



Vector Limited
101 Carlton Gore Road
PO Box 99882, Newmarket
Auckland 1149,
New Zealand
www.vector.co.nz
Corporate Telephone
+64-9-978 7788
Corporate Facsimile
+64-9-978 7799

Regulation Branch
Commerce Commission
PO Box 2351
Wellington

Sent by email to: regulation.branch@comcom.govt.nz

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Cross-submission on Starting Price Adjustments Update Paper

1. Vector welcomes the opportunity to provide this cross-submission to the Commerce Commission ("the Commission") on the *2010-2015 Default Price-Quality Path Starting Price Adjustments and Other Amendments Update Paper* ("Update Paper"), April 2011.

Reference year 2009/10

2. Vector notes that a number of submitters have commented on the use of the 2009/10 year data as the reference point for supplier-specific initial conditions – in effect, using that year's data as the single indicator for current profitability.
3. Submitters have adopted broadly similar views in respect of the Commission's proposal to rely on 2009/10 year information:
 - a) Aurora supports the Commission's approach to using 2009/10 (albeit within the overall context of preferring a 1% margin above the 75th percentile to allow for "inherent uncertainty in preparing forecasts of the various parameters for calculating future revenues and costs").¹
 - b) ENA express concern that the Commission relies on a single year, noting that "the Commission itself, in its two previous papers, and its advisor Economic Insights, identify[ed] the risks of placing too much reliance on one year's data".²

¹ Aurora Energy Limited: "Submission to the Commerce Commission on its Update Paper on 2010-12 Default Price Quality path Starting Price Adjustment and Other Adjustments"; 16 May 2011; page 11

² Electricity Networks Association; "Submission on DPP Starting Price Adjustments and Other Amendments"; 16 May 2011; para 3

- c) ENA also pragmatically accepts that, in the absence of a robust time series of data “the 2009/10 ROI [prepared on the basis of the input methodologies] is the best estimate the Commission has of the current and projected profitability of each supplier”.³
- d) Horizon makes similar points to the ENA.⁴
- e) Network Tasman expresses “considerable reservations about using firm specific single year (2009/10) data as the starting point for modelling projections”, on the basis that this may not be representative of normal operating conditions and may overstate profitability.⁵
- f) PwC, on behalf of 19 EDBs, suggests that consideration should also be given to 2011 information, noting the lack of reference to normalisation in the Commission’s Update Paper.⁶
- g) Unison notes that “it is unreasonable to rely on un-normalised 2010 ROIs to make starting price adjustments”.⁷ For Unison, abnormal characteristics of the 2009/10 year resulted in inflated revenue and potentially below normal storm response costs.⁸
- h) Vector expressed its own position as “include[ing] a band mechanism to address the uncertainties inherent in using 2010 data without normalisation ...”.⁹
4. Vector agrees with views expressed by other submitters that 2009/10 may not be a representative year. The Commissioners themselves have acknowledged that 2010 was part of a period of unusual economic conditions:

*“MS BEGG: I would have thought, though, that 2010 is a particularly, well currently anyway, it was a very uncertain time in that we are in a situation whereas set values are still adjusting in a very uncertain way I would have thought ...”*¹⁰

³ Ibid. Para 6

⁴ Horizon Energy Distribution Limited; “Electricity Distribution Business Default Price Quality Path – Proposed Starting Price Adjustments”; 16 May 2011; page 3

⁵ Network Tasman Limited; “Submission to the Commerce Commission on 2010-15 Default Price Quality Path Starting Price Adjustment and Other Amendments – Update Paper”; 23 May 2011; para 13

⁶ PriceWaterhouseCoopers; “Submission to the Commerce Commission on 2010-15 Default Price-Quality Path starting Price Adjustment and Other Amendments – made on behalf of 19 Electricity Distribution Businesses”; 16 May 2011; paras 20-21

⁷ Unison Networks Limited; “Submission on 2010-2015 Starting Price Adjustments Update Paper”; 16 May 2011; para 6(b)(ii)(1)

⁸ Ibid. Para 59

⁹ Vector Limited; “Submission to Commerce Commission on 2010-15 DPP Starting Price Adjustment and Other Amendments Update Paper”; 16 May 2011; para 159

¹⁰ Commerce Commission; Electricity Distribution Service Input Methodologies Conference- Transcript for 19 September 2009; page 339, lines 11-13

5. In addition to the prevailing economic conditions, 2010 may also have been atypical in terms of climate and the effects on network performance and operations, including the level of costs incurred for maintenance and repairs in response to storms. In this regard, Vector notes (as did PwC) that the Commission's Update Paper is silent on the concept of normalisation. This is surprising, given the Commission's previous discussion of normalisation in its August 2010 discussion paper.
6. However, Vector takes the view that normalisation may be less of an issue provided the Commission adopts an approach to setting starting prices that addresses the inherent uncertainty in using a single year's data to estimate current profitability. One such approach is Vector's proposal that starting prices are set within a band such that an EDB's ex ante forecasted profitability (and therefore reasonable expectations) are that it will earn at least the regulatory cost of capital over the regulatory period.
7. Vector would not support any information request for 2010/11 data to inform the 2012 reset. The cost and time involved in preparing 2010/11 disclosure information in line with the input methodologies should not be underestimated. As discussed in our previous submission¹¹, the uncertainty created by reliance on a single year's data can be addressed through an appropriate band mechanism.

Implications of the regulatory package are not reflected in current information

8. Having considered the submissions, Vector believes that there are further concerns with the Commission's proposed reliance on 2010 information as the basis of forecasting profitability and setting starting price adjustments which are absent from the submissions provided so far.
9. In particular, Vector has concerns that, to date, the Commission has only provided an incomplete regulatory package. That package will not be complete until the approach to starting price adjustments is known. Once the regulatory package is complete, EDBs will be able to consider the regulations and identify the incentives that arise from that package.
10. It is reasonable to expect that EDBs will seek to arrange and manage their business in light of those regulations and incentives (indeed, providing incentives to regulated firms to manage their businesses in a particular way is the general objective of incentive-based regulation like CPI-X). Based on their assessment of the regulations and incentives, EDBs may consider that different policies and practices (including choices about appropriate risk-reward trade-offs) are required than those in place currently.

¹¹ Refer footnote 9.

11. The Commission cannot therefore place particular reliance on the assumption that past performance is necessarily reflective of future performance. In the event Vector were to apply for a CPP, it might well do so with a set of policies, practices and forecasts that are fundamentally different from those of the past.
12. Furthermore, looking back to 2010 as the Commission proposes involves a significant degree of retrospectivity. Just as EDBs may reconsider the appropriateness of their current policies and practices in light of the regulations and incentives arising from the completed regulatory package, EDBs might also have adopted different policies and practices with effect from 2009/10 had EDBs had that opportunity at that time. This would not just impact the 2009/10 reported profitability but asset management plans may have also looked quite different.
13. Once we have the benefit of being able to assess the Commission's complete regulatory package, including the impact of the final starting price adjustment methodology, Vector may take a different view on the operational risk trade-offs, operational practices and the accounting treatments that are appropriate to align Vector's business operations with the incentives being provided by the Commission. Both our reported performance and our asset management planning in the future may therefore be notably different to Vector's current and previous practice. We may also wish to reconsider the appropriateness of our historical information.

Contact details

14. Thank-you for considering this submission. If you require further information please contact me on 09 978 8340 or at allan.carvell@vector.co.nz.

Yours sincerely



Allan Carvell
Group General Manager Regulation and Pricing