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VECTOR LIMITED
101 CARLTON GORE ROAD
PO BOX 99882
AUCKLAND 1149
NEW ZEALAND
+64 9 978 7788 / VECTOR.CO.NZ

Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
Commerce Commission
44 The Terrace
Wellington 6140

By email: im.review@comcom.govt.nz

Dear Keston,

Vector submission on the draft amended input methodologies determinations

1. This is Vector's submission on the Commerce Commission's (Commission) draft amendments to the electricity and gas distribution (EDB and GDB respectively) input methodologies (IM) determinations.
2. Vector's contact person for this submission is:

Sally Ma
Senior Regulatory Specialist
09 978 8284
Sally.Ma@vector.co.nz
3. Our comments on specific draft IM determination clauses are set out in the tables attached.
No part of this submission is confidential and we are happy for it to be publicly released.

Yours faithfully

A handwritten signature in blue ink, appearing to read "Richard Sharp".

Richard Sharp
Head of Regulatory and Pricing

APPENDIX A:
VECTOR'S COMMENTS ON THE DRAFT AMENDED IM DETERMINATIONS

TABLE 1. Comments on the EDB and GDB IM determinations

EDB and GDB	
Clause reference	Comment
1.1.4(2) Operating cost	<p>As discussed in Vector's submission on the IM review and IM report, dated 4 August 2016 ("Vector's IM review submission"), the Commission proposes to amend the IMs to exclude from the RAB any value associated with amounts treated as a finance lease recoverable cost. The Commission appears to have amended the definition of "operating cost" to address this in both the EDB and GDB IM determinations. In our view the proposed amendment does not correctly give effect to the Commission's intent.</p> <p>We recommend the Commission review the drafting and correct it. Additionally, based on the Commission's reasoning for this change we question whether the GDB IM needs to be amended at all.</p>
1.1.4(2) 67 th percentile estimate of WACC for Part 4 and Part 5, sub-clause (c)	<p>The sub-clause (c) of the definition of the 67th percentile for the mid-point estimate of WACC references clause 4.4.5(4). However there does not appear to be a sub-clause (4) in clause 4.4.5.</p> <p>We recommend the Commission review and correct this accordingly.</p>
<p>1.1.5(4) Next closest alternative approach (NCA);</p> <p>4.5.6(1)(d) When price-paths can be reconsidered; and</p> <p>4.5.7(2)(c) Amending a price path after reconsideration</p>	<p>As discussed in Vector's IM review submission, we are concerned with the Commission's proposal to introduce a NCA mechanism that allows the Commission to apply an alternative IM and reopen the default price-quality path ("DPP") where the alternative IM has a 'non-equivalent' effect.</p> <p>We are concerned with the material regulatory uncertainty this would introduce. We also question whether the NCA and section 52Q (discussed further below) DPP reopener mechanisms are consistent with the Commerce Act 1986 ("the Act") provisions that clearly state the processes and circumstances in which the Commission can amend the IMs and a DPP.</p> <p>Vector recommends the Commission review its proposals in light of Part 4. If the Commission retains this proposal, we recommend amending clause 1.1.5(4) to require:</p> <ul style="list-style-type: none"> • the Commission to demonstrate that the alternative IM is "materially more workable"; and • the Commission must consult before applying the NCA.
2.1.2(2)(a) Allocation approaches – ACAM threshold	<p>The Commission proposes to reduce the ACAM revenue materiality threshold from 20% to 10%.</p> <p>As discussed in Vector's IM review submission and the ENA's</p>

	<p>submission on Emerging Technology, we are not convinced the Commission has made a compelling case to justify this significant change to the ACAM cost allocation approach. Additionally, the Commission’s analysis includes several assumptions.</p> <p>We recommend the Commission review its proposal in light of our comments and the ENA’s, before progressing this.</p>
<p>2.2.11(2)(b) and (3)(b) Value of commissioned assets – cost of financing</p>	<p>The Commission proposes to change how suppliers calculate their cost of financing. Under sub-clause 2.2.11(2)(b) suppliers will be required to use a rate not greater than the supplier’s weighted average of borrowing costs for each applicable disclosure year.</p> <p>Clause 2.2.11(3)(b) requires that the borrowing costs must include borrowing costs specifically for the purpose of any particular capex projects or programmes.</p> <p>This requirement makes sense for suppliers who raise debt for specific capex projects and / or suppliers who provide a single service.</p> <p>However, this requirement is not practicable for suppliers that do not raise debt at a capex project or programme level. The combination of these changes would impose significant and disproportionate compliance costs to require this level of disaggregation.</p> <p>We recommend that a better approach is to:</p> <ul style="list-style-type: none"> • Change “weighted average of borrowing cost” to “average borrowing cost”; and • Remove sub-clause 2.2.11(3)(b).
<p>2.2.11(3) Value of commissioned assets – cost of financing</p>	<p>Sub-clause 2.2.11(3) also proposes suppliers calculate finance costs based on an asset balance net of any capital contributions received.</p> <p>In addition to the above, this proposal would impose further compliance costs on suppliers who will have to calculate two separate financing costs – one that complies with GAAP and another for the purposes of information disclosure (for GDB and EDB).</p> <p>Under the current IM requirements we use the same accounting system set up to comply with GAAP. The proposal will require an entirely new system for the purpose of reporting a single item in Schedule 6a. The introduction of an additional system will require considerable effort and resources to construct.</p> <p>Moreover, we believe the proposal will have an immaterial impact while the compliance costs to meet the proposal will be significant.</p> <p>We recommend the cost of financing IM remain as it is currently drafted, which is in line with GAAP (for DPPs and CPPs).</p>
<p>3.1.2(1) Pass-through costs</p>	<p>The Commission has amended the definition of pass-through costs so that new pass-through costs can be specified at the time of a DPP reset, provided certain criteria is met.</p>

	<p>Vector supports this proposal and considers it a sensible way to make the pass-through cost IM more workable.</p>
<p>When price-quality paths can be reconsidered and amending a price path after reconsideration</p> <p>EDB: 4.5.6(1)(e); 4.5.7(2)(d); 5.6.7(10); and 5.6.8(5)</p> <p>GDB: 4.5.5(1)(d); 4.5.6(2)(d); 5.7.7(10); and 5.7.8(5)</p>	<p>These clauses introduce a new scenario into the IMs where the Commission may reconsider a DPP if “the application of section 52Q results in a non-equivalent effect”.</p> <p>Section 52Q of the Commerce Act allows the Commission to make an amendment to a DPP. Where material amendments must only be made after the Commission has consulted with interested parties.</p> <p>As discussed in Vector’s IM review submission, these new IM clauses appear to be inconsistent with section 52Q of the Act. We also question whether the IMs need to cater for section 52Q given it is provided for in the Act.</p> <p>We recommend the Commission amend the IMs to either:</p> <ul style="list-style-type: none"> • Remove all reference to section 52Q; or • Ensure any incorporation of section 52Q, and the NCA mechanism, is not inconsistent with the Act.

Table 2. Comments on the EDB IM determination

EDB	
Clause reference	Comment
2.4.4(5)(c) Methodology for estimating debt premium	<p>Sub-clause 2.4.4(5)(c) refers to “sub-clauses (4)(b) to (4)(e)”. There does not appear to be a sub-clause (4)(e). We recommend the Commission correct this accordingly.</p>
3.1.3(1)(v) and (12) Recoverable costs – revenue wash up draw down	<p>As discussed in Vector’s IM review submission, Vector supports the new recoverable cost for revenue wash up account and draw down amounts – subject to the removal of a wash up account cap.</p> <p>The wash up account and draw down amounts are an important feature of the revenue cap, and is particularly appropriate given the removal of the pass-through balance.</p>
3.1.3(12) and (13) Recoverable costs – price constraint mechanisms	<p>As discussed in Vector’s submission, we do not support the introduction of various IMs that depend on a future section 52P determination (i.e. DPP) to inform suppliers whether or not the Commission will apply it. In effect, this creates multiple “optional IMs”.</p> <p>Drafting IMs in this manner unduly risks introducing material uncertainty to the regulatory regime. As we consider the only price volatility mechanism required under a revenue cap is a symmetrical</p>

	<p>cap and collar on the wash-up draw down amount, we recommend:</p> <ul style="list-style-type: none"> • removing clauses related to a voluntary undercharging deduction amount (i.e. sub-clauses (12)(b); (13)(a) and (i)(i); and (13)(l)(ii)); and • removing clauses relating to a wash up amount cap (i.e. sub-clauses (13)(f)).
<p>3.1.3(13)(i) and (l) Recoverable cost – timing of entries</p>	<p>These sub-clauses relate to the timing of entries into the wash up account. The current drafting is difficult to follow. We presume that the timing of the entries would be the same as the current timings for the pass-through balance. However, we are not sure.</p> <p>We recommend the Commission consider clarify the drafting of sub-clauses (i) and (l), and / or include an equation to help clarify.</p>
<p>4.2.2(3) Total depreciation – adjustment factor</p>	<p>Sub-clause 4.2.2(3) includes IM amendments giving effect to the Commission’s proposals for accelerated depreciation (via an “adjustment factor”). Vector supports this proposal, which addresses the real partial capital recovery risk suppliers face from technology innovation in the energy sector.</p> <p>Sub-clause 4.2.2(3)(d)(i) states that the Commission may not apply an adjustment factor lower than 0.85 or higher than 1.</p> <p>Sub-clause 4.2.2(3)(e) appears to prevent the supplier from applying for an adjustment factor under sub-clause 4.2.2(3)(d), if the Commission has previously applied an adjustment factor. I.e. the IMs appear to enable the Commission to apply an adjustment factor <i>once</i>.</p> <p>As set out in Vector’s IM review submission (paragraphs 58-66), we do not consider that a capped, one-off adjustment gives effect to the Commission’s proposed solution to address risk of partial capital recovery.</p> <p>We recommend the IMs be amended to allow:</p> <ul style="list-style-type: none"> • suppliers to apply for accelerated depreciation at each DPP / CPP reset; and • remove the specification limits for the adjustment factor. <p>These changes will make the adjustment factor appropriately flexible in terms of both frequency and recovery as the Commission deems necessary, based on the suppliers’ application.</p> <p>The combination will create a more appropriate mechanism to address risk of partial capital recovery without putting undue risk on consumers because the Commission would be required to assess the merits of each application before determining whether to apply an adjustment. It puts the onus on suppliers to make a compelling case, consistent with the purpose of Part 4 of the Commerce Act.</p> <p>Further, the current drafting links sub-clause 4.2.2(3)(e) to sub-clause 4.2.2(3)(d)(iii) with an “and”. We consider that sub-clause 4.2.2(3) would read better if 4.2.2(3)(e) was re-numbered as <u>“4.2.2(3)(d)(iv)”</u>.</p>

4.5.6(2) When price paths may be reconsidered	Sub-clause 4.5.6(2) should refer to sub-clause (1)(a)(i) instead of sub-clause (1)(c).
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Table 3. Comments on the GDB IM determination

GDB	
Clause reference	Comment
1.1.4(2) Capex wash-up adjustment	The definition should refer to clause 3.1.3(5) and not 3.1.3(4).
1.1.4(2) Cost of debt	Sub-clause (b) of the cost of debt definition should refer to 4.4.1(3) and not 4.4.1(2).
1.1.4(2) Forecast CPI	Sub-clause (b) of the forecast CPI definition for Part 5 contains minor typos we recommend correcting.
3.1.1 Specification and definition of price	<p>As discussed in Vector's submission on the GPB DPP implementation paper, we have not experienced any issues with the management of pass-through and recoverable costs under the 'ascertainable' model and see limited benefit in moving to a 'pass-through balance' approach for GDBs.</p> <p>The 'pass-through balance' is more appropriate for EDBs who face greater annual variations in transmission charges, which can cause significant risk for price compliance. GDBs do not face these risks.</p> <p>We recommend:</p> <ul style="list-style-type: none"> removing sub-clause 3.1.1(1)(f) and retaining the current 'ascertainable' approach for pass-through and recoverable costs; and removing IMs that relate to "distribution price" and "pass-through price" – thereby reverting back to "prices".
3.1.3(1)(a) and 3.1.3(1)(g) Claw-back recoverable costs	We are not sure if both of these clauses are necessary and recommend the Commission clarify.
4.2.2 Total depreciation	<p>As discussed in Vector's submission, the Commission recognises that GDB is at risk of partial capital recovery and is closer to the "death spiral tipping point". However the Commission also dismisses the need to provide for accelerated depreciation as an option in the total depreciation IMs.</p> <p>Ensuring the IMs include a mechanism to address risk of partial capital recovery is a prudent way to manage future risk, by giving suppliers the opportunity to seek an adjustment factor. It does not</p>

	<p>automatically guarantee suppliers an acceleration of remaining depreciation but gives the Commission the discretion to allow it on a case by case basis.</p> <p>We recommend the GDB IMs provide suppliers the opportunity to apply for an “adjustment factor” as the EDB IMs allow, and in a manner consistent with our comments on the EDB IMs (see above).</p>
<p>4.5.5(2) When price-quality paths may be considered</p>	<p>Sub-clause 4.5.5(2) should refer to sub-clause (1)(a)(i) instead of (1)(c).</p>
<p>Subpart 5 Reconsideration of the default price-quality path</p>	<p>As discussed in Vector’s submission on the GPB DPP implementation paper, Vector considers there is merit in including a supplier initiated DPP reconsideration for constant price revenue growth (CPRG) as part of a GDB weighted average price cap form of control.</p> <p>While the Commission’s forecasts to date for the initial GDB DPP were reasonable estimates of demand, we do not believe that that in itself is an adequate basis for not including a CPRG reopener for potential future risk. This is because the Commission (and stakeholders) recognise the significant complexities and risks associated with forecasting CPRG.</p> <p>We recommend the Commission reconsider including a CPRG reopener.</p>