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Treatment of changes in economies of scale due to transactions

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1 Introduction

1. Vector has asked CEG to provide a review of the Commission's treatment of changes in economies of scale that result from it sale of gas assets to First Gas Limited (FGL). FGL acquired Vector's gas transmission pipelines in April 2016. This transaction appears to have generated economy of scale gains for FGL, while leading to economy of scale losses for Vector.

2. In the 2017 Draft Reasons Paper, the Commission decided that Vector should be made to bear the economy of scale losses arising out of the transaction, up until the end of the next regulatory period in 2022. At the same time, no adjustment was made for FGL's increased economies of scale, as the Commission was not able to identify any economy of scale effects from the transaction.

3. The decision in the 2017 Draft Reasons Paper, however, appears to contradict the 2010 IM that was in force at the time of the transaction. Although the Commission claimed that its 2017 decision was consistent with the 2010 IM, it is clearly stated in the 2010 IM that firms achieving gains in economies of scale would only retain such gains until the end of the regulatory cycle in which the transaction occurred. The 2017 Draft Reasons Paper therefore requires Vector to incur economies of scale losses for 6.5 years instead of the expected timeframe of 1.5 years under the 2010 IM.

4. This report thus evaluates and compares how the 2017 Draft Reasons Paper and the 2010 IM address the issue of gains and losses of economies of scale from mergers and acquisitions of regulated assets.

5. We establish the inconsistency between the 2017 Draft Reasons Paper and the 2010 IM, and that as a result, the Commission's 2017 decision is, actually, a retrospective change to the policy that applied at the time of the transaction between Vector and FGL. In addition to this fundamental problem, we are of the view that the 2017 decision lacks of transparency, symmetry, and a proper consideration of the full and proper context of the policy.

2 2017 draft gas decision is inconsistent with 2010 IM framework

6. The Commission's 2017 Draft Reasons Paper[1] addressed, among other things, the issue of how economies of scale losses from mergers and acquisitions of regulated assets should be treated.

7. In the Draft Reasons Paper, the Commission interpreted the previous 2010 IMs as allowing suppliers to temporarily retain any economies of scale resulting from mergers and acquisitions, for the regulatory period following the transaction [emphasis added]:[2]

> *In the 2010 IM reasons paper, we stated that suppliers are able to temporarily retain cost reductions caused by efficiencies that result from a merger or acquisition* ***during the regulatory period following the transaction****. Consumers will then benefit from the cost reductions during the regulatory period after that.*

8. Based on the above characterisation of the 2010 IM reasons paper, the Commission decided to apply similar reasoning for inefficiencies, and thus decided that Vector would have to bear the cost of lost economies of scale arising out of its sale of assets to First Gas until 2022. Given the transaction was settled in April 2016, Vector would be required to bear the costs of lost economies of scale for 6.5 years. That is, from the date of the sale until the end of the next regulatory cycle that spans 2017-2022 [emphasis added]:[3]

> *Consistent with this, we consider that the suppliers should temporarily retain the cost of any forecast inefficiencies resulting from industry transactions (such as the split of the Vector distribution network)* ***for the regulatory period following the transaction****. Consumers would then bear the costs in the regulatory periods after that.*

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[1] Commerce Commission, Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022, Draft Reasons Paper, February 2017.

[2] Commerce Commission, Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022, Draft Reasons Paper, February 2017, p. 50 at [4.59].

[3] Commerce Commission, Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022, Draft Reasons Paper, February 2017, p. 50 at [4.60].

9. This resulted in downward adjustments to Vector's capex and opex 2017-2022 forecasts in order to account for the losses of economies of scale incurred by Vector as a result of the sale of its non-Auckland distribution assets to First Gas:[4]

> *we have identified some economy of scale losses in the Vector distribution business (but not the First Gas distribution business) in both capex and opex. Due to this, we have made the following downward adjustments to Vector's forecast expenditure (in real 2016 prices):*
>
> *5.25.1 capex: $0.6 million*
>
> *5.25.2 opex: $1.6 million*

10. In our view, the Commission has mischaracterised its earlier 2010 IM decision, which sets out a clear and different position compared to the interpretation in the 2017 Draft Reasons Paper. Specifically, that economy of scale gains/losses would be kept/borne until the end of the regulatory period in which a transaction occurred. It therefore follows that the Commission's decision to adjust Vector's allowance below costs for a further 5 years is based on an error in reasoning.

11. Furthermore, the 2010 IM decision framework was the only policy on record at the time of Vector's transaction, and had an explicit legislative purpose to "promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services".[5]

12. The Commission's 2017 Draft Reasons Paper therefore amounts to a post-transaction retrospective rewriting of the rules without advance warning or consultation. Such an approach is disconcerting and is likely to stymie future transactions, given the risk associated with a regulator that is inclined to retrospectively change established rules.

2.1 The 2010 IM

13. The 2010 IM decision treated economies of scale in the same manner as efficiencies derived from any other source. That is, suppliers would be allowed to temporarily retain any efficiency gains attained from transactions occurring in the middle of the regulatory period, up until the end of said regulatory period, after which the next price determination would take those economies of scale into account.

14. The 2010 IM decision explicitly stated that the same incentive properties would apply to cost changes resulting from transactions, as they would to any other source of cost savings, such as the renegotiation of a vendor agreement or contracting service. That

4 Commerce Commission, Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022, Draft Reasons Paper, February 2017, p. 63 at [5.25].

5 *Commerce Act 1986* s 52R.

decision states that suppliers should be allowed to retain any efficiency gains arising out of a merger or acquisition occurring part-way through a regulatory period, up until the end of the regulatory period in which the transaction occurred [emphasis added]:[6]

> *Following a merger or acquisition part-way through a regulatory period, under the IMs suppliers are not required to reallocate their costs and reflect any changes in shared cost costs* [sic] *in their prices (e.g. by re-opening their price path). For transparency, however, suppliers must report their actual costs as part of information disclosure. The effect of this is that suppliers may retain any benefits from efficiencies resulting from the transaction, since they may 'double count' costs and hence recover the shared costs more than once from consumers of regulated services. The ability to retain these gains provides the incentive to achieve these efficiencies, consistent with s 52A(1)(c).* ***At the end of the regulatory period the Commission resets the price path through starting price adjustments under a DPP or a new CPP.*** *Through this the benefits from efficiency gains made in the previous period are shared with consumers. If efficiencies are not achieved until the next regulatory period, or additional efficiencies are made in subsequent periods these would be passed on in subsequent resets.*

15. In this way, the 2010 IM decision effectively placed acquisition cost changes on the same level as all other sources of cost changes, in that achieving these cost changes would result in the same set of consequences regardless of how they were achieved – the gains from all efficiencies and cost savings (or the losses from cost increases) would be retained (borne) until the end of the regulatory period, before being taken into account in the next period. This is entirely sensible policy as there is no compelling reason why the regulatory regime should treat changes in costs differently based on how those cost changes are achieved.

16. Although the 2010 IM decision framed its discussion in terms of gains in economies of scale to the acquiring party, the only possible reading of this decision is that a symmetrical approach would be taken to losses of economies of scale to the selling party. That is, in circumstances where a transaction involved one regulated entity selling some, but not all, of their regulated assets to another entity then there would be a symmetrical treatment. The selling party would have to bear the loss of economies of scale until the end of the DPP period and the other party would, symmetrically, gain until the end of the DPP period. (Noting that this symmetry is required in order to not discourage efficient transactions as discussed in section 2.2 below).

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6 Commerce Commission, Input Methodologies (Electricity Distribution and Gas Pipeline Services, Reasons Paper, December 2010, p. 80 at [3.3.28].

17. This is also consistent with the IMs establishing a regime to assess and compensate for "forward looking" costs when setting a DPP or CPP. There was no 'carve out' for different treatment to be applied to cost changes as a result of a transaction. Indeed, the 2010 IMs were explicit that the same treatment would apply.

18. We also note that, notwithstanding its mischaracterisation of the 2010 IM, the Commission's 2017 Draft Reasons Paper also proceeded on the same reasoning that losses of economies of scale arising out of acquisitions should be treated in a symmetric manner to economies of scale:[7]

> *Vector submitted on our policy paper that we should take a consistent approach between efficiencies and inefficiencies caused by economies of scale and diseconomies of scale. We agree with this. However, Vector argued this on the basis that we should not make adjustments for either increased or decreased expenditure.*

19. It is not obvious to us that the Commission's 2017 policy is symmetric (indeed, as explained in section 3.2 we believe that it almost certainly is not). However, it could potentially be made to be symmetrical but it would still be:

- retrospective (applying a different set of rules to those that applied at the time of the transaction); and
- 'backward looking' (i.e. regulating Vector based on its historical conglomerate business and transmission pipelines based on two different owners MDL and Vector and not FGL).

2.2 How the 2010 IM framework would operate – shared services example

20. It is helpful to set out the mechanism of the 2010 IM using a simplified example. Consider a scenario in which regulated firm A transfers a portion of its regulated assets to regulated firm B. Further assume that the sum total of fixed common costs across both firms is unchanged by the transaction. In this baseline example there is no overall efficiency or inefficiency created by the transaction. Total costs are the same across both firms both pre- and post-transaction. All that has happened is that there has been a transfer of economies of scale from one firm to another.

21. The regulatory impact of such a transaction is that prices will increase for the customers of firm A (who is losing economies of scale), while prices will decrease for the customers of firm B (who is gaining economies of scale). However, the total costs and regulatory allowance obtained from the two firms remains unchanged.

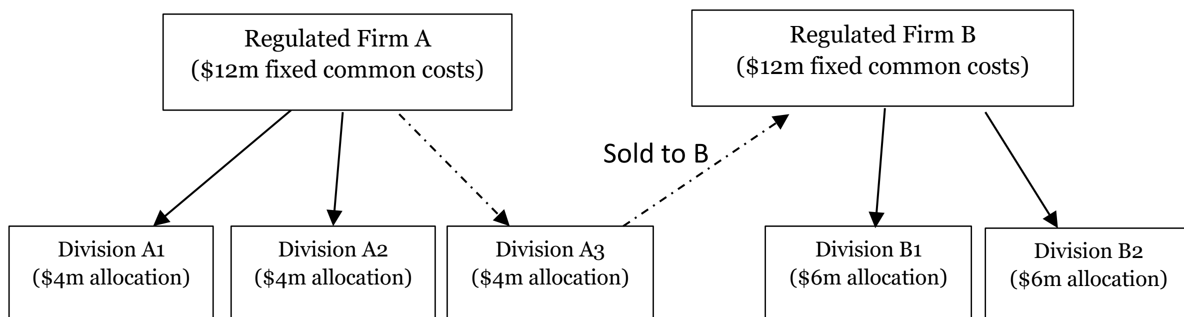
[7] Commerce Commission, Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022, Draft Reasons Paper, February 2017, p. 51 at [4.62].

22. Figure 2-1 provides a numerical example with the above concepts. Here, Firm A and Firm B each incur $12m in common costs. Firm A allocates its common costs equally among its three divisions ($4m for each division), while Firm B allocates its common costs equally among its two divisions ($6m for each division).

23. If Firm A were to sell one of its three divisions (A3) to Firm B, its fixed common costs would remain unchanged at $12m, but it would lose $4m of compensation towards those costs from the moment the A3 division was sold. Firm B's fixed common costs would also remain fixed at $12m, but, from the moment it received control of A3, it would earn an additional $4m of compensation ($16m in total).

24. Under the 2010 IM, Firm A would be required to bear the $4m loss until the end of the current regulatory cycle, since its average price cannot be raised until then. Firm B would in turn get to retain the $4m gain since it does not have to lower its prices until the end of the regulatory cycle. Naturally, each firm will factor these gains and losses of economies of scale into the negotiated final sale price of Division A3.

Figure 2-1: Illustration of a transaction with economy of scale transfers



Source: CEG

25. The fundamental point is unchanged even if it is assumed that the transaction creates some overall efficiency (or inefficiency). Imagine that, Vector's total common costs actually fell by $1m – say as a result of some sort of reduction in complexity of the business and FGL's rose by $0.5m. Then there would be overall economies of scale in the transaction – which the two parties (on net) would benefit from until the end of the DPP period. Of course, there would still be a very significant element of simply transferring economies of scale between the parties. The same logic applies if there are economies of scale/scope in relation to areas other than common costs, such as the direct cost synergies associated with contracting field services.

26. The symmetrical nature of the 2010 IM policy is critical. In this context, symmetry means that, in the baseline example where there are no net economies of scale (just a transfer between the parties), there is no net advantage or disadvantage to the parties from the transaction. The 2010 IM policy achieves this via:

- The seller losing the regulated revenue associated with the assets being transferred – including any contribution to fixed common costs from those assets

and not receiving any increase in revenues on other assets despite the unit cost of fixed common costs increasing with smaller economies of scale;

  - The effect of which is the seller bears the cost of lost economies of scale until the end of the regulatory period;

- The buyer gaining exactly the revenues lost - including any contribution to fixed common costs from those assets and not receiving any reduction in revenues on other assets despite the unit cost of fixed common costs falling with greater economies of scale;

  - The effect of which is that the buyer receives a benefit of **exactly the same** value as the loss that the seller incurs and for exactly the same time period.

- During the next regulatory period revenues are reset to reflect the new allocation of economies of scale and both parties recover their costs.

27. Under this symmetrical policy, a transaction with zero net economies of scale is neither encouraged nor discouraged by the regulatory regime. While the seller will, by definition, lose economies of scale and make a loss from the transaction the buyer will make an offsetting gain. The buyer, therefore, has the capacity to, and would need to, compensate the seller for their anticipated loss in the negotiated sale price.

28. However, critically:

- if there are positive net economies of scale/scope from the transaction then the regulatory regime encourages the transaction because the combined costs of the two firms will be lower as a result of the transaction but revenue will not be reset lower until the end of the DPP period; and

- if there are negative net economies of scale/scope from the transaction then the regulatory regime discourages the transaction because the combined costs of the two firms will be higher as a result of the transaction but revenue will not be reset higher until the end of the DPP period.

2.3 The 2017 policy

29. Comparing the bolded quote in paragraph 14 against the bolded quote in paragraph 8 demonstrates a clear inconsistency between the 2017 Draft Reasons Paper and the 2010 IM: while the 2010 IM states that economies of scale will be retained by the supplier until the end of the regulatory period in which the transaction occurred, the 2017 Draft Reasons Paper extends that timeframe to also include the subsequent regulatory period after that.

30. Such a change in policy has a very large impact. Under the 2010 IM, Vector would only bear the loss of economies of scale for approximately 1.5 years, from the time when the transaction occurred in April 2016 until the beginning of the new DPP in October 2017. Similarly, FGL would receive the gains from economies of scale for the

same timeframe of 1.5 years. Consequently, the two parties' negotiated sale price would rationally have reflected compensation to Vector for its loss of economies of scale for only 1.5 years, as well as an additional charge to FGL for its 1.5 years of surplus from the gains in economies of scale arising out of the combined MDL and Vector transmission businesses.

31. Under the 2017 Draft Reasons Paper, however, Vector is now, after the fact, required to bear the loss of economies of scale for 6.5 years until the end of the 2017-2022 regulatory period, while FGL would also receive the benefits of economies of scale for 6.5 years. Even if the 2017 policy is symmetrical (which the Commission claims but which is unclear to us), this involves a very large after-the-fact transfer of wealth..

32. If the policy is symmetrical then, on net, customers as a group should not be affected. Relative to the 2010 IM policy, Vector customers are made better off and FGL customers are made worse off by the same amount. Conversely, Vector shareholders are made worse off and FGL customers are made better off by the same amount.

33. There can, naturally, be no incentive effect of this policy on the transaction given that it is introduced after the transaction.[8] As such, the 2017 policy, applied to a 2016 transaction, is tantamount to a retrospective intervention into a settled transaction in order to create windfall gains and losses that could not have been anticipated at the time of the negotiation. Instead, the prices and terms of the transaction would have been negotiated under the 2010 IM rules, and neither party would have had the opportunity to factor the 2017 Draft Reasons Paper policy into their private valuations of the assets and into the final price of the transaction.

34. It may be that the Commission believes that it would, prospectively, be appropriate to signal a strengthening of incentives for gas businesses above and beyond the incentives provided in the 2010 IM policy. It is not obvious why the Commission would only want to do this for efficiencies from transactions as opposed other sources (especially in the context of the level of activity that occurred under the current rule). Nonetheless, if that were the Commission's objective, then the appropriate way to do so is to set out the policy now, consult on it, and apply it prospectively to new transactions. The Commission may even decide that it wishes to apply a more high-powered incentive regime to cost changes deriving from transactions, than to other sources of cost changes. If so, it would need to clearly specify that this was the case and how this would practically operate (although it is not obvious there is a need for a greater incentive for rewarding merger transactions given the level of transaction activity occurring under the current policy).

8 There is a potentially materially negative incentive effect in the form of a reduction in the credibility of Commission policies prospectively and the ability of regulated businesses to plan effectively.

3 Non-transparent, non-symmetric and inconsistent with electricity

35. The Commission's reasoning in the 2017 Draft Reasons Paper is:

    i. not transparent; and

    ii. not symmetric.

36. Furthermore, the Commission's reasoning fails to make the new policy in a full and proper context, taking the electricity regulation framework into account. As will be discussed in section 3.3, the context of the electricity regulation framework is important due to issues such as different regulatory period timings and regulatory certainty.

3.1 Not transparent

37. Vector has provided us with the spreadsheet that the Commission used to generate its estimate of the decrement that should apply to Vector in order to remove the effects of economies of scale losses arising out of the transaction. However, we were unable to independently verify the Commission's estimates because these estimates appear to have been hardcoded into the spreadsheet.

38. In addition, we are unable to verify whether any equivalent increment has been applied to FGL, and neither are we able to corroborate the following statement found in the 2017 Draft Reasons Paper:[9]

> *For the draft decision we have not yet identified any economy of scale effects from the transmission merger or the sale of Bay of Plenty assets from GasNet to First Gas.*

3.2 Not symmetric

39. Notwithstanding the fact that we cannot verify the Commission's methodology for calculating the economies of scale adjustments that apply to Vector and FGL, the 2017 Draft Reasons Paper suggests that the Commission did not apply a symmetric negative and positive adjustment to Vector and FGL to account for changes in economies of scale.

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9 Commerce Commission, Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022, Draft Reasons Paper, February 2017, p. 63 at [5.25].

40. In Vector's case, the Commission imposed downward adjustments of $0.6 million for Vector's capex and $1.6 million for Vector's opex. FGL, on the other hand, did not receive any adjustments because the Commission did not identify any economies of scale effects from Vector's sale of assets to FGL.[10]

41. Such an asymmetric treatment of the gains and losses of economies of scale resulting from an acquisition is conceptually problematic. As explained in section 2.2, the sale of regulated assets from one regulated business to another typically results in a transfer of economies of scale from the seller to the buyer. The transaction should neither create economies of scale nor destroy it.

42. The Commission has not made any attempt to explain how the decrement imposed on Vector is offset by an equal increment above cost applied to FGL. It may be that the Commission has some reasoning for why this is the case but it certainly has not explained it. Moreover, as noted in section 3.2.1 below, the complex nature of the interactions with electricity decisions has not even been mentioned by the Commission, particularly the issue of how the Commission intends to apply the decrement to electricity business mergers in the context of the IRIS framework. Given that this is critical to defining a symmetric treatment, it seems unlikely that any (undisclosed) explanation for how symmetry is currently being achieved would be correct.

3.2.1 Consistency with electricity and other issues

43. It is very important to consider how any change to the overall policy would operate and interact between gas and electricity regulated assets. The 2017 policy appears to seek, in effect:

- to impose a stronger version of the efficiency carryover (IRIS) type scheme in gas that is similar to that applying in electricity (one where the penalty/reward for cost reductions/increases is carried over for the entire next regulatory period - not just until 5 years have passed from the cost change – as prescribed by the IRIS); but
- only apply this to cost changes that result from a transaction (i.e., not other sources of cost changes), which deviates from the IRIS framework that does not distinguish between the source of the efficiency gain, thereby elevating the incentive for suppliers to merge in order to retain the gains for a full regulatory period.

44. The following are just some of the issues raised:

[10] Commerce Commission, Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022, Draft Reasons Paper, February 2017, p. 63 at [5.25].

- What would application of this rule imply in electricity?
  - Would the Commission impose a further decrement above and beyond that which would already apply under the IRIS scheme?
  - If so, this would imply, in effect, the seller/buyer bearing/keeping lost/gained economies of scale for the equivalent of 10 years (although this may be compressed into a shorter period if imposed concurrently with IRIS).[11] Critically, if truly applied symmetrically, this would mean that customers had to wait 10 years until receiving any net economies of scale benefits from the transaction.
- Why would the Commission apply a different incentive regime to cost changes from a transaction as opposed to other sources of cost savings?
- How would the Commission ensure that the policy is symmetric when, as was the case in the 2016 transaction, a diversified gas-and-electricity businesses sold an asset to a gas-only business? Noting that:
  - the electricity businesses currently have a different incentive regime (IRIS) and different time periods; and
  - electricity and gas decisions are not made simultaneously – such that the symmetrical nature of the first decision will depend on the treatment in the (at that time unmade) second decision.
- Higher powered incentives being applied to transaction-related cost changes than cost changes resulting from other sources may be problematic. Specifically, it would:
  - promote inefficient transactions expected to achieve $Xm economies of scale (e.g., due to lower unit common costs) but raise long run costs by more than $Xm through other channels less obviously identifiable as transaction related (e.g., higher complexity of the business);
  - discourage efficient transactions expected to lose $Xm economies of scale (e.g., due to higher unit common costs) but lower costs by more than $Xm through other channels less obviously identifiable as transaction related (e.g., lower complexity of the business).

[11] That is, in the Commission's 2017 gas decision the Commission is requiring the seller to bear the lost economies of scale for a further 5 year period - above and beyond the period that they would have borne the cost under the current rules (which could be from zero to 5 years if the transaction occurred at the end/beginning of the regulatory period). That is, in gas there would be a 5 to 10 year penalty. If the same approach was taken in electricity of adding a 5 year penalty to the existing penalty this penalty would always be a 10 year penalty. This is because the existing rules impose a 5 year penalty under the IRIS no matter when the transaction occurs.

45. Furthermore, even if the Commission still believed that its 2017 policy was 'the answer' to all of the above questions, this would not provide a justification for retrospective application to the 2016 transaction. Moreover, for the reasons set out in the above dot points, the 2017 policy is not currently a true policy because it does explain the Commission's approach to electricity and the interaction with the IRIS regime already in place there.

46. As a thought experiment (and in no way a policy recommendation), consider what symmetrical treatment, which the Commission states is its goal, would require if the Commission were to apply its 2017 policy to the 2016 transaction. As already explained, symmetrical treatment requires that FGL needs to receive above cost allowances that exactly match the below cost increases imposed on Vector. This means that FGL's revenues need to be above cost by:

- the amount Vector's gas revenues are below cost (including a share of allocation of common costs); plus
- the amount Vector's electricity revenues are below cost (including a share of allocation of common costs) as a result of the operation of the IRIS; plus
- the amount Vector's electricity revenues are below cost (including a share of allocation of common costs) as a result of any ad hoc decrement that the Commission intends to apply in that (as yet unmade) decision.

47. We see no evidence that the Commission has actually estimated FGL's allowance consistent with the above. Certainly, given that the operation of the 2017 policy in electricity is unclarified, it is difficult to imagine that the Commission has done so.

48. A much more simpler approach would be to, consistent with the 2010 IMs, estimate the costs for FGL and Vector on a forward looking basis. This would require the Commission to compensate Vector for lost economies of scale (i.e., not apply the decrements proposed) and estimate the FGL gains from economies of scale. This avoids the need to make all of the dot point estimates above.

3.3 Failure to make the new policy in a full and proper context

49. In implementing a new rule with an extended timeframe for adjusting revenues to incorporate gains and losses of economies of scale, the Commission has failed to fully consider and elaborate on the implications that the new rule would have on the interactions between regulated firms in the gas and electricity industry. The 2017 Draft Reasons Paper therefore reduces regulatory certainty for suppliers due to the lack of explanation as to how the Commission intends to apply the rule.

50. For example, as previously discussed, an IRIS system exists for the electricity industry, whereby opex incentive amounts are carried forward for 5 disclosure years,

regardless of the year in which the transaction occurred, and irrespective of the source of the gain or loss in efficiency.

51. However, the 2017 Draft Reasons Paper puts in place a new policy that requires Vector to bear the loss of economies of scale for 6.5 years in gas, which exceeds the anticipated time period of 1.5 years, and even exceeds the 5-year period set out in the electricity IRIS scheme. This policy was not implemented through a formal operation of the pre-existing incentive regime for mergers but through an ad hoc change in policy after consideration for the sale of regulated gas assets.

52. Exactly how the Commission's policy should be interpreted in relation to electricity businesses is also unclear:

    a. Is the Commission trying to make ex-post and ad-hoc adjustments to the gas regime to make it more like the electricity regime? If so, and putting aside the problems with an ex post change like this, why is the Commission then penalising Vector for 6.5 years instead of 5?

    b. Is the Commission trying to make an adjustment on top of the incentives that already existed in the 2010 IM? Does this imply the Commission plans to impose a 10 year penalty on Vector for electricity (5 years under IRIS plus another 5 years of penalty in the form of an additional ex-post and ad-hoc adjustment)?

    c. How would the Commission's new policy work with an IRIS as a result of two EDBs merging? Do the firms get to retain the synergy benefits for: the regulatory period in which the transaction occurred; the subsequent regulatory period; and for any IRIS carry over incentive payments in the regulatory period after that?

53. Both of these approaches are demonstrably unreasonable:

    a. Under approach 52.a, the Commission is effectively implementing a (more aggressive than electricity) IRIS for gas by stealth and without warning or consultation, and only applies this specifically for merger transactions even though there is limited benefit to customers for elevating merger efficiencies above any other form of efficiency. This does not represent good practice, and in any case should not be retrospectively applied to transactions that have already occurred under the existing set of rules;

    b. Under approach 52.b, the same problem exists. However, in addition, this would clearly make the new policy asymmetrical. In order for it to be symmetrical, FGL would need to be able to keep economies of scale gains lost by Vector electricity not just for 5 years but, actually, for 10 years (i.e., the period Vector would be losing them for). Under the 2017 Draft Reasons Paper, any gains to FGL would seem to be only earned for 5 years instead of 10.

3.4 2017 draft gas decision is capricious

54. The Commission's decision in the 2017 draft reasons paper is capricious in that it overturns earlier IM frameworks without prior warning or consultation. This amounts to retrospective regulatory intervention.

55. Even if the Commission were able to resolve the issues discussed in sections 3.1 to 3.3 by formulating a prospective decision that was transparent, symmetric, and properly set out, applying it retrospectively would still amount to a unpredictable post-transaction transfer of value from one party to another, resulting in windfall gains and losses that hold no incentive value. To the extent that the Commission now believes that there is a better regulatory framework than the 2010 IM framework, it should set that framework out but only apply it to prospective decisions.

4 Conclusion

56. This report considered the 2017 Draft Reasons Paper, particularly the Commission's decision that Vector would need to bear the cost of lost economies of scale from the date of the transaction in April 2016 to the end of the subsequent full regulatory period in 2022.

57. The 2017 Draft Reasons Paper is clearly inconsistent with the 2010 IM that applied at the time of the transaction, which only required the gains and losses of economies of scale to be internalised from the time of the transaction to the end of the regulatory period in which the transaction took place.

58. The 2017 Draft Reasons Paper is highly problematic because it is: not transparent; not symmetric; fails to make the new policy in a full and proper context; and amounts to a retrospective regulatory intervention that generates windfall gains and losses on FGL and Vector without providing any prior warning or consultation.

59. In our view, the Commission should be cautious about implementing its decision set out in the 2017 Draft Reasons Paper because ex-post adjustments to policy do not, by definition, improve incentives for past decisions. Even if the Commission were to now be of the view that an IRIS-like scheme should be put in place for gas, it should not do that retrospectively.

60. Moreover, even on a prospective basis, there are complex issues that would need to be considered and consulted on before applying the 2017 decision logic. Such a consultation process should include electricity businesses as well and should, in our view, be held outside the context of the gas DPP decisions.