Submission to Commerce Commission on Starting Price Adjustments for DPPs

10 September 2010

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INTRODUCTION

1. Vector Limited ("**Vector**") welcomes the opportunity to provide this submission in response to the Commerce Commission's ("**Commission**") *Discussion Paper: Starting Price Adjustments for Default Price-Quality Paths* dated 5 August 2010 ("**DPP Discussion Paper**").

2. Vector's contact person for this submission is

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STRUCTURE OF SUBMISSION

3. This submission is structured as follows:

   (a) Part A outlines the relevant regulatory framework and the extent to which the Commission's views are consistent with this framework;

   (b) Part B considers the:

      i. proposed methodology;

      ii. return on investment (**"ROI"**) band;

      iii. implementation details; and

      iv. efficiency gains.

SUMMARY AND RECOMMENDATIONS

Commission's approach inconsistent with the regulatory framework

4. While Vector considers that aspects of the Commission's Discussion Paper provide a workable basis for setting and adjusting starting prices (to the extent explained in this submission), Vector submits that the Commission's overall approach is inconsistent with the regulatory framework. Specifically:

   (a) The Commission provides itself with a discretion either to apply or not apply the relevant input methodologies when setting or adjusting default price-quality paths ("**DPPs**") starting prices contrary to sections 52S and 52R of the Commerce Act 1986 ("**Act**").

(b) The rules and processes for determining and adjusting starting prices are not proposed by the Commission as an input methodology as is required under sections 53R, 52T(1) and 52T(2).

(c) More generally, the Commission introduces an unacceptable degree of uncertainty by not clearly setting out (or acknowledging it is required to set out) all the various rules and processes that it will apply when setting or adjusting starting prices. While the Commission may exercise a degree of discretion in determining its approach to setting and adjusting starting prices, the point of the regime is to explain in advance how that discretion will be exercised.

(d) The Commission does not fully consider what is necessary for the effective operation of the DPP / customised price-quality path ("**CPP**") regime. Parliament has introduced a requirement that any adjustments to starting prices be based on current and future profitability. This enables the DPP starting prices to better reflect business specific circumstances and reduce the number of likely CPPs. It is not sufficient to argue that engaging with this statutory requirement is too high cost for a DPP. The DPP / CPP regime will not be low cost if a significant number of suppliers apply for CPPs.

(e) Finally, the symmetrical approach to the weighted average cost of capital ("**WACC**") band is inconsistent with the Part 4 purpose as it could potentially result in suppliers earning less than normal returns and this prospect will negatively impact on incentives to invest. Further, the symmetrical approach is not required in order to limit excess profits.

Recommended approach

5. Vector submits that in order to comply with the requirements of Part 4 and provide a sufficiently certain regulatory environment, the Commission should:

(a) Develop the proposed methodology for setting and adjusting DPP prices over the next three months and incorporate this methodology into the input methodology draft determinations. Vector is willing (and no doubt others in the industry) to work with the Commission to develop an acceptable methodology in the time available. This would need to include more detailed processes and rules for issues not covered or properly developed in the Discussions Paper (for example information normalisation and adjustments to rates of change to address undue financial hardship and price shocks).

(b) Subsequently, further refine the methodology if necessary under section 52X (consultation requirements would apply). In particular

the Commission should further consider whether and how future profitability could be appropriately assessed applying a less than building block approach (and thereby reducing the need for CPP applications and the overall cost of the regime).

(c) Consider, with industry input, whether the Commission can reasonably and meaningfully adjust the starting prices (that have already been set) in a manner that is consistent with the requirements of the Act prior to the next reset. As the Commission notes, it will likely need to consider ROI information over a number of years (Vector recommends three years as set out below). However, under the Act, once the input methodologies are set, these must be applied when determining prices (section 52S). Accordingly, only limited appropriate information will be available at the beginning of the regulatory period. Vector notes that this will be particularly problematic for gas distribution businesses ("**GDBs**") and gas transmission businesses ("**GTBs**"). The Commission could either:

i. Adjust prices at the next reset at which time appropriate time series information will be available (three years from 2011). In the interim the current DPP would apply for electricity distribution businesses ("**EDBs**") and current prices could be applied for gas pipeline businesses ("**GPBs**") (under section 55F(1)); or

ii. Use the 2011 ROI information and make further normalisation adjustments but without applying historical information inconsistent with the input methodologies. Vector recommends that this option should only be adopted if clear rules and processes for such adjustments are set out up front (and no such process has been put forward by the Commission at this stage).

6. In any event, Vector submits that, if the input methodologies are appealed (which will be known by early 2011) the Commission should wait until the appeals have been determined or the next reset (whichever occurs first).

Recommendations specific to the Commission's proposed approach.

7. In terms of the Commission's proposed methodology (which should be determined as an input methodology by December 2010) Vector submits that:

(a) Current and projected profitability should be assessed based on a supplier's average ROI over the three most recent disclosure years of a regulatory period, assessed against an ROI band around the WACC

point estimate (from 2011 when appropriate information will be available).

(b) Assessment of suppliers' ROIs must be based on input methodology determinations (and not historical ROIs as previously disclosed).

(c) The Commission should specify a process for determining when and whether it will set starting prices based on current and future profitability and when it will set starting prices as the prices that applied at the end of the preceding regulatory period (under section 53P(3))

(d) The Commission should not use qualitative analysis to assess current and projected profitability.

(e) The Commission should express the starting price adjustments with reference to the current year's allowable notional revenue (or equivalent).

(f) The Commission should not attempt to use the starting price adjustments to drive efficiency gains.

8. In relation to the ROI band, Vector submits that:

(a) The ROI band should not be symmetrical. The bottom of the ROI band should be set at the 75th percentile WACC estimate – anything lower fails to set a rate of return for suppliers that can attract sufficient capital to invest.

(b) The Commission should develop with stakeholders, as a matter of urgency, clear processes for assessing changes in ROI. The Commission should not assess changes in ROI based only on variances in operating expenditure. ROI is influenced by other factors including demand, discounts and rebates, non-line charge revenues, recovery of pass through costs, revaluations, capital expenditure and depreciation. The Commission has not provided any evidence that these are not better predictors (or that in combination with operating expenditure or other factors these are not better predictors) than operating expenditure on its own.

(c) Suppliers must be involved in and consulted on the process of adjusting historical ROI data for known and quantifiable one-off events.

(d) The Commission should consider setting the ROI band for each participant, instead of applying an industry-wide average to all suppliers.

(e) The Commission should specify a mechanism within the starting price adjustment process which provides for expected step changes in asset replacement needs, as these will be experienced by suppliers from time to time.

(f) The Commission must ensure that the CPI is normalised for the purpose of determining the ROI for comparison with the ROI band.

(g) The DPP pricing methodology should include a mechanism within a DPP to account for large one-off investments in gas transmission businesses. Vector submits that without such a mechanism, critical investment decisions that need to be taken in early 2011 will not be made. Vector intends to provide a further more detailed paper on this issue, providing appropriate evidence and explaining further why a CPP proposal is not an option for this purpose.

(h) The Commission should allow a considerable period of time for starting price adjustment information requests to be processed and responded to.

9. In relation to efficiency gains, Vector submits that:

(a) The DPP pricing methodology should provide for the retention of all efficiency gains from a transaction event for a period of at least ten years (as described in more detail in Vector's input methodology submission on cost allocation, regulatory tax, pricing methodologies and rules and processes dated 9 August 2009 ("**Vector's cost allocation submission**").[1]

(b) The Commission should implement its current view that costs incurred in achieving efficiencies from transactions should be shared with consumers and that positive net balances from an Incremental Rolling Incentive Scheme ("**IRIS**") should be retained when a supplier moves from a CPP to a DPP.

[1] Vector's submission on cost allocation, rules and processes, regulatory tax and pricing methodologies dated 9 August, 2010.

PART A - REGULATORY REQUIREMENTS WHEN SETTING OR ADJUSTING THE DPP STARTING PRICES

Overview and summary

10. In its DPP Discussion Paper, the Commission sets out its current view on the regulatory framework for setting DPP starting prices. The Commission invites submissions on whether these views are consistent with the DPP regulatory framework and the purpose of Part 4.

11. In this Part Vector considers the requirements of the regulatory framework for DPP starting prices in relation to the:

    (a) interrelationship between input methodologies and the DPP;

    (b) extent to which the Commission's approach otherwise creates uncertainty about how DPP regulation will apply to suppliers;

    (c) DPP price methodology as an input methodology;

    (d) requirements of the DPP / CPP framework; and

    (e) resetting of the starting prices under section 54K.

Relationship between input methodologies and the price regulation applying to goods and services

12. A primary objective of the Part 4 regime is to better promote incentives to invest by providing a more certain and predictable regulatory environment. This is reflected in various provisions throughout Part 4 and in the policy material underlying the Act. Certainty, in particular, is considered to be a prerequisite to incentives to invest.[2]

13. Input methodologies provide a key mechanism for achieving a more certain regulatory environment by enabling suppliers to understand how regulation will apply to their businesses. As set out in section 52R, the purpose of input methodologies is 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 under this Part.

14. It is the connection between input methodologies and the application of the form of regulation that is critical to the promotion of certainty. Indeed,

[2] Explanatory note to the Commerce Amendment Bill.

there would be little or no purpose in developing input methodologies up front unless these input methodologies provided a reasonably clear indication of how the supplier is likely to be regulated.[3]

15. The importance of the connection between input methodologies and the setting and adjustment of DPP starting prices is clear from the following provisions in the Act:

    (a) under section 52S(b)(ii) the Commission *must* apply "every relevant methodology relating to the supply of particular goods and services" when determining "the prices or quality standards applying to the goods and services";

    (b) the section 52P DPP determination must specify the relevant input methodologies that apply (section 52P(3)(c);

    (c) every input methodology must provide sufficient detail so that the supplier is able to reasonably estimate the material impact on its business (where any material impact under a DPP for a supplier will primarily arise from the starting price) (section 52T(2)(a));

    (d) every input methodology must set out how the Commission intends to apply it to the particular goods and services (section 52T(2)(B));

    (e) under section 52V the Commission is required to follow a full consultation process when setting input methodologies and must not rely on previous work done or action taken when determining an input methodology unless it has first consulted with interested parties;

    (f) input methodologies cannot be materially changed unless a consultation process is followed (section 52X); and

    (g) section 54K(2) specifically sets out when the Commission may not apply the relevant input methodologies (in relation to EDBs). This is where, and only where, the input methodologies have not been determined. Once the input methodologies have been determined the Commission may reset the DPP, but only to the extent the relevant input methodologies would have resulted in a materially different path if they had applied at the time.

16. In its asset valuation submission Vector refers to the policy underlying the Act and the relevance of the August 2006 (the Government economic policy

[3] For most EDBs and GPBs, DPP regulation is likely to be the most significant form of regulation. The most significant aspect of DPP regulation for a supplier is the setting and adjustment of starting prices.

statement ("**2006 GPS**").[4] The Commission notes that the 2006 GPS has particular relevance for starting price adjustments as starting price adjustments can affect incentives for efficient investment[5] However, the Commission does not then consider the importance of establishing certainty around the starting price adjustments rules and processes (which is central to incentives to invest).

Input methodologies relevant to the DPP

17. As set out above, the Commission is required to apply the input methodologies that are relevant to the DPP when determining prices. Accordingly what is or is not a relevant input methodology is a critical question.

18. Vector submits that, in order to meet the relevant purposes of the Act, "relevant' input methodologies should include all input methodologies that inform the DPP starting prices. These relevant input methodologies necessarily include asset valuation, regulatory tax and cost allocation as these input methodologies provide the basis for determining a suppliers ROI. Cost of capital is also relevant as the Commission used this to provide the point estimate. Rules and processes relevant to DPP re-openers and efficiency carry over mechanism are also relevant input methodologies.[6]

19. As set out in Vector's cost allocation submission, it is not credible for the Commission to suggest that only the input methodology for WACC is relevant to the DPPs and / or that all other input methodologies only "indirectly" affect the starting price adjustments through the way in which they apply to information disclosure.[7]

20. Information disclosure provides a mechanism for obtaining the relevant input methodology information that is required for determining the ROIs relevant to DPP prices. The input methodologies are still relevant to DPPs and, if necessary, the information could be separately obtained. ,Vector notes that the Commission itself considers that information consistent with the relevant input methodologies could be requested separately from the

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4 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.*

5 Commerce Commission, S*tarting Price Adjustments for Default Price-Quality Paths Discussion Paper*" **[DPP Discussion Paper].** Para 2.24).

6 Noting that Vector considers all the rules and processes relevant to setting and adjusting starting prices should be specified in advance as input methodologies.

7 Vector's submission on cost allocation, rules and processes, regulatory tax and pricing methodologies dated 9 August, 2010.

information disclosure requirements where the information disclosure determinations have not been set.[8]

21. By indentifying an input methodology as not "relevant" to the setting of the DPP, the Commission provides itself with a wide discretion to choose to apply or not apply the input methodology in question. This introduces a considerable degree of uncertainty about how the various rules will be applied contrary to section 52R and the Part 4 purpose.

22. Vector notes that if only the cost of capital input methodology is relevant to the DPP starting prices, the Commission is unlikely to be able to invoke section 54K (and reset the existing DPP for EDBs on the basis a materially different price path would apply if the input methodologies had applied). Even if all the input methodologies are relevant, it is arguable that the Commission could not invoke section 54K without a methodology that sets out how the prices would be set or adjusted.

Historical data

23. As set out above, the Commission must apply the relevant input methodologies when setting and adjusting DPP starting prices. Historical data may have a place to the extent it can be examined, considered or investigated by the Commission under section 53ZD(c) for the purpose of carrying out its functions. However, this data cannot be used as a substitute for information derived from the applicable input methodologies (nor used in any other way that is inconsistent with the purposes and specific provisions of the Act). To apply historical data in this way would:

    (a) Render the requirement in section 52S that input methodologies must by applied redundant and undermine the very purpose of input methodologies, to provide a considerably more certain regime. For example, the formula for the ROI relies in part on regulatory tax. It would be inconsistent with the Act to apply regulatory tax information derived from previous methodologies or under previous regimes.

    (b) Be inconsistent with section 54V, which requires the Commission to consult with other parties before adopting previous work and approaches to avoid inconsistent approaches being carried over into the new regime.

24. The Commission indicates that is intends to use previous analytical work and data collected under the existing information disclosure regimes (where information disclosure determinations are not yet set).[9] It says that this is

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8 Vector also refers to its marked up EDB draft determination where it sets out a worked example of input methodologies relevant to the DPPs.

9 DPP Discussion Paper at para 2.9.

likely to promote section 53K (the purpose of DPP/ CPP regulation) by minimising compliance costs. It notes that it would request information from the supplier only where the inconsistencies with the input methodologies are "material".

25. Section 52S, however, does not provide the Commission with a discretion to consider the extent that inconsistencies with input methodologies are material (and noting that such a discretion would only introduce further uncertainty). The Commission is required to apply every relevant input methodology when setting and adjusting the starting prices. Other approaches cannot be applied.

26. Vector also notes that the Commission elsewhere in the Discussion Paper notes that, where disclosed information is not yet consistent with the relevant input methodologies, the ROI calculations would be based on information requested by the Commission (see for example paragraph X5 of the Draft Discussion paper).

27. Overall, to promote the purposes of Part 4, historical data should be directly applied to the DPP only to a limited extent and should not be used at all where the new input methodologies now apply.[10] Further, the Commission should clearly set out in advance when and how such data will be applied.

Commission's approach to input methodologies and the DPP

28. While the Commission suggests that the various relevant input methodologies may be applied when determining or setting prices, it does not consider that they *must* be applied as is required under section 52S.

29. For example, the Commission considers:

   (a) The Commission's assessment "**may be usefully informed by the relevant input methodologies"**;[11]

   (b) The input methodology for rules and processes "**might be taken into account**";[12]

   (c) Input methodologies "**may be relevant** to informing the Commission's assessments in respect of stating price adjustments"; [13]

   (d) "In **some cases**, IMs will directly impact on the starting price adjustments"; and[14]

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[10] The extent to which it is feasible to provide revised information disclosure for previous years (where information is represented in accordance with the input methodologies) is discussed further below.

[11] DPP Discussion Paper, para 1.3.

[12] DPP Discussion Paper, para 1.9.

[13] DPP Discussion Paper, para 2.18.

(e) Information that is prepared consistent with IMs "**may provide useful inputs** for the starting price adjustment process…".[15]

30. This language is inconsistent with the statutory requirement in section 52S (which is clear that the relevant input methodologies must be applied) and creates considerable uncertainty for suppliers about how regulation will be applied.

The Commission's approach otherwise creates uncertainty about how DPP regulation will apply to suppliers

31. The Commission refers to possibly narrowing the ROI band in the future (without setting out how or in what circumstance this would apply). This introduces further discretion and associated uncertainty for suppliers.

32. For example, the introduction of a ±1-1.25% band around the 75th percentile WACC estimate would have a material impact on supplier revenues resulting from the implementation of the Part 4 regulatory regime. However, under the Commission's proposals, there is no certainty around the eventual size of the band (or even if there will be a band).

33. Even when the Commission makes its final decision on starting price adjustments, which it indicates will be by December 2011 for EDBs, it appears likely to remain unclear how the Commission will adjust any band in the future (except to the extent the Commission indicates the band should be narrowed as more information becomes available).

34. Compounding this uncertainty is the even greater lack of information regarding how starting price adjustments will be specified; what the quantitative analysis for determining the ROI band limits will be; and whether claw-back will be applied. Further, the Commission will not decide these issues under its current timetable until after the input methodologies are set. For example, will the average of one standard deviation of the ratio of operating expenditure to RAB for the 17 non-exempt EDBs over 7 years consistently be the methodology for determining the width of the band for the foreseeable future? Does the Commission intend to use this methodology for future regulatory resets or will it attempt to develop a new methodology?

35. Vector submits that the Commission is retaining a significant and inappropriate degree of discretion for itself in setting starting price adjustments, contrary to providing certainty for suppliers and incentives to invest.

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[14] DPP Discussion Paper, para 2.18.

[15] DPP Discussion Paper, para 2.18.

36. Such certainty and incentives would be better provided for if the Commission developed an input methodology for DPPs in advance, including for the starting price adjustment process as set out below.

The DPP pricing methodology should be an input methodology

37. Vector submits that in order to meet the purposes of the Act and the requirements of section 52T, the Commission must determine an input methodology for setting and adjusting starting prices. Vector refers to its cost allocation submission and the ENA letter to Mark Berry.[16] Specifically:

(a) Setting the process for starting price adjustments as an input methodology is required to provide certainty for suppliers about how DPP regulation will be applied in accordance with section 52R.

(b) The Commission must set rules and processes (including for the specification of price) which Vector submits covers setting and adjusting starting prices.[17]

(c) Even if starting prices did not fall within this definition, which is not agreed, the Commission must include other matters in the rules and processes as necessary to achieve the purpose of section 52R and section 52T(2).

(d) Under section 52T(2), the Commission must provide sufficient information and detail in the input methodologies so that regulated suppliers are reasonably able to estimate the material impact of the input methodology on their business. The Commission must also provide sufficient detail so that the supplier can understand how the input methodology will be applied.

(e) In relation to DPP regulation, section 52T(2) cannot be meet unless the Commission sets out the proposed rules and processes for setting starting prices (including how the various input methodologies will apply) as an input methodology..It is clearly not appropriate to determine the starting price adjustment process both outside the input methodology process and long after the input methodologies have been determined.

38. Addressing starting price adjustment processes outside the input methodology process will necessarily result in an uncertain process even

16 Vector's submission on cost allocation, rules and processes, regulatory tax and pricing methodologies dated 9 August, 2010 paras 181 - 195.

17 Given the interaction between the Electricity Industry Bill and the Commerce Act 1986 in relation to the definition of "pricing methodologies", Vector considers the input methodology for DPP starting prices is more appropriately a requirement under the rules and processes input methodologies rather than pricing methodologies.

when final decisions are made. There are minimal constraints on the Commission's approach relative to the input methodology process, for example, in relation to the level of detail required or the processes for changing the rules. Further, the discipline of merits review does not apply. The purpose of setting input methodologies that apply to DPP regulation would clearly be undermined if key rules and processes that are applied to DPP regulation were set outside the input methodology process.

The DPP / CPP framework

39. Vector refers to its cost allocation submission and CPP submission where it sets out in detail the requirements for an effective DPP / CPP framework.

40. The Commission notes that starting price adjustments are the primary mechanism for making the price related aspects of the DPP more specific for individual suppliers. The Commission also emphasises that CPPs are available. However the Commission does not engage with what is required for the DPP / CPP to effectively operate as a low cost regime.

41. Specifically the requirement to adjust prices with reference to current and projected profitability enables the Commission to ensure the DPP is appropriate for most suppliers (which is necessary if the regime as a whole is to remain low cost). However, the Commission considers that assessing future profitability would be too costly (including, for example, independent verification of management plan ("**AMPs**") but does not consider the cost of additional CPPs being made.

42. As Vector sets out in this submission, while the Commission's proposed ROI band may be an appropriate starting point for the DPP pricing methodology, the Commission should consult further on how it can best assess future profitability for DPP purposes as intended by the Act.

Setting and resetting the DPPs

43. The Commission may reset starting prices in the DPP under section 53P. It may either adopt the prices that applied in the previous period or set new prices based on the current and future profitability of the supplier. Section 53P also sets out the process for setting rates of change and adjusting rates of change to address price shocks or hardship.

44. The Commission has determined a DPP for EDBs for the current regulatory period (to 2015).

45. Under section 54K, the Commission may reset the current DPP on the basis of the publication of input methodologies after 1 April 2010 only if, had the relevant input methodologies applied at the time the DPPs were reset, a

materially different DPP would have been set. Any reset must take place within 9 months of the relevant input methodologies being set.

46. Section 55F(4) sets out a similar provision for GPBs (although input methodologies should be determined prior to the first starting prices being set).

47. The Commission has a general power to change a section 52P determination, subject to section 54K. However, this would need to be consistent with the re-openers set out in the relevant input methodology.

48. In the DPP Discussion Paper that the Commission does not set out the statutory basis for resetting the EDB DPP. Vector assumes that the Commission is intending to apply section 54K (indeed the Commission appears to consider itself constrained by the 9 month time limit). It is also unclear how the Commission will determine whether the relevant input methodologies would have resulted in a materially different price path. Again, Vector assumes that the ROIs that fall outside the ROI band are considered by the Commission to be materially different. Vector considers it is critical that the Commission clearly set out the statutory basis for resetting the EDB DPP.

PART B - RESPONSES TO THE DETAIL OF THE PROPOSAL

Overview

49. In this Part, Vector considers the Commission's proposal for determining and adjusting starting proposals in relation to:

    (a) the method of setting starting prices;

    (b) the ROI band (including in relation to forward investment for gas transmission); and

    (c) Implementation details and treatment of efficiencies.

Method of setting starting prices

Commission's proposal

50. The Commission's current view is that to undertake starting price adjustments it will:

    (a) calculate the supplier's returns using ROI statistics and other information (current profitability);

    (b) assess the supplier's profitability by comparing the supplier's returns against an industry-wide ROI band centred around the WACC point estimate (projected profitability);

    (c) if a supplier's returns are above or below the ROI band, calculate the percentage difference with respect to the relevant limit of the ROI band;

    (d) translate the ROI differential into an adjustment to supplier's actual weighted average prices or revenues for a specified year; and

    (e) not undertake any qualitative analysis.

Means of specifying starting price adjustment

51. Vector considers that the Commission's view of the process for making starting price adjustments misses a key preliminary step.

52. The Commission notes that section 53P(3) of the Act requires it to specify starting price adjustments as either the prices that applied at the end of the preceding regulatory period or those based on an assessment of the current and projected profitability of each supplier.

53. The focus of the consultation paper is entirely on the implementation of the second of these options. There therefore appears to be a decision step missing from the discussion paper and the starting price adjustment framework. This is the step where the Commission decides whether to set starting prices as those that applied at the end of the previous regulatory period or those based on current and future profitability of the supplier.

54. Vector recommends that the Commission consider and consult on the circumstances in which it may set starting prices that equate to the prices at the end of the previous regulatory period, which would negate the need for an assessment of current and future profitability for the suppliers concerned.

55. While the Commission has determined this choice for this regulatory period, it should also set out the criteria it will use to make this decision at future resets. This is necessary to provide the certainty to suppliers intended by the Act. The Commission appears to be of the view that it will always make an assessment of current and future profitability. Vector submits that such an approach would not fulfil the requirements of the Act.

Assessment of current and projected profitability

56. Vector considers that the use of a single year's ROI for a supplier to determine their starting price adjustment is risky as a single year's performance may be impacted by underlying trends that are not likely to be adjusted for in any "normalisation" process. Any starting price adjustment based on that return may therefore be inappropriate.

57. This issue could be addressed either by using a supplier's average ROI over, say, the three most recently reported disclosure years, or by normalisation of the data being applied to each data set first (subject to the comments above in relation to a single year).

58. As set out above, the Commission must apply the relevant input methodologies when determining or adjusting the starting price. Given that at this stage of the regime the ROI information consistent with the relevant input methodologies will be limited to 2011 and onwards, the Commission must either:

    (a) Determine the ROI for with reference to 2011 only and apply a normalisation process.

    (b) Reset the DPP at the end of the regulatory period. This would mean the Commission has the benefit of three years of ROI developed on the basis of the input methodologies. The requirement for normalisation, if any, is likely to be limited and the potential for uncertainty also limited.

59. Vector submits that, unless the Commission can develop a clear ex ante approach to normalisation (and any other rules and processes) in relation to (a), (b) is the approach that is most consistent with the requirements of the Act and the relevant purpose statements. While the Commission notes that normalisation may be required, it provides no detail of the process of normalising data or the factors that would be taken into account. In the absence of that detail, Vector's preference is for the Commission to reset the DPP starting price at the end of the regulation period. The Commission could then use a supplier's average ROI over the most recently reported three disclosure years to determine the starting price adjustment as this provides more certainty and stability.

60. Vector remains concerned that the Commission provides no evidence to demonstrate that historical ROIs are a sound basis for determining current profitability.

61. Vector recognises the difficulty and cost necessarily involved in assessing projected profitability of suppliers using a partial or full building blocks analysis. Vector therefore consider that the Commission's proposal to set an ROI band around the 75th percentile WACC estimate may be a reasonable approach in the circumstances, at least for electricity distribution services.

62. Nevertheless, the Act expressly provides that the Commission should adjust prices on the basis of current and future profitability. Vector recommends that the Commission engage with the industry to determine if there is a need to develop a different methodology for the 2015 (electricity) and 2017 (gas) resets once experience has been gained with this method.

63. Specifically, the Commission may be able to use better information to reflect an estimate of projected profitability. For example, an independently verified asset management plan that demonstrates a forthcoming step change in expenditure by a supplier would demonstrate that the supplier's future profitability may be about to change. Vector will be involved with an effort by the ENA to develop an alternative proposal for assessing projected profitability and we recommend the Commission consider any proposal arising from that work.

64. The Commission cites a 2007 study by Farrier Swier that a step-change in asset replacement needs is unlikely to occur (for EDBs) during the next regulatory period. As we have previously noted[18], Vector disagrees with Farrier Swier's analysis. However, even if it was correct, the 2007 study did not cover gas pipelines and the Commission cannot be sure that a step change in gas pipeline investment needs will not occur during the 2012-

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[18] Vector submission *Re: Commerce Commission request for Comment on Use of EDB Provided Information by Farrier Swier Consulting*, 29 November 2007.

2017 regulatory period. In fact, as the Commission is aware, Vector's gas transmission business may need to make a significant investment in its northern pipeline supply route to Auckland to meet increased capacity demand and/or to service potential new generation in the area. Also, there will be future regulatory periods for both gas and electricity where a step change in investment is required. It is therefore inadequate for the Commission to provide no means for suppliers to meet the costs of a step change in asset replacement costs.

Qualitative assessment

65. Vector agrees with the Commission that the assessment of suppliers' current and future profitability should not be adjusted by a qualitative assessment as the information requirements would be onerous and the decisions may not be robust.

The starting price adjustment should be expressed clearly

66. In the worked example in the Discussion Paper, the Commission applies the required revenue adjustment to both line charge revenue and to distribution revenue. When calculated with reference to the distribution revenue the P0 is a higher value because it is referenced to a lower base.

67. Vector considers that the P0 value should be both clear and meaningful. To achieve this, Vector submits that the starting price adjustment should be expressed with reference to the current year's allowable notional revenue (or equivalent). This would be beneficial as it has a direct relationship to the extent of average price change and this would also be easier for consumers to understand as one of perhaps several reasons for price changes (e.g. along with changes in pass through costs).

Starting price adjustment as an efficiency mechanism

68. In paragraph 3.17 the Commission sees the starting price adjustment as a further mechanism to enforce efficiency gains, over and above CPI-X. However, as the Commission is not able to carry out comparative benchmarking it is unclear what approach it would use to implement starting price adjustments to drive efficiency gains.

69. Vector considers that the rate of change is the mechanism to incentivise efficiency gains (and is relevant to efficiency as it is based on an estimate of industry-wide productivity) while the starting price adjustment is the means of sharing the efficiency gain with consumers or bringing suppliers' returns back up to a level at which necessary investment can be incentivised.

Vector considers that the Commission should not consider the starting price adjustment as an efficiency tool and doing so would result in confusion.

Information requests

70. Vector notes that the Commission may make information requests to EDBs for data to inform the starting price adjustment analysis.

71. Vector submits that these requests must be made well in advance and suppliers must be given significant time to respond to these requests. This information will require auditing and appropriate internal sign-off, which takes time. In addition, the Commission must recognise that it may be difficult to extract historical data from systems that were not designed to meet the Commission's current needs so the data may not all be as robust as the Commission may expect.

72. In addition, previously disclosed ROIs were disclosed under information disclosure requirements that do not reflect the new input methodologies and were not for the purpose of setting prices or revenues under the new regime. If the Commission wished to obtain information from years where the input methodologies did not apply, it would be required to use revised information disclosures that reflect the new input methodologies to ensure consistency across the Part 4 regime.

73. Vector submits that the Commission should instead rely on information disclosed consistent the input methodologies for the 2011 year. Further, Vector concurs with the ENA view that it would take at least 3 to 4 months to revise the 2009/10 information disclosures to account for the new input methodologies if the Commission were to rely on amended data from this year. Significantly, more time would be needed if disclosures for years prior to 2009/10 were also need to be re-cast to reflect the new input methodologies, however Vector does not consider it would practicable for restatement under the tax input methodology (for example) to apply prior to 1 April 2009.

Timing of starting price adjustments

74. Vector notes that if a supplier appeals an input methodology and that appeal results in a change to an input methodology, the first regulatory period for electricity distribution businesses would see two starting price adjustments in mid-regulatory period (the first in 2012 and the second once the outcome of the input methodology appeal process is known).

75. Vector recommends that, if an input methodology is appealed (which the Commission will know by early 2011), the Commission should place the starting price adjustment process for electricity distribution businesses and

gas pipeline businesses on hold until the outcome of that appeal is known (for gas pipeline businesses, the prices that apply at 30 June 2012 could be used as the starting prices). If no starting price adjustment is made in this regulatory period, this regulatory period could be used to gather information and determine final input methodologies (including DPP and starting price adjustment processes) that can be consistently used in future years.

Applicability of the Commission's proposed approach to a DPP

76. Vector agrees that the Commission's approach is applicable to a DPP. However, we note that a DPP and starting price adjustment mechanism should not be so generic and low-cost as to require suppliers to apply for a CPP for any slight variation. Such an outcome would fail to meet the requirement of section 53K that default/customised price-quality regulation (as a whole) is intended to be low cost.

Vector recommendation

77. To summarise, the Commission should:

(a) Specify a process for determining when it will set starting prices based on current and future profitability and when it will set starting prices as the prices that applied at the end of the preceding regulatory period.

(b) Assess current and projected profitability based on a supplier's average ROI over the three most recent disclosure years of a regulatory period to determine the starting price adjustment, assess against a ROI band around the WACC estimate.

(c) Work with stakeholders to determine if there is a need to develop a different starting price adjustment approach for the next reset(s).

(d) Assess suppliers' ROIs based on input methodology determinations (and not use historical ROIs as previously disclosed).

(e) Not use qualitative analysis to assess current and projected profitability.

(f) Express the starting price adjustment with reference to the current year's allowable notional revenue (or equivalent).

(g) Not attempt to use the starting price adjustment to drive efficiency gains.

(h) Allow a considerable period of time for information requests for starting price adjustments to be processed and responded to.

(i) If an input methodology is appealed (which the Commission will know by early 2011), place the starting price adjustment process for electricity distribution businesses and gas pipeline businesses on hold until the outcome of that appeal is known.

ROI Band

Commission's proposal

78. In considering the extent of any starting price adjustment for a regulated supplier, the Commission intends to compare a supplier's ROI against an ROI band around an industry-wide WACC point estimate (the 75th percentile). If a supplier's ROI:

(a) Is within the band, the starting price adjustment will be zero.

(b) Is below the band, a starting price adjustment will be made to increase the supplier's returns to the bottom of the band.

(c) Is above the band, a starting price adjustment will be made to decrease the supplier's returns to the top of the band.

79. The Commission proposes to set the ROI band based on the industry average of each supplier's standard deviation of operating costs to the RAB value for a set historical period.

The ROI band should not be symmetrical

80. Vector considers that the concept of an ROI band around the 75th percentile WACC estimate may be an appropriate way to address uncertainty in assessments of suppliers' profitability.

81. However, Vector considers that there may be a more statistically robust means of achieving the same outcome than the Commission has proposed. The Commission should fully consider any alternative proposals developed by ENA.

82. Regarding the band itself, Vector strongly submits that the band should not be symmetrical and that the bottom of the ROI band should be the WACC point estimate (i.e. the 75th percentile value) or, at the very least, should be set no lower than the 50th percentile value.

83. The logic behind the Commission's WACC draft determination is that a WACC estimate is set in the face of parameter uncertainty including, for example, statistical error surrounding the individual parameter estimates.

84. The Commission rightly aims not to select a WACC that is below the true WACC because that will likely result in underinvestment, the consequences

of which are significant by comparison with the consequences of over-compensating a supplier because the WACC estimate is above the true WACC. Vector agrees with this approach in principle.

85. The Commission accounts for these parameter uncertainties by identifying a range for each of the 'uncertain' parameter estimates within which the 'true' parameter value could plausibly lie. The range is based on the standard error of the sample of observations on which the parameter estimate is based (assuming a normal distribution). The impact of this uncertainty on the WACC estimate is then determined by computing a standard error for the WACC estimate, using the standard errors of the parameters and assuming the parameters are uncorrelated.

86. The Commission's approach is therefore to assume there is a range of WACC estimates, as a result of parameter uncertainty, within which the 'true' WACC estimate plausibly lies. Again assuming normal distribution and using the standard error, the Commission selects a WACC estimate that is above the mid point to reduce the chance it has set the WACC below the true WACC value from a 50% probability to a 25% probability (by adopting the 75th percentile value from within the range).

87. However, based on the Commission's worked example, it appears that a symmetrical 1% or 1.25% ROI band sets the bottom of the band at the 38th or 28th percentile respectively (paragraph 3.13 seems to understate the issue). This means that the Commission is explicitly setting the ROI of firms operating below the band at a level which has a ca. 60% to 70% chance probability that it is below the true WACC value. This is inconsistent with the Part 4 purpose statement section 52A(1)(a) as it is not consistent with incentivising investment in regulated services.

88. Where setting the bottom of the band at the 75th percentile implies a significant price increase for firms earning a lower ROI, any price shocks for consumers can be reduced by using section 53P(8) (provided that the Commission provides sufficient guidance about how this will be applied), and in any event firms will not be compelled to increase prices to the new price path.

89. The discussion in the paragraphs above is without prejudice to Vector's view that the Commission's cost of capital input methodology draft decisions produce a WACC that is inadequate, fails to reflect prevailing market circumstances and is not, despite the Commission's assertion in paragraph 4.13, a methodology that errs on the side of caution.[19]

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[19] Vector's views on the Commission's draft decisions regarding the Cost of Capital for electricity distribution services and gas pipeline services are set out in more detail in Vector's submission on Cost of Capital dated 13 August 2010.

Adjustment to ROI data

90. Vector notes that the Commission intends to adjust the historical ROI data for known and quantifiable one-off events prior to calculating the ROI statistics.

91. Vector strongly submits the Commission cannot rely solely on data entered into the information disclosure templates to date, especially where these would be inconsistent with the input methodologies.

92. Further, EDBs must have a clear understanding (and input into) the process and factors the Commission will apply to adjusting historical data. Otherwise suppliers could see significant gains or losses on the basis of the Commission's interpretation of what is "one-off" and what is a permanent adjustment (although this would be smoothed by the option discussed above of using a multi-year set of ROIs to produce the estimate of "current profitability"). The Commission appears to be giving itself broad discretion in this area, which creates a level of uncertainty that Vector considers to be inconsistent with the legislative direction to provide regulated suppliers with incentives to invest.

Determination of the ROI band

93. Vector considers that statistical analysis of variations in historical ROIs may be a reasonable way to determine an ROI band (subject to Vector's submission that only information consistent with the input methodologies must be applied and that this is likely to be from 2011).

94. However, the Commission proposes to retain wide discretion as to how the analysis is carried out and how the results are interpreted, and is also signalling an intention to adjust the outputs in some way once their impact becomes apparent to the Commission. This level of uncertainty for suppliers is not conducive to providing incentives for investment and underlines the need for the starting price adjustment to be set out as an input methodology.

95. Vector also submits that the Commission should consider more sources of information in determining the ROI band and not limit its analysis to variances in operating expenditure. This is because ROI is influenced by other factors including demand, discounts and rebates, non-line charge revenues, recovery of pass through costs, revaluations, capital expenditure and depreciation and these factors should be included in the statistical analysis and the Commission has not provided evidence that these are not better predictors, or in combination with operating expenditure or other factors are not better predictors, than operating expenditure on its own.

96. Another point to consider may be whether an ROI band should be set for each participant rather than applying the industry average to all participants. As section 53P(3)(b) refers to the "current and projected profitability of each supplier", an ROI band that is set based on an industry average may not meet the requirements of the Act.

ROI and CPI indexation

97. Vector notes that the ROI regime encompasses RAB revaluations based on annual CPI indexation. This has the effect of raising the ROI value, although the increase is non-cash in the year of adjustment. While this may be theoretically appropriate, it represents a departure from the information disclosure regime prevailing pre-2008 and gives rise to measured results (ROI versus ROI band) that were not apparent through information disclosures in the years prior to 2008. In other words, reported returns since 2008 are substantially higher than those reported pre-2008 and this is not due to any action by EDBs.

98. In addition, CPI can be volatile and this volatility would have significant impacts on the reported ROI. The Commission must ensure that the CPI is normalised for the purpose of determining the ROI for comparison with the ROI band.

99. The Commission should therefore be cognisant of the difficulties firms face in adjusting to the addition of non-cash returns into their ROI calculation and apply a transitional mechanism (section 53P(8) may be of value here) if this results in potentially significant starting price adjustments..

ROI band and forward investment for gas transmission

100. As discussed its previous submissions[20], Vector considers that an investment test is required in the DPP which applies to GTBs. Potential investors in gas transmission require certainty as to the return on and return of their investments under the new regulatory regime.

101. There is nothing special or abnormal in gas transmission businesses about periodically having to make large-scale investments based on uncertainty surrounding future demand. Indeed, lumpy investment is an intrinsic part of the nature of the gas transmission business, which the Act requires the Commission to regulate. Accordingly, planning for lumpy investment to meet uncertain demand is a matter that needs to be recognised by the DPP (or another approach to regulation other than a CPP).

[20] Vector's submission on cost allocation, rules and processes, regulatory tax and pricing methodologies dated 9 August, 2010 at paragraphs 234-237; and Vector's submission on the customised price-quality path input methodology dated 25 August, 2010 at paragraphs 195-207.

102. Vector therefore believes that the framework provided by the CPP and contingent project mechanism is unsuitable for GTBs in its current form. Suppliers should not be forced to apply for a CPP, and face the associated costly, lengthy and uncertain process, in order to ensure these types of large projects are included in their revenue path.

103. Accordingly, Vector believes that further consideration is required of an alternative approval mechanism for GTB investments. Vector will consider this in more detail in a future paper and will engage with the Commission on our proposal to provide for gas transmission investment projects within a DPP.

Others issues relevant to GDBs and GTBs

104. It is not clear that an assessment of the historical variations of ROI could be completed for GDBs and GTBs. The information disclosure regime in place for gas pipeline businesses may not provide sufficient data and is not based on input methodologies. While the Commission can request further information, this will be a request for historical information gathered in previous years for different purposes. It may therefore not be available or of auditable standard.

105. Further, Vector is unclear what value an industry-wide ROI band would serve for gas transmission. As there are only two businesses within the industry, the arithmetic mean of the ratio of operating expenditure to RAB for Vector and MDL may produce an outcome of no statistical validity and limited applicability to either company. It may be more appropriate to set any ROI band separately for Vector and for MDL.

Vector recommendation

106. Vector recommends that:

(a) The bottom of the ROI band should be set at the 75th percentile WACC estimate.

(b) Suppliers must be involved in and consulted on the process of adjusting historical ROI data for known and quantifiable one-off events.

(c) The Commission should not assess changes in ROI only based on variances in operating expenditure. Demand, discounts and rebates, non-line charge revenues, recovery of pass through costs, revaluations, capital expenditure and depreciation should also be included in the statistical analysis.

(d) The Commission should consider setting the ROI band for each participant, instead of applying an industry-wide average to all suppliers.

(e) The Commission include a mechanism within a DPP to account for large one-off investments in gas transmission businesses.

(f) The Commission should provide a mechanism within the starting price adjustment process to provide for expected step changes in asset replacement needs, as these will be experienced by suppliers from time to time.

(g) The Commission should ensure that the CPI is normalised for the purpose of determining the ROI for comparison with the ROI band.

Implementation details

Commission's proposal

107. The Commission seeks submissions (but does not express views of its own) on the following issues:

(a) The process for consulting with suppliers on the nature of any starting price adjustments.

(b) Consideration of how to assess whether an adjustment might cause undue financial hardship.

(c) How to implement smoothing of a price change to reduce hardship, including how to ensure a mechanism to smooth price adjustments over time is NPV neutral.

(d) Implications of making a Po adjustment for EDBs in 2012 (as it is in the middle of a regulatory period).

(e) The interaction of starting price adjustments with claw-back provisions in the Act.

(f) The interaction of starting price adjustments with compliance obligations and therefore enforcement guidelines.

Consultation process

108. Suppliers will require a reasonable opportunity to comment on all aspects of the starting price adjustment process, including the setting of the band, any change in methodology and on normalisation adjustments. Vector recommends that the Commission hold workshops with participants to

discuss the details of how the adjustment may be implemented and what information will be required.

How to assess whether a starting price adjustment may cause undue financial hardship

109. Vector suggests that changes, or potential changes, in credit ratings, noting the Commission's concern to ensure "an adequate margin of safety"[21], or determination in appropriate financial ratios may be reasonable indicators of an adjustment that causes undue financial hardship for a supplier.

110. Vector currently strives, where practicable, to limit price increases to consumers of regulated services to a maximum of ten percent. Price increases above this level could be seen as creating hardship for consumers.

Implications of making a starting price adjustment for EDBs in the 2012 and the interactions of starting price adjustments and claw-back

111. Vector submits that the Commission should consider the application of claw-back for the revenues earned by EDBs in the regulatory years 2010-11 and 2011-12 very carefully. An intractable paradox arises where the different between actual revenues and those that would have applied had the starting prices been applied earlier is sufficiently material to motivate the Commission to consider claw-back because the impact of recovering the claw-back over the remaining three years or the regulatory period, on top of the impact of the starting price adjustment itself, is likely to exacerbate any price shock or financial hardship outcomes.

112. There will also be a more limited set of information disclosure information to support the 2012 adjustment than for future regulatory resets.

Link between starting price adjustments and compliance enforcement

113. Vector does not see any need for a link between starting price adjustments and enforcement of breaches of the price path. The consequence of a breach should be the return of any over-recovery to consumers, but this should be separate from the process of setting starting prices based on current and projected profitability.

Treatment of efficiencies

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21 Commerce Commission; Input Methodologies Electricity Distribution Services Draft Reasons Paper; June 2010; para 6.7.34, p 251

Commission's proposal

114. The Commission has repeated its view that efficiency gains from a transaction should be shared with consumers at the end of the regulatory period in which the gain is realised. However, it has acknowledged that some efficiency gains from a transaction may not be realised until the subsequent regulatory period.

115. The Commission also proposes to transfer a supplier's outstanding positive net balances from an IRIS under a CPP to the supplier's DPP when their CPP ends.

116. Vector notes that the content of this section is focused on (a) providing more information to support its position regarding the sharing of efficiency gains from transactions, and (b) clarifying how positive net gains from an incremental rolling incentive scheme would be carried over from a CPP to a DPP. This is information that was missing from the recent Input Methodology Draft Reasons Papers. The Commission's inclusion of this material in a discussion paper on starting price adjustments for a DPP confirms Vector's view that input methodologies and DPPs are strongly linked and together form the set of issues that should all be covered by the input methodologies.

Retention of efficiency gains after the initial DPP

117. Under the Commission's proposal there continues to be no retention of efficiency gains from previous mergers or acquisitions beyond the beginning of the next regulatory period. The Commission's description of how efficiencies from mergers and acquisitions will be retained by suppliers is not a step forward, or a change of any kind, but a more detailed explanation of how the efficiencies will be shared under the Commission's proposals.

118. However, Vector supports the Commission's view that the costs incurred in achieving efficiencies from mergers should be shared with consumers. The Commission proposes to achieve this by including these costs from the previous regulatory period as operating expenditure when calculating the supplier's returns. Vector suggests that a better way would be to include the costs in the revenue achieved by a supplier under an IRIS mechanism, spread across the length of the IRIS.

Treatment of positive net gains from an IRIS in moving from a CPP to a DPP

119. Vector agrees with the Commission's proposal that any positive net benefits from an IRIS that have not been realised under a CPP when that CPP ends should be realised by the supplier as a recoverable cost (although our preference is for this to be a pass-through cost) under a DPP.

Vector recommendation

120. Vector recommends that the Commission:

(a) Provides for the retention of all efficiency gains from a transaction event for a period of at least ten years (as described in more detail in Vector's input methodology submission on cost allocation, regulatory tax, pricing methodologies and rules and processes).[22]

(b) Implement its current view that costs incurred in achieving efficiencies from transactions should be shared with consumers and that positive net balances from an IRIS should be retained when a supplier moves from a CPP to a DPP.

[22] Vector's submission on cost allocation, rules and processes, regulatory tax and pricing methodologies dated 9 August, 2010.