 and 2011/12 regulatory years, but makes some initial comments and seeks stakeholder input.
165. Vector agrees with the Commission that applying claw-back to earnings in the 2010/11 and 2011/12 regulatory years would create substantial practical implementation problems. It would also be inequitable and exacerbate price shocks.

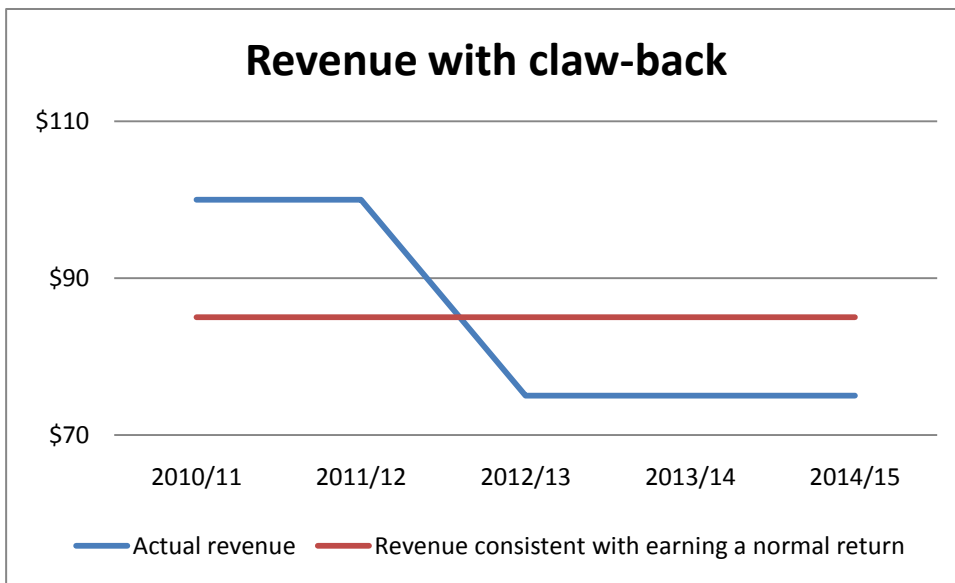
The impact of claw-back

166. Claw-back (i.e. adjustments to prices to compensate for perceived past over-recovery or shortfall) is likely to detrimentally affect future investment incentives. It is conceivable that input methodologies will change again during regulatory periods and regulated suppliers will need to have certainty about how the impact of any amendments to the input methodologies will be handled in those instances.
167. Vector also agrees with Economic Insights that it is preferable to implement the starting price adjustment methodology on a purely forward looking basis, in part because it "has least potential to distort EDB decision-making".⁴⁶
168. Claw-back in the case of perceived over-recovery of revenues is likely to lead to under-investment for the remaining years of the regulatory period.
169. For example, consider a firm that the Commission determines should have earned \$85 in each year of the regulatory period (Figure 3, below). However, in years 1 and 2 it earns \$100 as no starting price adjustment had been made. There has therefore been an over-recovery of \$30 $(=(100-85)*2)$. If the regulator were to spread recovery of this amount over the remaining years of the regulatory period, the firm would earn \$75 per year $(= \$85 - (\$30/3))$. This is \$10 less than the Commission will have estimated the firm needs to earn to make a normal return.
170. The firm may deal with this shortfall by reducing expenditure over those three years, meaning claw-back could reduce incentives to invest during the remaining years. As a result, claw-back would be likely to reduce incentives to invest during the remaining years of a regulatory period after claw-back is applied.

⁴⁶ Economic Insights, *Review of the Commerce Commission's Analytical Framework for Starting Price Adjustments*, 20 April 2011, page 10.

171. Similarly, a firm that is subject to claw-back of a perceived over-recovery of revenues (and therefore operating below a level where it can earn a normal rate of return) has limited incentive to make efficiency gains as these are, in effect, passed on to consumers immediately and in full. With no potential gain to investors the firm is more likely to delay instituting efficiency gains until prices are reset for the next regulatory period.

Figure 3: Revenue of hypothetical firm with claw-back applied to recover perceived past over-recovery



172. While in theory the perceived over-recovery and claw-back should cancel each other out, in reality EDBs will have made their capital investments in years 2010/11 and 2011/12 without being aware that claw-back would be applied. As a result, the EDB will have limited opportunities to reduce these costs to offset the claw-back that is to be applied in later years. The result would most likely be under-investment by the EDB in the later years of the regulatory period.
173. Claw-back would also create inequity due to timing differences. Customers move and change so the customers receiving the prices adjusted due to claw-back will not all be the same customers who paid too much or too little in previous years.

The Commission may not apply claw-back across regulatory periods

174. The magnitude of the claw-back that would be envisaged for some firms is such that recovery would need to take place over a number of years in order to smooth the price/revenue impacts to manageable increments. However, section 53P(4) prohibits the Commission from setting starting

prices to recover any excessive profits made during an earlier regulatory period. This means the Commission is prohibited from setting prices at the 2015 reset in order to seek to recover any over-recovery of revenues received in 2010/11-2011/12.

175. However, section 53P(4) does not prohibit the use of claw-back of under-recovered revenues across regulatory periods. Therefore, recovery over multiple regulatory periods could be implemented for upward revenue adjustments.

Application of claw-back would be retrospective

176. Vector notes that EDBs have set prices for the 2010/11 and 2011/12 regulatory years in the absence (until 22 December 2010) of final input methodologies and without any certainty on the impact that the Commission's approach to setting starting price adjustments would have.⁴⁷

177. Any claw-back that is applied would be based on applying new rules – the input methodologies and the starting price adjustment process – to prices that were set prior to the rules being determined. In our view that would be retrospective penalisation of pricing decisions that were taken without any certainty of what the new regulatory regime's rules would be. Such an outcome would not be consistent with natural justice.

178. The Commission's statement in paragraph 7.17 that when EDBs set prices for 2011/12 input methodologies had already been published implies that claw-back for that year may therefore be justified. However, this view is based on a misunderstanding of the practical realities. Electricity price changes come into effect on 1 April each year. Vector's Use of System Agreement with electricity retailers on its Auckland electricity distribution network requires 90 days' notice to retailers of price changes (i.e. notice must have been provided by around 1 January 2011). In order to achieve internal approval of the price changes and to manage the notification over the Christmas period, it is necessary to finalise prices by early December. Vector therefore had no realistic prospect of adjusting its prices for the 2011/12 year in light of the input methodologies, especially as the Commission had not yet provided a final starting price adjustment methodology with which to translate the input methodologies into prices.

179. At the time prices were set, the ROI-band approach was thought likely to be the starting price adjustment model. This would have produced materially different outcomes to the new industry-wide forecasting approach. Even if EDBs had been able to set prices to reflect the input methodologies and the starting price adjustments, those prices would have been consistent with

⁴⁷ EDBs acted in accordance with Commission decision No. 685, dated 30 November 2009, which relied on section 53P(3)(a) approach to setting prices.

the ROI-band approach, not the industry-wide forecasting approach. The industry-wide forecasting approach was not released for consultation until 11 April 2011, eleven days after 2011/12 prices came into effect, and was not signalled to EDBs in advance.

180. Overall, it is unreasonable to expect Vector or other EDBs to have set prices for the 2011/12 year based on the IMs given the timeframes involved and the lack of a confirmed starting price adjustment methodology. Implementing claw-back would retrospectively penalise past pricing decisions that were taken without full knowledge of the input methodologies or the final starting price adjustment approach in *both* 2010/11 and 2011/12.

Conclusion

181. Vector recommends that the Commission does not apply claw-back to any perceived over recovery of revenues in the 2010/11 and 2011/12 regulatory years.

Alternative rates of change

182. Vector welcomes the Commission's acknowledgement that starting price adjustments may cause financial hardship for suppliers or price shocks to consumers. The Commission's view is that undue financial hardship must be demonstrated for the regulated services only and seeks indications of potential EDB financial hardship on the basis of the illustrative outcomes from the Commission's draft SPA methodology. Vector considers that hardship should be demonstrated on a group basis where multiple businesses are operated by an EDB.
183. The Commission's focus on EDB-specific hardship does not reflect the way in which firms with multiple business units operate. When making judgements about Vector's financial position, Vector's Board considers the operations of Vector Group as a whole, not individual business units. Vector recommends that the Commission permit EDBs to demonstrate financial hardship across their group operations where appropriate.
184. Vector envisages that financial hardship could have both regulated supplier and group characteristics, and that the fundamental analysis would cast a counterfactual against a factual proposition in which the non-regulated activity was held constant. To the extent that financial hardship might be defined in terms of ability to fund capital expenditure or maintenance activities, the focus would be on regulated activities alone. To the extent that the financial hardship is reflected in access to debt capital markets or impacts on borrowing covenants, these must be group focussed.

185. The Commission should also be careful when requiring firms to show that they have addressed financial hardship by reducing the level of investment and / or dividend payments. Vector already operates a highly efficient approach to investment, and reducing investment would not be consistent with the Part 4 Purpose and is not in the long-term interest of consumers. Reducing dividend payments should not be seen as a costless option as it would inevitably lead to a reduced share price and hamper the ability of the firm to attract capital.
186. Finally, we are unsure what value would be obtained by suppliers providing views to the Commission of potential financial hardship caused by the illustrative starting price adjustments produced by the Commission's model. The actual starting price adjustments will differ from these amounts and it would be preferable to provide information based on the impact of actual rather than illustrative starting price adjustments.
187. Vector will address the issue of financial hardship further in our submission in response to the Draft Decisions paper.

Price path compliance formula

188. The Commission has proposed two approaches to implementing the starting price adjustment in the 2010-15 DPP price path compliance formula:
 - (a) implementing starting revenue in an NPV equivalent approach over five years; or
 - (b) implementing starting revenue in an NPV equivalent approach over three years.
189. Vector's strong preference is for the three-year NPV equivalent approach. As noted by Economic Insights, this approach has the least potential to distort EDB decision making and allows EDBs and other stakeholders to become familiar with the implementation of a forward-looking framework without claw-back, as will be standard practice from 2015.
190. Implementing the 3-year option could require quantity information that will not be available at the time of determining starting price adjustments, if the formula used for the initial reset DPPs was used. However, there are other approaches open to the Commission to make starting price adjustments. For example, in the Gas Authorisation the Commission simply required an on-average percentage reduction in Vector's prices to realise the starting price adjustment. Such an approach could be implemented in this case also.

Other amendments to 2010-15 DPP

191. The proposed changes to the 2010-15 DPP determination to take account of the IM determination appear to be appropriate. Vector will provide more detailed comments on the draft determination when this is released.

Approval of certain recoverable costs

192. The Commission proposes that avoided transmission cost approval will be undertaken as part of the *ex post* annual compliance process for an EDB. Vector is comfortable with this approach provided that the only evidence required will be evidence of the value of the avoided transmission investment. We also assume that this proposal applies to new investment contracts.
193. Vector notes that the only recoverable cost approval process discussed in the Update Paper relates to avoided transmission costs. However, under the input methodology determinations, charges payable by EDBs to Transpower in respect of new investment contracts are also only recoverable costs where they are approved by the Commission. Vector assumes that the Commission's proposals relating to avoided transmission can be read as also applying to new investment contracts.
194. Vector is generally opposed to *ex post* approval for expenditure due to the inherent risk in making an investment before it is approved. If an investment is not approved, there is a risk that the price path could be breached inadvertently. This risk is likely to dampen investment or lead to sub-optimal solutions, such as EDBs building and owning assets rather than contracting with Transpower.
195. However, on the basis of the Commission's statement that the only evidence that will be required for approval is proof of the amount of the avoided transmission or the new investment contract, Vector supports the Commission's proposed process for approving avoided transmission costs.
196. The Commission has also proposed that the same avoided cost (in nominal terms) is recovered each year for the 5-year recovery period as this approach is simple and transparent. Vector recommends that where the distributor can demonstrate to the Commission's satisfaction that the avoided cost has changed, for example by the application of Transpower's pricing methodology, then this changed cost should be able to be included as an avoided transmission charge.

Mergers and acquisitions

197. Vector considers that the proposed amendment to make the DPP consistent with clause 3.2.1 of the Electricity Distribution Services Input Methodology Determination is appropriate.

Actual revenue impacts are not clear

198. Vector notes that the starting price adjustments produced by the model do not represent the actual price adjustments for suppliers. They are merely the difference between the Commission's assessment of EDBs' actual position and the Commission's estimate of where the EDBs would be if they were earning a "normal" return.
199. The price adjustments are being estimated net of pass through costs, while allowable notional revenue includes pass-through costs. They also take no account of the two-year lagged volumes that are an important input in the price path formula. This makes it difficult for EDBs to estimate the likely impact on them of the Commission's proposal.
200. Vector requests that the Commission provide a worked example in which the Commission demonstrates how the model outputs would be translated into a price path adjustment for an EDB. This is necessary for EDBs to determine the likely impact of the starting price adjustment approach.

Comments on the consultation process

Significant changes in direction should be signalled in advance

201. The Commission's new proposal is a significant change from the previous "ROI-band" proposal,⁴⁸ and will produce materially different outcomes for most EDBs. The ROI-band approach was first suggested in June 2009, with a formal proposal being made in early August 2010. Over this time, until the new "industry-wide forecasting" proposal was released in April 2011, Vector and others in the industry have operated on the assumption that something like the ROI-band proposal would be implemented by the Commission. This view has been the basis of business planning by EDBs and reporting by market analysts. With the new proposal, the Commission has fundamentally changed the situation at a late stage, causing market concern and heightening regulatory uncertainty.
202. Some examples of the market responses to the Commission's release of the new SPA methodology are:

⁴⁸ Commerce Commission, *Starting Price Adjustments for Default Price-Quality Paths: Discussion Paper*, 5 August 2010.

- (a) Goldman Sachs: the Commission “has once again made a material but seemingly arbitrary change to the regulatory framework” and “the regulatory regime remains as uncertain and subjective as ever”;⁴⁹
 - (b) Macquarie: “market is likely to see this as a disappointing lurch in regulation”;⁵⁰ and
 - (c) Forsyth Barr: “it is frustrating for investors that the regulatory certainty that appeared to be improving has ended up being an illusion”.⁵¹
203. This late change in direction, especially when combined with such a short consultation period, has also created serious challenges for stakeholders’ ability to provide informed and well-developed responses to the consultation process.
204. For the future, we recommend that if the Commission is contemplating a material change in approach it should insert an additional step into its process. For example, in these circumstances the Commission should release its summary and assessment of the submissions it has received, so regulated suppliers and other stakeholders have advance warning of any contemplated change in direction and engage on the development of the new approach with the Commission at an early stage.
205. Such early engagement would improve regulatory certainty and foster better relations between stakeholders and the Commission. It would also promote more informed submissions and information exchange.

The Commission should balance its consultation requirements

206. The Commission is requiring a large volume of information and views from suppliers over the period April-June 2011. During that time suppliers have been required to respond to a statutory notice information request, provide submissions and cross submissions on EDB starting price adjustments and provide submissions and cross submissions on a GPB DPP discussion paper. In addition, the Commission has scheduled a series of workshops on information disclosure.
207. Vector recognises that the Commission is under pressure to complete work to challenging timeframes and in some cases is driven by statutory deadlines. However, it is generally the same employees within regulated businesses that need to respond to these requests for input and engagement.

⁴⁹ Goldman Sachs, Vector Limited: Setback on the Regulatory Rollercoaster, 11 April 2011.
⁵⁰ Macquarie, Vector: Returns differential removed, Merits Review in stark focus, 12 April 2011.
⁵¹ Forsyth Barr, Vector (VCT): ComCom Flip Flop, 12 April 2011.

208. The Commission should take steps to reduce the burden on regulated businesses by staggering its consultation and information gathering processes over time. We suggest that the workstreams required to meet statutory deadlines should be prioritised and other matters staggered around them. This approach will also improve the quality of responses as suppliers will be better able to provide considered and well-developed responses.