Submission in response to the Commerce Commission's Input Methodologies Draft Reasons and Determinations for Electricity Distribution Businesses and Gas Pipeline Businesses

Cost Allocation, Regulatory Tax, Pricing Methodology, Rules and Processes

9 August 2010

CONTENTS

INTRODUCTION ... 1
STRUCTURE OF SUBMISSION ... 1
EXECUTIVE SUMMARY ... 2
PART A: COST ALLOCATION ... 10
Overview ... 10
A principled approach that addresses regulatory concerns ... 10
The Commission's approach ... 12
Relevant legal requirements ... 14
Section 52A(1)(c) ... 16
The Commission's approach ... 16
Correct interpretation of section 52A(1)(c) ... 16
Section 52T(3): **undue deterrence** ... 18
The Commission's approach ... 18
Correct interpretation of Section 52T(3) ... 19
Commission's approach would unduly deter investment irrespective of the optional variation approach ... 21
Efficiency gains and cost allocation ... 23
Workably competitive markets ... 25
Long term contract analogy ... 27
Pole sharing between EDBs and Telecom ... 28
Consistency with the Commission's other approaches ... 29
Experts review reports ... 30
SAC / IC compliant with the Act and materially better in meeting the relevant purpose statement relative to the Commission's accounting - based approach ... 31
Consistent with 52A(1)(c) and section 52T(3) ... 31
Consistent with promotion of workably competitive outcomes ... 31
Consistent with section 52A(1)(a) to (d) ... 31
Consistent with 2006 GPS ... 32
Cost Allocation Methodology Screening Criteria and Optional Variation Approach ... 33
CAMSC…… ... 33
Optional Variation ... 34
Cost allocation between regulated businesses ... 36
Mergers and acquisitions ... 36
Cost allocation methodology - other issues ... 37
Details of the accounting-based approach ... 37
Arms Length Transactions ... 38
Use of cost allocation input methodology for DPPs and CPPs ... 39
PART B: REGULATORY TAX ... 42
Overview ... 42
The Commission's approach ... 42
Support for deferred tax approach ... 43

PART C: PRICING METHODOLOGIES 46
Overview 46
The Commission's approach 46
Inclusion of DPP pricing methodology in the Pricing Methodologies input methodology 47
Statutory requirements 48
Vector is unable to estimate the material impacts of input methodologies on its business in the absence of a DPP pricing methodology 49
Proposed alternative methodology 51
Applicability of pricing methodologies to CPPs 51
Draft Pricing Principles for GPBs 52
Alignment with Electricity Authority 52
PART D: RULES AND PROCESSES 54
Overview 54
Effective operation of the DPP / CPP framework 55
Requirements of the DPP / CPP regime 56
Implications for the Commission 57
Aspects of the Commission's approach in relation to Rules and Process input methodologies inconsistent with the DPP / CPP framework 57
Reconsideration of price-quality paths 58
The Commission's proposals 58
Commission's approach is inconsistent with the DPP / CPP framework and / or its reasons for adopting this approach are flawed 59
Reconsideration of CPPs 60
Reconsideration due to a transaction event 60
CPP applications following a major catastrophic event 60
GTB trigger event for CPPs contingent projects 61
IRIS methodology 63
The Commission's proposals 63
Controllable opex 63
Implementing IRIS for a DPP 64
IRIS and mergers and acquisitions 65
Specification of price 65
The Commission's proposals 65
Price cap or revenue cap 66
Pass-through costs 66
Criterion 66
Levies 67
Costs of regulation 67
Recoverable costs 68
Price structure flexibility and energy efficiency incentives 69
Transmission pipeline balancing 71
Appendix A: Vector's proposed efficiency carryover mechanism for DPPs 72

INTRODUCTION

1. Vector Limited ("**Vector**") makes this submission in response to the Commerce Commission's ("**Commission's**") Input Methodologies Draft Reasons and Determinations for Electricity Distribution Businesses ("**EDBs**") and Gas Pipeline Businesses ("**GPBs**") and various experts' reports.[1]

2. This submission addresses the following topics: Cost Allocation; Regulatory Tax; Pricing Methodology; Rules and Processes.

3. Vector's contact person in relation to this submission is:

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

STRUCTURE OF SUBMISSION

4. This submission is structured as follows:

   (a) Part A: Cost allocation;

   (b) Part B: Regulatory Tax;

   (c) Part C: Pricing Methodology; and

   (d) Part D: Rules and Processes.

5. This submission should be read together with previous submissions and reports provided by Vector in this process and together with Vector submissions and reports yet to provided (as those submissions may be directly or indirectly relevant to the topics covered by this submission).

6. This submission does not include a general overview of the regulatory framework and the policy intent underlying the new Part 4 regime (other than where directly relevant). Rather, this will be covered in subsequent submissions. Further, Vector

---

[1] Commerce Commission, *Draft Input Methodology (Electricity Distribution Services Input Methodologies) Determination*, 2 July 2010 ["**EDB Draft Determination**"]; Commerce Commission, *Draft Commerce Act (Gas Distribution Services Input Methodologies) Determination*, 2 July 2010 and Commerce Commission, *Draft Commerce Act (Gas Transmission Services Input Methodologies) Determination*, 2 July 2010 [together "**GPB Draft Determinations**"]; Commerce Commission, *Input Methodologies (Electricity Distribution Services) Draft Reasons Paper*, 18 June 2010 ["**EDBs Draft Reasons Paper**"]; Commerce Commission, *Input Methodologies (Gas Pipeline Services) Draft Reasons Paper*, 21 June 2010 ["**GPB Draft Reasons Paper**"]; Martin Cave, Michael Pollitt, John Small, George Yarrow, *Experts' Reviews of the New Zealand Commerce Commission's Draft Reasons Papers for Electricity Distribution and Gas Pipeline Services*, 13 July 2010.

is intending to provide one statement from its Chief Executive Officer in relation to the draft reasons and determinations (likely to be provided with the asset valuation submission and reports) and this may include material in support of matters raised in this submission.

7. Vector has read and supports the Electricity Networks Association ("**ENA**") submission and attached reports (unless otherwise stated).

8. Attached to this submission is:

   (a) Appendix A: Vector's proposed efficiency carryover mechanism for default price-quality price paths ("**DPPs**"); and

   (b) A report by Synergies Economic Consulting entitled *Response to Commerce Commission's Input Methodologies Draft Reasons Papers - Cost Allocation*, 9 August 2010 ("**Synergies Cost Allocation Report**").

9. Any documents or other materials referred to in the submission or the Synergies Cost Allocation Report (including in footnotes) are intended by Vector to form part of the evidential record.

EXECUTIVE SUMMARY

Cost allocation between regulated and unregulated businesses

10. Vector submits that the Commission's proposed approach to cost allocation between regulated and unregulated businesses is inconsistent with the relevant statutory provisions. It is based on an incorrect interpretation of the Commerce Act 1986 ("**Act**") that renders the relevant provisions of no effect, contrary to Parliament's intent.

11. Further, even if the Commission's interpretation is correct, a principles-based approach bounded by standalone / incremental cost ("**SAC / IC**") is more consistent with the promotion of workably competitive market outcomes, section 52A(1)(a) to (d) of the Act and the Infrastructure Government Policy Statement ("**2006 GPS**")[2] than the Commission's proposed accounting-based approach.

Legal requirements

12. Under the Part 4 regime, Parliament has for the first time provided express statutory direction to the Commission in relation to the allocation of costs between regulated and unregulated businesses. These provisions reflect the underlying policy position previously articulated in the 2006 GPS; to promote incentives to invest in unregulated businesses by enabling regulated businesses to leverage off their assets (provided that consumers are not disadvantaged).

---

[2] Ministry of Economic Development, *Statement to the Commerce Commission of Economic Policy of the* Government*: Incentives of Regulated Businesses to Invest in Infrastructure*, 7 August 2006 ["**2006 GPS**"].

13. Applying a correct interpretation of the relevant provisions:

    (a) In relation to section 52A(1)(c), the Commission must not seek to share with consumers efficiency gains resulting from the existence of both the regulated and unregulated service. However, the Commission considers it must seek to share with consumers these efficiency gains.

    (b) In relation to section 52T(3), the Commission must select the cost allocation approach that least deters incentives to invest in other businesses unless there is good reason (for example, where consumers are disadvantaged in the regulated business and / or the approach is inconsistent with section 52A(1)(d)). Inconsistent with this high threshold, the Commission starts from a position that investment should be deterred to some extent; it is just a question of how much.

14. Vector submits that the Commission's approach would clearly have a deterring effect on incentives to invest in other businesses. Vector would face the prospect of lower prices in its regulated business (where a cost transfer to unregulated business will not affect price due to the competitive environment, it would represent a "tax" on the regulated business). Further, regulated consumers would be sharing the benefits of the unregulated business although the risk remains with Vector.

15. The Commission appears to accept that its approach is likely to have a deterring effect and proposes the optional variation to the accounting-based allocation approach ("**optional variation approach**") (with Director Certification that investments in other businesses would not proceed or would be discontinued *solely* because of the accounting-based approach).

16. Vector submits that this is an unreasonably high threshold to be satisfied and will not be effective in avoiding deterrence of incentives to invest. Specifically, it is unlikely Directors would be able to certify that investment would be deterred "solely" because of the cost allocation approach.

17. Vector submits that a SAC / IC approach is most consistent with the requirements of the Act (while the accounting-based approach is not consistent). Specifically, under an SAC / IC approach consumers would be indifferent to investment in a regulated business and / or would benefit from investment in other activities in the long term. Further, the Avoidable Cost Allocation Methodology ("**ACAM**") (with no double counting) is a methodology that effectively manages any issues of cross subsidisation and double counting and would also be consistent with section 52A(1)(d).

Efficiency gains and cost allocation

18. Even if, contrary to the positions set out above, the Commission is required to promote outcomes where efficiency gains arising from the operation of regulated and unregulated businesses are shared with regulated consumers, Vector submits that the cost allocation input methodology is not an appropriate or effective

mechanism for addressing efficiency gains and that it should be guided by pricing principles such as those set out in the GPB determination (where Ramsey principles cannot be practically applied).

Workable competition

19. Further, notwithstanding the Commission's approach to the relevant statutory provisions, the Commission's approach is inconsistent with promoting outcomes in workably competitive markets relative to SAC / IC. Applying Ramsey pricing principles (which the Commission agrees apply but which cannot be practically implemented) cost allocation between regulated EDBs / GPBs and unregulated businesses would tend towards the SAC/IC boundary rather than towards an accounting-based approach (the Commission also agrees that this would occur in the short and medium term and possibly in the long term)

20. The Commission's main reason for adopting an accounting-based allocation is that this approach is within SAC / IC bounds (and that allocation at or beyond SAC / IC would not be observed in workably competitive markets). The Commission concludes that SAC / IC cost allocations are, therefore, not consistent with workable competition and section 52A(1)(a). Vector considers this reasoning is not persuasive because:

    (a) An accounting-based approach is considerably further away from the type of allocation observed where there are differences in demand elasticities (which would tend towards or equal SAC / IC particularly in short to medium term).

    (b) It is a flawed approach to adopt an approach that is less consistent with Ramsey pricing principles (and workably competitive market outcomes) on the basis a more consistent alternative does not replicate workably competitive markets outcomes. Given Ramsey pricing principles cannot be practically applied, any solution is imperfect and the Commission must find the approach that is closest to, and therefore most likely to promote, workably competitive outcomes.

    (c) An accounting-based approach would likely result in socially inefficiently low allocation of such costs to the regulated businesses (the net effect is to tax the regulated business) which would have adverse impacts on consumers in the long term.

    (d) While over time elasitisites of demand may change (in which case allocations could move further within SAC / IC bounds), there is no indication that this would happen for a considerable period. The Commission would have an opportunity to amend or adjust the methodology where there is strong evidence that that circumstances have changed such that, applying Ramsey pricing principles, a different approach is justified.

21. The Commission's reference to the long term contract analogy does not advance its position that the accounting-based approach should apply. Here the Government has set the terms of the regulatory compact in the 2006 GPS. In any

event there is no basis for the Commission's view that long term contracts are likely to allow for sharing of efficiency gains resulting from the existence of another business.

CAMSC / optional variation approach

22. Without prejudice to Vector's position that it is not open to the Commission to seek to share efficiency gains between regulated and unregulated businesses Vector comments on the optional variation approach as follows:

    (a) Vector proposes an optional variation test that is more likely to enable investment in unregulated businesses than the Commission's approach. Specifically, the test should be whether application of an accounting-based cost allocation methodology is a significant factor in the investment ceasing or not going ahead (but not necessarily the sole factor).

    (b) If such certification is provided, the regulated business should be able to apply ACAM.

    (c) The Commission should accept the Director's certification unless there is good reason to consider that the information may be false or if no supporting information is provided (given the certification represents a serious undertaking which carries the prospect of penalties).

23. In relation to the materiality thresholds, Vector supports the ENA submission and alternative proposals put forward in relation to the Cost Allocation Methodology Screening Criteria ("**CAMSC**") materiality test, specifically that:

    (a) The criterion 1 threshold for unregulated revenues should have to be greater than 20% of regulated revenues.

    (b) A third criterion, threshold for unregulated gross profit, should be added, should have a threshold of greater than 10% of total gross profit and should be applied to individual unregulated businesses.

    (c) The Commission’s 15% threshold for opex and 10% threshold for asset-related costs under criterion 2 are appropriate.

Other cost allocation issues

Allocation of costs between regulated businesses

24. Vector agrees with the Commission's proposal to apply an accounting-based cost allocation between regulated businesses (subject to its proposal in relation to efficiency gains from mergers and acquisitions).

Mergers and acquisitions

25. Vector agrees with the Commission that the sharing of efficiency gains that result from mergers and acquisitions, after a period of retention, is consistent with

outcomes in workably competitive markets and maintains suppliers' incentive to seek these efficiencies.

26. However, Vector submits that the period of retention proposed by the Commission (the remaining regulatory period) is too short and will significantly disincentivise mergers and acquisitions, especially later in a regulatory period.

27. Vector submits that a modified IRIS mechanism should apply to enable efficiency gains to be shared with consumers over at least two regulatory periods depending on the WACC that is applied (and using the ENA proposed mechanism for implementing this approach) 10 years

28. Vector supports the ENA proposal that a materially better approach is to adopt a modified Incremental Rolling Incentive Scheme ("**IRIS**") mechanism to share efficiency gains with consumers over at least two regulatory periods.

Use of cost allocation for DPPs and CPPs

29. Vector submits that in relation to the application of the cost allocation methodology:

    (a) No adjustments should be made to the disclosed cost allocation information for DPP and customises price-quality path ("**CPP**") purposes. Doing so on an ad hoc / case-by-case basis would undermine the certainty of the regime (contrary to incentives to invest) and is otherwise contrary to the Act.

    (b) For alternative cost allocation approaches certified by Directors under the optional variation approach, the Commission should specify in its cost allocation input methodology that these certified allocations will be used by the Commission for DPP and CPP purposes.

Regulatory tax

30. Vector supports a modified deferred tax approach for all EDBs and all GPBs other than MDL.

31. However, Vector does not support the Commission's proposed approach to establishing the regulatory tax value of acquired assets. Rather, Vector submits that on acquisition the tax value of an asset in the purchaser's regulatory accounts should equal the RAB value. This is broadly analogous to real-world outcomes and is representative of what occurs in workably competitive markets.

Pricing methodologies

32. Vector submits that the Commission is required under the Act to include an input methodology for setting and adjusting starting prices and rates of change ("**DPP price methodology**") in its pricing methodologies input methodology (or alternatively in its rules and processes input methodology).

33. Currently the Commission has not included a DPP pricing methodology, which is inconsistent with the Act. Further, without a DPP pricing methodology, EDBs and GPBs are unable to reasonably anticipate the effects of this and other input methodologies on their businesses (contrary to sections 52T(2) and section 52R). Specifically:

    (a) Input methodologies for asset valuation, WACC and cost allocation (among other things) will clearly inform the determination and adjustment of starting prices under DPPs (which are intended to be the primary form of regulation for EDBs and GPBs).

    (b) How these input methodologies (or information disclosed under these input methodologies) are used when determining and adjusting starting prices is clearly critical and without this link a regulated business cannot reasonably understand how the various input methodologies will impact on its business (undermining a key objective of the regime).

    (c) It is not credible for the Commission to suggest that only the input methodology for WACC is relevant to the DPP because it is only information disclosed under the other input methodologies that is used to determine starting prices.

34. Vector generally supports the other matters that are included in the proposed Pricing Methodologies input methodology. However, Vector submits that:

    (a) the Commission should detail the criteria for determining when and why pricing methodologies will be required for a CPP proposal.

    (b) as submitted by ENA, a CPP application should show regard to and consistency with pricing principles but the choice of CPP methodology should remain with the applicant.

    (c) If the Commission and the Electricity Authority both require pricing methodologies for EDBs, the Commission should seek complete alignment between its EDB pricing principles and the Electricity Authority's pricing principles (at the expense of alignment with GPB pricing principles if necessary).

Rules and processes

35. Vector submits that the Commission's discretion when setting rules and processes is constrained by the need to promote the purpose and intended operation of the CPP / DPP regulatory framework. The DPPs and CPPs are intended to work together to provide a regime that is low cost overall (and there would be no purpose in a low cost DPP regime if most suppliers were incentivised to apply for high cost CPPs because DPPs were too harsh or inflexible). In particular:

    (a) CPP proposals should be the exception to the rule. To achieve this DPPs must be set in the way that meets the needs of most suppliers; and

(b) suppliers must have incentives to apply for CPPs where this is appropriate to accommodate their specific circumstances and enable innovation and investment.

36. Vector is concerned that the Commission is not engaging with the requirements of this framework and is consequently proposing approaches that are fundamentally inconsistent with the DPP / CPP regime requirements.

37. In relation to reconsideration of price-quality paths, Vector submits that:

(a) Reconsideration of DPPs should be permitted in the same circumstances as reconsideration of CPPs, otherwise suppliers may be unnecessarily forced to apply for a CPP.

(b) A transaction event should not trigger a re-opening of a CPP (or DPP), because this would be likely to eliminate the already limited incentives for suppliers to engage in a merger or acquisition. Instead, merged suppliers should be permitted to amalgamate their price quality paths according to the criteria set out by the Commission.

(c) In relation to a catastrophic event, the CPP process cannot on its own provide an effective mechanism to address the impact on suppliers. A DPP adjustment could be made in a more timely manner and have a lower cost for both suppliers and the Commission.

(d) There should be an alternative approval mechanism (either within the DPP or a more targeted approach within the CPP) that is available to EDBs and GPB's generally, rather than the contingent project approach.

(e) The materiality threshold should be set at 1% of allowable revenues in the year(s) in which the costs are incurred, so that all events are treated equally regardless of the year in which they occurred.

38. Vector broadly supports the Commission's proposals in relation to IRIS, but submits that:

(a) IRIS should also apply to DPPs. This is consistent with purpose of the regulatory regime not to drive suppliers to a CPP in order to achieve satisfactory outcomes / receive fair share of efficiency gains / disincentivise suppliers from seeking efficiencies if they stay on DPP.

(b) IRIS should not be limited to controllable opex only. In particular, the Commission's proposal for identifying costs that are within the control of suppliers will add additional costs and complexities.

(c) If an IRIS is to be limited to a CPP, suppliers should be able to propose how it could be implemented in their CPP application.

(d) The Commission should specify the process for realising IRIS gains for suppliers moving from a one CPP to a new CPP or to a DPP.

(e) The Commission's use of a cost of capital estimate at the 75th percentile of the range of possible outcomes and the application of an ROI band as proposed in the DPP Starting Prices Discussion paper are not factors designed or intended to address efficiency carryover issues. As such, they should not be conflated with the efficiency carry over issue, especially in the context of a DPP.

39. In relation to specification of price, Vector submits that:

(a) before being able to make a judgment about whether a price or revenue cap is preferable, suppliers must be provided with detail about how the caps would be implemented;

(b) the Commission's view of pass-through costs is too narrow, and a portion of regulation costs should be passed through;

(c) it is not clear that the new category of Recoverable Cost is useful and these costs should be identified as pass-through costs;

(d) energy efficiency expenditure should be classed as a Recoverable Cost (if that class is retained); and

(e) the administrative tasks associated with pipeline balancing should form part of the regulated service as such administrative services can be provided independently of the Transmission System Owners ("**TSO**"). If they are determined to form part of the regulated service, Vector and other pipeline owners should not bear any costs associated with administering balancing arrangements.

PART A: COST ALLOCATION

Overview

40. In this Part Vector first responds to the Commission's approach to cost allocation between regulated and unregulated businesses with reference to:

    (a) a principled approach that addresses regulatory concerns;

    (b) the Commission's approach;

    (c) relevant legal requirements;

    (d) the correct interpretation of section 52A(1)(c) with reference to the Commission's approach;

    (e) the correct interpretation of section 52T(3) (and unduly detered) with reference to the Commission's approach;

    (and notwithstanding Vector's position on the legal requirements)

    (f) the distinction between cost allocation and efficiency sharing objectives;

    (g) the relevance of workably competitive market outcomes to determining an appropriate cost allocation approach (including Ramsey principles and the Commission's application of the long term contract analogy);

    (h) the Commission's view on pole sharing arrangements between EDBs and Telecom;

    (i) the Commission's expert's review reports; and

    (j) Vector's summary of why a SAC / IC approach (ACAM) complies with the requirements of the Act and would be materially better in meeting the purpose statements; and

    (k) the Commission's proposed CAMSC and optional variation approach;

41. In relation to other cost allocation issues, Vector responds to the Commission's approach to:

    (a) cost allocation between regulated businesses;

    (b) mergers and acquisitions; and

    (c) other cost allocation issues.

A principled approach that addresses regulatory concerns

42. Before addressing the Commission's approach and the specific legal and economic issues, it is helpful to consider (what should be) the key regulatory concerns in relation to cost allocation between regulated and unregulated businesses and how these specific concerns could be addressed.

43. In relation to cost allocation, this is an important exercise as there are significant risks associated with an approach that goes further than required to address these concerns or is unduly focused on sharing efficiency gains. This is because seeking to achieve specific results in advance by allocation of common costs is an inherently artificial exercise (for example it is impossible to predict in advance if and when those gains will occur), yet risks socially inefficient outcomes (as explained in this submission). In, short cost allocation is a poor mechanism for achieving efficiency sharing.

44. In respect of cost allocation, regulators are generally concerned to protect consumers of regulated services from poor decisions by regulated firms to invest in unregulated services, and to protect consumers from supporting the earning of supernormal profits in unregulated businesses (these concerns are interrelated).

45. As a direct corollary, if the consumers of regulated services are not to be exposed to the risks of poor investments in unregulated services by their service provider, then they should not expect to benefit from good decisions (that is, where the unregulated investment is able to earn good or super-good returns). Accordingly, the key consideration is that the regulated consumer is not disadvantaged by the investment in the unregulated business.

46. Accordingly, the regulator's primary objective should to find an approach:

    (a) that ensures the regulated consumer is no worse off because of the unregulated business;

    (b) carries the least risk of inadvertent suboptimal outcomes; and

    (c) ideally, is principle-based with some flexibility to allocate within those principles.

47. Vector submits that an approach that would best meet all of the above is an approach based on the relevant pricing principles (and the Commission and its experts[3] agree that pricing principles are highly relevant). This is similar to the approach adopted in the Australian National Gas Rules 2009.[4]

48. Such pricing principles provide clear parameters so that regulated consumers are protected from cross-subsidisation (and it can be specified that there is no double counting). Regulated firms can then allocate costs within those principles and consistently with the principles for setting prices. Problems associated with CAMSC and the optional variation tests are also avoided.

---

[3] See, George Yarrow, *Experts' Reviews of the New Zealand Commerce Commission's Draft Reasons Papers for Electricity Distribution and Gas Pipeline Services*, 13 July 2010 where he comments; "*In arguing about cost allocation … the real argument is about pricing*".

[4] See Rule 93: Allocation of total revenue and costs 2(c) other costs are to be allocated between reference and other services on a basis (which must be consistent with the revenue and pricing principles) determined or approved by the AER. Available online at http://www.aemc.gov.au/Gas/National-Gas-Rules/Current-Rules.html.

49. The Commission's approach, while arguably meeting (a) and (c) above, does not meet (b) as it carries significant risks of socially inefficiently low allocation of common costs to the regulated businesses (as explained in the Synergies Cost Allocation report and in this submission).

50. Cost allocation principles based on pricing principles should cover:

    (a) cost allocations must be within the SAC/IC range (as this is a subsidy free range);

    (b) allocations of indirect costs to have regard to consumers' demand responsiveness, to the extent practicable; and

    (c) costs allocated to unregulated businesses must be at least the avoidable costs as a result of that business.

51. Vector submits that ACAM provides a good proxy of such an approach.

52. In this submission, Vector sets out the various legal and economic arguments (with reference to the Synergies Cost Allocation Report) all of which lead to a position that an approach based on pricing principles / ACAM is significantly better than the approach proposed by the Commission (in terms of both meeting the legal requirements and from an economic perspective).

The Commission's approach

53. The Commission's draft decision is that the cost allocation input methodology for suppliers should include a default accounting-based approach to cost allocation that uses causal factors for allocating costs ("**default accounting-based approach**").[5] Where cost allocators based on causal factors are not available, proxy allocators must be used.[6] Suppliers should use this accounting-based allocation approach to allocate operating costs and asset values between:[7]

    (a) the regulated services;

    (b) other services regulated under Part 4; and

    (c) unregulated services (in aggregate).

54. Suppliers that are involved in a merger or acquisition with another regulated supplier should report their actual costs incurred as part of their information disclosures, but price-quality paths will not be re-opened.[8]

55. The Commission includes a CAMSC screening process which is intended to avoid investments being unduly deterred[9] and address the potential for the perceived

---

5 EDBs Draft Reasons Paper, paragraph 3.3.1; GPBs Draft Reasons Paper, paragraph 3.3.1.

6 EDBs Draft Reasons Paper, paragraph 3.3.1; GPBs Draft Reasons Paper, paragraph 3.3.1.

7 EDBs Draft Reasons Paper, paragraph 3.3.1; GPBs Draft Reasons Paper, paragraph 3.3.1.

8 EDBs Draft Reasons Paper, paragraphs 3.3.2 and 3.5.10; GPBs Draft Reasons Paper, paragraphs 3.3.2 and 3.5.10.

9 Section 52T(3) provides that cost allocation methodologies must not unduly deter investment in the provision of other goods or services.

benefits of the default account-based allocation approach to be outweighed by compliance costs. Specifically: [10]

(a) In relation to undue deterrence, under certain circumstances suppliers may apply the optional variation, and if they do so must provide the Commission with appropriate supporting information.

(b) In relation to cost / benefit concerns:

i. suppliers may apply ACAM to allocate operating costs and asset values to the regulated services (in aggregate), if unregulated revenues are not material;

ii. suppliers may apply ACAM to allocate operating costs to the regulated services (in aggregate) if operating costs that are not directly attributable are not material; and

iii. suppliers may apply ACAM to allocate asset values to the regulated services (in aggregate) if the value of assets that are not directly attributable is not material.

56. Other key Commission decisions are that:

(a) 'causal relationship' means a current causal relationship based on an 18 month timeframe;[11]

(b) where proxy cost allocators are used instead of allocators based on causal factors, suppliers need to provide a justification for this as part of the information provided to the Commission;[12]and

(a) the types of information that may be required to be publicly disclosed are a transparent description of the cost and asset allocation process including identification of costs and assets to be allocated, cost and asset allocators, the rationale for selecting one causal allocator over another and for selecting a proxy allocator over a causal allocator.[13]

57. In respect of the optional variation to the accounting-based cost allocation approach (which is intended to enable suppliers to seek an alternative cost allocation to avoid investment being unduly deterred) the Commission in its draft decision requires that:[14]

(a) Director's Certifications be provided, supported by accompanying evidentiary information; and

(b) such certification must confirm that if one or more unregulated service had to bear the costs implied by the accounting-based cost allocation approach, these services would be either discontinued, in the case of existing services, or not provided in the case of potentially new services (not yet invested in)

[10] EDBs Draft Reasons Paper, paragraph 3.3.4; GPBs Draft Reasons Paper, paragraph 3.3.4.

[11] EDBs Draft Reasons Paper, paragraph 3.4.2; GPBs Draft Reasons Paper, paragraph 3.4.2.

[12] EDBs Draft Reasons Paper, paragraph 3.4.2; GPBs Draft Reasons Paper, paragraph 3.4.2.

[13] EDBs Draft Reasons Paper, paragraph 3.5.2; GPBs Draft Reasons Paper, paragraph 3.5.2.

[14] EDBs Draft Reasons Paper, paragraph 3.4.10; GPBs Draft Reasons Paper, paragraph 3.4.10.

and that this would be *solely* due to the application of the accounting-based cost allocation approach.

(c) The alternative cost allocation must allocate only as far a necessary to alleviate the deterrence (and must breach the ACAM boundaries).

Relevant legal requirements

58. As set out in Vector's previous submissions,[15] Parliament has for the first time provided express statutory direction to the Commission in relation to the allocation of costs between regulated and unregulated businesses.

59. In addition to the relevant purpose statements, the specific statutory provisions are:

(a) Section 52A(1)(c) of the Act which provides that:

> The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services:
>
> …
>
> (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices.
>
> …

(b) Section 52T(3) of the Act which provides that:

> Any methodologies referred to in subsection 52T(1)(a)(iii) [the allocation of common costs] must not unduly deter investment by a supplier of regulated goods or services in the provision of other goods or services.

60. The driver for including these provisions in the Act was the Government's policy decision that New Zealand needs to lift its economic performance and that this can best be achieved if regulated infrastructure companies are encouraged to invest in unregulated businesses by being able to take advantage of economies of scale and scope. This policy position was articulated in the 2006 GPS and reflected in the provisions above. Key paragraphs of the 2006 GPS include:[16]

> 6. It is in the long term interests of the economy in general and consumers in particular that regulated businesses, in common with non-regulated businesses, are able to utilise existing assets to reduce the cost of investing in new infrastructure and to take advantage of economies of scale and scope.

---

[15] Vector Submission on Input Methodologies Discussion Paper, 14 August 2009, pargraphs 257 to 264; Vector Cross-submission on Input Methodologies Discussion Paper, 28 August 2009, paragraphs 107 to 110.

[16] Ministry of Economic Development, *Statement to the Commerce Commission of Economic Policy of the* Government*: Incentives of Regulated Businesses to Invest in Infrastructure*, 7 August 2006 ["**2006 GPS**"].

> 7. The Government's economic policy objective is that regulated businesses have incentives to invest in replacement, upgraded and new infrastructure and in related businesses for the long term benefit of consumers. The Government considers that this objective will be achieved by:
>
> …
>
> c. regulated businesses being confident they will not be disadvantaged in their regulated businesses if they invest in other infrastructure and services.

61. Given the connection between the 2006 GPS and the Part 4 reforms (both in terms of timing and influence)[17] the 2006 GPS operates not only as a statement that the Commission must "have regard to" under section 26 of the Act, but as an interpretative tool.

62. Well accepted principles of statutory interpretation should be applied when ascertaining the intended meaning of sections 52A(1)(c) and 52T(3). In particular, the Commission should consider these provisions in light of:

    (a) the sections in which the words being interpreted appear, the Subpart,[18] and the Act as a whole (the "scheme of the Act");[19] and

    (b) the underlying intent and purposes of the Part or subpart (and the meaning of specific sections can take colour from such intent and purposes).[20]

63. In relation to the underlying policy and intent, it is acceptable to look to the legislative and Parliamentary history (here the 2006 GPS is particularly relevant), Explanatory Notes, debates in Parliament, and any changes made to the Bill during its passage through the House.[21] Differences in wording between the

---

[17] See for example Ministry of Economic Development *Review of Regulatory Control Provisions under the Commerce Act 1986: Discussion Document* April 2007, which explains the 2006 GPS is reflected in the Part 4 purpose statement (para 87). In terms of timing, it is relevant that the 2006 GPS (August 2006) immediately preceded the decision to review Part 4A (September 2006).

[18] See, for example, *R v Schildkamp* [1971] AC 1 (HL).

[19] Looking to the scheme of the Act as whole means "that no section should have an interpretation placed on it until one has examined how it sits in the Act as a whole" (Burrows *Statute Law in New Zealand* (Wellington, LexisNexis, 2009) page 238). An initial reading of a section in isolation may suggest one meaning, but when read in the context of the Act as a whole, may bear a different meaning (Burrows *Statute Law in New Zealand* (Wellington, LexisNexis, 2009) pages 239 - 242). See also for example, *Unison Networks v Commerce Commission* [2008] 1 NZLR 42 (SC), [53].

[20] For example, see *Astrazeneca Ltd v Commerce Commission* [2008] NZCA 479. Also section 5(1) of the Interpretation Act 1999 and *Unison Networks v Commerce Commission* [2008] 1 NZLR 42 (SC), [53].

[21] Burrows *Statute Law in New Zealand* (Wellington, LexisNexis, 2009) page 258.

current Act and an earlier Act may also be relevant.[22] These materials are particularly significant when considering reformist legislation such as Part 4.[23]

64. For the reasons set out below, Vector submits the Commission's approach to cost allocation between regulated and unregulated businesses is based on an incorrect interpretation of sections 52A(1)(c) and 52T(3) and, accordingly, is inconsistent with the Act. Conversely, the SAC / IC approach supported by Vector and the most other EDBs and GPBs would be materially better than the Commission's approach at meeting the relevant purpose statements.

Section 52A(1)(c)

The Commission's approach

65. The Commission considers that:

(a) Efficiency gains arising from the provision of regulated services when these are simultaneously provided with unregulated services need to be passed on to consumers of regulated services. This is because the efficiency gains are partly attributable to the provision of the regulated services. As such, consumers should share in the in the benefit of such gains because these gains are "*associated* with" the supply of the regulated service (rather than "*in* the supply of").[24]

(b) The only issue then is what proportion of the economic common costs (not directly attributable to the regulated business) EDBs or GPBs should be required to bear.[25]

(c) Part 4 does not require EDBs and GPBs to share with consumers any efficiency gains that are solely attributable to the unregulated business (or another regulated business).[26]

66. The Commission does not accept submissions from EDBs and GPBs that efficiencies arising from the provision of regulated and unregulated businesses are not covered by section 52A(1)(c). The Commission makes no reference to the underlying policy intent or the changes from the previous Part 4A in its analysis (despite this being comprehensively covered in submissions).

Correct interpretation of section 52A(1)(c)

67. As set out above, the section 52A(1)(c) objective is to promote an outcome such that suppliers:

---

22 Burrows *Statute Law in New Zealand* (Wellington, LexisNexis, 2009) page 252.

23 For example, see *Air New Zealand Ltd v Wellington International Airport Ltd* [2009] 3 NZLR 713.

24 EDBs Draft Reasons Paper, paragraphs 3.2.62 to 3.2.70; GPBs Draft Reasons Paper, paragraphs 3.2.62 to 3.2.71.

25 EDBs Draft Reasons Paper, paragraph 3.2.71; GPBs Draft Reasons Paper, paragraph 3.2.72.

26 EDBs Draft Reasons Paper, paragraph 3.2.68; GPBs Draft Reasons Paper, paragraph 3.2.69.

(c) … share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and

68. The plain wording of section 52A(1)(c) (efficiency gains in the supply of the regulated services) could potentially mean either:

 (a) efficiency gains that wholly and solely arise from the supply of the regulated service (excluding efficiency gains that wholly arise from the existence of *both* the regulated and unregulated businesses); or

 (b) efficiency gains that arise wholly and solely from the supply of the regulated service *and* efficiency gains wholly arising from the existence of the regulated business and unregulated business together.

69. Efficiency gains that arise wholly and solely from the supply of the unregulated service are clearly not covered by Part 4 (as acknowledged by the Commission at paragraph 3.2.68).[27] Further, sharing of these gains was not covered by the previous section 57E in Part 4A (which did not regulate the unregulated service).[28]

70. Vector submits that "in the supply of the regulated goods and services" on its plain reading should not include efficiency gains generated from operating a regulated and unregulated service together (these do not arise from the supply of the regulated services) and the Commission's reading as "associated with" is not consistent with the text.

71. To the extent the wording is ambiguous, guidance on the intended application of section 52A(1)(c) is provided by the deliberate and significant changes of the wording of this subsection at the Bill drafting stage made in direct response to submissions. Specifically:

 (a) The wording in the initially proposed Part 4 purpose statement was "to share the benefits of efficiency gains with consumers" (adopting the same wording as the purpose for the previous Part 4A).[29] This wording did not rule out the sharing of efficiency gains arising from the provision of regulated and unregulated services together (noting that efficiency gains arising wholly or solely from the unregulated business were clearly outside the ambit of the previous Part 4A).

---

27 EDBs Draft Reasons Paper, paragraph 3.2.68; GPBs Draft Reasons Paper, paragraph 3.2.69.

28 Efficiency gains that arise wholly from the existence of a regulated business and another regulated business are arguably captured by section 52A(1)(c) which refers to the regulated goods and services where "regulated good and services" means regulated under any of the subparts 9 to 11 (ie regulated under Part 4) (section 52C). This would also be consistent with the policy intent underlying the provision (the changes were not made for the purpose of addressing cost allocation between regulated businesses). In any event, Vector agrees that there are reasons for not applying ACAM across regulated businesses (discussed below).

29 Cabinet Paper, *Review of Parts 4 and 4A of the Commerce Act*, page 5.

(b) Vector submitted that the wording should be changed to refer to efficiency gains arising only from the supply of goods and services in the regulated business because of concerns that:[30]

> … the Commission will continue to set input methods that do not incentivise investment in other businesses. The Commission was required to have regard to the GPS in the Draft Authorisation for controlled gas pipelines yet adopted a cost allocation approach that disadvantaged Vector's interests in its other businesses…

(c) These submissions were accepted by the Government and the purpose statement changed accordingly to "share with consumers the benefits of efficiency gains *in the supply of the regulated goods or services*".

72. Vector submits that the Parliamentary history (where the wording was deliberately changed) and the policy and intent underlying the Act clearly point to the first interpretation (paragraph 68(a) above). Specifically:

(a) The underlying policy evidenced by the GPS, the basis for the changes to the section 52A(1)(c), and section 52T(3) were all intended to enable businesses to leverage off their regulated businesses. The first interpretation is most consistent with this intent (the Commission should not seek to find an allocation methodology that shares with regulated consumers efficiency gains associated with the existence of the unregulated business) whereas the Commission's interpretation is likely to undermine it.

(b) The Commission's interpretation (paragraph 68(b)) would render the deliberate changes to section 52A(1)(c) redundant. This is because the Commission's approach (interpretation (b)) is no different to the approach that would have applied under the Part 4A purpose.

73. Applying the first and in Vector's submission correct interpretation, it is not open to the Commission to adopt a cost allocation methodology which has the purpose of sharing with consumers in the regulated business efficiency gains arising wholly from the provision of the regulated and unregulated business together.

Section 52T(3): **undue deterrence**

The Commission's approach

74. As set out above, section 52T(3) provides that:

> [Any methodologies for the allocation of common costs] must not unduly deter investment by a supplier of regulated goods or services in the provision of other goods or services.

75. The Commission considers that in workably competitive markets some investments would be deterred. Provided the cost allocation methodology is consistent with the type of cost allocation that occurs or would be expected to

30 Vector, *Submission on the Review of Parts 4, 4a and 5 of the Commerce Act 1986*, December 2007, paragraphs 66 to 72.

occur in workably competitive markets, such an approach would not unduly deter investments in other services.[31]

76. The Commission notes that, in workably competitive markets, funding would not be made available for existing or new services that are not expected to make a normal return in the long run so, where a service does not eventually bear at least its incremental costs (i.e. consistent with Ramsey principles), discontinuing that service would increase overall profitability.[32]

77. Accordingly, the Commission considers that deterring investment in the unregulated business may be consistent with outcomes in a workably competitive market and, accordingly, would not be undue deterrence under section 52T(3).

78. On this basis, the Commission starts with a default-accounting-based approach that has a deterring effect relative to a SAC / IC approach. It then provides the optional variation mechanism in order to avoid investment being deterred in limited circumstances; that is, where the supplier can establish that the default accounting-based allocation approach is the sole reason for not investing in, or continuing with, an unregulated business.

Correct interpretation of Section 52T(3)

79. Section 52T(3) provides an express direction that allocation of common costs must not "unduly deter" investment by a supplier of regulated goods or services in the provision of other goods or services. The plain meaning of "undue" is "unwarranted" or "unnecessary".[33] This meaning should also be considered with reference to Part 4 as a whole and its underlying policy and intent (it is not open to the Commission to adopt a different policy approach).

80. Given the clear policy intent in the 2006 GPS which underpins 52T(3) (to promote investment by regulated businesses in unregulated businesses) and the deliberate changes to section 52A(1)(c), Vector submits that "unduly deter" should be interpreted so that deterrence is only warranted where there is good reason (which is explained further below). More specifically, in order to give effect to the intended meaning, the Commission must aim not to deter incentives to invest in unregulated businesses *unless* there are good reasons for doing so. This interpretation is further supported by the following:

   (a) The Commission is required, not to replicate workably competitive markets, but to promote outcomes in the regulated markets consistent with outcomes in workably competitive markets "*such that*" (a) to (d) are achieved (and under objective (c), only efficiency gains in the supply of regulated

---

31 EDBs Draft Reasons Paper, paragraph 3.2.52; GPBs Draft Reasons Paper, paragraph 3.2.52.

32 EDBs Draft Reasons Paper, paragraphs 3.2.50 and 3.2.51; GPBs Draft Reasons Paper, paragraphs 3.2.50 and 3.2.51.

33 For example, Black's Law Dictionary 9th ed (Minnesota, 2009) defines "undue" as "excessive or unwarranted". The Shorter Oxford English Dictionary defines "unduly" as: 1. Without due cause or justification; unrightfully, improperly, unjustifiably.

businesses are a relevant consideration). It would be inconsistent with the Part 4 to seek to achieve outcomes that are inconsistent with objective (c);

(b) In any event, Part 4 is not concerned with achieving workably competitive market outcomes in relation to unregulated businesses. The Commission's concern is with the regulated services, and provided the regulated consumers are indifferent, investment in an unregulated business should be encouraged.

(c) 52T(3) would have limited, if any, effect if the Commission simply deters incentives to invest to a degree which it then largely determines at its discretion (contrary to Parliament's intent).

81. When considering if and when there is a good reason for deterring investment, it is appropriate to look to 2006 GPS (which underpins section 52T(3)) for guidance. Paragraph 8 of the GPS specifically addresses the intended limits of the policy. Specifically, that the Government considers it is important that regulatory control ensure that:

> a. **the consumers of regulated businesses are not disadvantaged by the investments of regulated businesses in other infrastructure and services**;
>
> b. regulated businesses are held accountable for making investments in that business where those investments have been provided for in regulated revenues and prices; and
>
> c. regulated businesses provide infrastructure at the quality required by consumers at an efficient price.
>
> [Emphasis added]

82. Vector submits that this approach fits well with the provisions of the Act as referred to above. Accordingly, a good reason for adopting an approach that deters investment would be because this is necessary to avoid consumers being disadvantaged and / or would be inconsistent with purpose (d), for example due to double counting or cross subsidisation.

83. Vector submits that the Commission does not provide good reasons for adopting an approach that would relatively deter investment because:

(a) Provided the price of the unregulated service is at least equivalent to the incremental or avoidable cost of its supply and the price for the regulated services is no more than the stand alone cost of its supply, then consumers of the regulated businesses will be no worse off (relative to a situation where the unregulated service had not been provided at all).[34]

(b) ACAM is a well understood and tested methodology in New Zealand and, indeed, is proposed by the Commission in its CAMSC. ACAM effectively deals with any cross subsidisation or double counting issues. Accordingly,

[34] Synergies Economic Consulting, *Response to Commerce Commission's Input Methodologies Draft Reasons Papers* - Cost *Allocation, 9 August 2010*, page 11 ["**Synergies Cost Allocation Report**"].

there is no good reason for the Commission to select an alternative approach that will relatively harm incentives to invest.

(c) Section 52A(1)(d) is of limited relevance unless there is a real risk of double counting or cross subsidisation.

84. The Commission's reference to pole sharing arrangements between Telecom and EDBs as an example of consumers being worse off under an ACAM approach does not provide a credible basis for preferring the default accounting-based approach (this is addressed below at paragraphs 110 to 112).

Commission's approach would unduly deter investment irrespective of the optional variation approach

85. The Commission's approach is inconsistent with the requirement of section 52T(3) as it will unduly deter incentives to invest without good reason relative to the ACAM approach. This effect is not mitigated by the optional variation approach.

86. Specifically:

(a) The Commissions' default accounting-based approach is very likely to result in socially inefficiently low allocation of shared costs to regulated businesses (that is, Vector would be disadvantaged in its regulated business compared to the status quo). The inefficiency consequences are likely to increase with the size and extent of any associated unregulated businesses

(b) As explained by Synergies, the net effect is to tax the regulated business, as:[35]

> - the extent of recovery of joint and common costs through the regulated business is limited by the lower than optimal allocation allowed by regulators;
> - the extent of recovery of joint and common costs from the unregulated businesses is limited by competitive circumstances;
> - the integrated business fails to recover all the joint and common costs; so
> - there is an effective transfer from the regulated business to its customers (through lower profitability), which is essentially a tax.

(c) As a result, incentives to invest in unregulated business are weakened, a result contrary to workably competitive market outcomes and section 52T(3).

<u>Optional variation approach</u>

---

35 Synergies Cost Allocation Report, pages 26 to 27.

87. The optional variation approach proposed by the Commission is intended to be the sole mechanism for achieving consistency with section 52T(3). However, the Commission considers that a cost allocation approach that relatively deters investment is acceptable as the default approach, and then places an unreasonably high onus on the business to prove otherwise through the optional variation process.

88. The threshold to be satisfied for the optional variation (that a business will not invest "solely" because of the accounting-based cost allocation methodology) will not be effective in avoiding deterrence of incentives to invest.

89. Under the Commission's approach:

(a) Directors must certify that investment in unregulated services would not go ahead or cease "solely" because of applying the accounting-based allocation (having formed a view regarding the viability of the current or prospective unregulated service(s) based on factors such as prices, demand, quality etc). This certification must be supported with evidence.

(b) The EDB may then reduce the allocation of shared costs to the unregulated service only to a level where that service is then no longer unduly deterred (as a minimum the unregulated business has to bear the cost allocation that would result from applying ACAM). The costs not applied would be then reallocated using the accounting-based approach.

90. Vector submits that the Commission's requirement (that the investment would be unduly deterred "solely" because of the cost allocation approach) is an unreasonably high threshold and not a practicable test for the purposes of Director Certification. Specifically:

(a) Requiring EDBs to establish cost allocation as a sole cause ignores the realities of business decisions where this will be one of a multitude of factors which together may tip the balance against investment. Directors will be confronted with a number of matters that invariably will, as a matter of practical reality, inform any investment and divestment decision. A test involving a threshold that imputes that the cost allocation methodology is the sole certifiable reason for not preceding with an investment is a test that, practically, could never be achieved.

(b) These practical issues should also be considered in light of the fact a certification from a Director is a significant document and carries with it penalties if the Director provides false or negligent information.[36]

---

[36] Directors have a general duty under section 137 of the Companies Act 1993 to exercise care, diligence and skill when exercising their powers (taking into account the nature of the decision and the nature of the responsibilities undertaken by him or her, both of which are onerous in this case). Failure to discharge this obligation can expose a Director to personal actions by shareholders. Further, it is a criminal offence under section 103 of the Act for a Director to attempt to deceive or knowingly mislead the Commission.

(c) This approach is inconsistent with section 52T(3) and with the policy and spirit underlying the Act which points to promotion of incentives to invest (where "not deterring" and "promoting" are closely aligned according to their plain meaning considered in light of the underlying policy).[37] As set out above, the Commission starts with a presumption that a cost allocation approach that deters investment is acceptable and then places an unreasonably high onus on the business to prove otherwise.

(d) The Commission will only accept a reduction that represents the minimum reduction the unregulated business could bear. Again this is an unreasonably high test to meet and contrary to section 52T(3) and the general tenor of Part 4. Further, it permits the Commission to make subjective and arbitrary judgements in relation to the EDBs unregulated business (it cannot be empirically established that a particular reduction is the minimum it can bear) which leads to an uncertain and arbitrary regime.[38]

91. For the reasons above, it is likely that this approach will rarely be used with potential investment incentives being unduly deterred. Without prejudice to this position Vector further comments on the optional variation approach at paragraphs 131 to 137 below.

Efficiency gains and cost allocation

92. Even if, contrary to the positions set out above, the Commission is required to promote outcomes where efficiency gains arising from the operation of regulated and unregulated businesses are shared with regulated consumers, Vector submits that the cost allocation input methodology is not an appropriate or effective mechanism for addressing efficiency gains.[39]

93. As set out by Synergies:

(a) The allocation of common costs between regulated and unregulated services / activities does not itself generate any efficiency gains.[40]

(b) Common cost allocation rules do not apply in workably competitive markets. Rather, the common costs of a business must be covered in aggregate by

---

37 Vector, *Post-Conference Cross-Submission*, 15 October 2009, paragraph 109.

38 Also see Synergies Cost Allocation report (at page 7) which notes that "this requirement is unreasonable and implies an ex ante shared cost re-allocation can be precisely calibrated where there is no guarantee that the proposed investment in the unregulated service will be successful or not and hence whether the shared cost allocation will be appropriate or not. The unregulated market will determine the outcome which will depend on an efficiency gain actually being achieved".

39 The appropriate mechanism for promoting the section 52A(1)(c) objective under the regime is at the reset where some sharing of efficiency gain occurs over the next regulatory period on the basis of the current and future profitability reset.

40 Synergies Cost Allocation Report, page 23.

profits in excess of incremental costs from the combined business activities.[41]

(c) Strict cost allocation rules set in advance cannot hope to achieve the "right" outcome otherwise than by chance. This is because it is extremely difficult to predict when and if common costs (or benefits) will be recovered and / or to achieve those efficient outcomes by highly prescribed rules set in advance (without detailed knowledge of demand conditions). This creates high risk of sub-optimal outcomes and / or activities being inadvertently made unprofitable, contrary to the long term benefit of consumers.[42]

94. Indeed, the allocation of costs may bear no relationship to efficiency gains actually generated by a business as:[43]

> If the unregulated activity is unable to generate sufficient revenues to recover its total effective cost to an EDB/GPB, including any allocated common costs, the business will either not pursue the efficiency enhancing opportunity or record a loss on that activity which reduces overall profitability of the business as a whole (regulated and unregulated activities). **Effectively, the common costs allocated to the unregulated service, which could have been recovered from regulated users, are not recoverable from unregulated users. In other words, the inefficient allocation of common cost could mean that there is no efficiency gain to be shared**.
>
> [Emphasis added]

95. On the other hand, pricing principles are highly relevant to cost allocation rules. They provide a sound basis for determining the methodology (compared to seeking to share efficiency gains) while ensuring consumers are no worse off. Indeed the Commission considers that "costs would be implicitly allocated in line with Ramsey principles (i.e. the market prices would be Ramsey prices)"[44] (albeit Ramsey principles in practice cannot be strictly implemented). This is also the specific approach taken in the Australian National Gas Rules 2009:[45]

> **93 Allocation of total revenue and costs**
>
> 2(c) Other costs are to be allocated between reference and other services on a basis (which must be consistent with the revenue and pricing principles) determined or approved by the AER.

96. Pricing principles proposed by the Commission for GPBs are as follows:[46]

> [Prices are to be] … subsidy free, that is equal to or greater than incremental cost and less than or equal to stand alone cost …

---

41 Synergies Cost Allocation Report, page 23.

42 Synergies Cost Allocation Report, pages 23 to 24.

43 Synergies Cost Allocation Report, page 23.

44 EDBs Draft Reasons Paper, paragraph 3.2.51; GPBs Draft Reasons Paper, paragraph 3.2.51.

45 Available online at http://www.aemc.gov.au/Gas/National-Gas-Rules/Current-Rules.html.

46 GPBs Draft Determinations, paragraph 2.6.2.

> … where prices based on 'efficient' incremental costs would under-recover allowed revenues, the shortfall is made up by prices being set in a manner that has regard to consumers' demand responsiveness …

97. The strong connection between cost allocation and revenue / prices (as acknowledged by the Commission) together with the Commission's proposed pricing principles for GPBs referred to above, in Vector's view clearly support a SAC / IC cost allocation basis. This approach avoids the difficulties and risks of suboptimal outcomes attached to setting cost allocation rules for the purpose of sharing efficiency gains while ensuring consumers are not disadvantaged (for example by cross-subsidisation or double counting). Vector submits that this outcome is best proxied by ACAM (with no double counting as proposed by the Commission in its CAMSC), which is a methodology with a long history of use in New Zealand.[47] The connection and consistency with pricing principles is also consistent with workably competitive market outcomes as discussed further below.

Workably competitive markets

98. Notwithstanding Vector's arguments above in relation to the correct interpretation of the relevant statutory provisions, Vector considers that the Commission's application of workably competitive market outcomes is necessarily flawed.

99. Vector agrees the Commission's view that Ramsey principles would in theory provide an efficient way of allocating EDB / GPB shared costs consistent with workably competitive market outcomes. While Ramsey principles cannot be strictly applied, the Commission's approach is to incorporate the theoretical insights that can be gained from Ramsey principles.[48]

100. Vector also agrees with the Commission's position that applying Ramsey principles to allocation between regulated and unregulated EDBs / GPBs (given the likely demand characteristics between regulated and unregulated businesses) cost allocation would tend towards the SAC / IC boundary even in the long term.[49]

101. Applying the Commission's approach to cost sharing between regulated and unregulated businesses, a SAC / IC approach such as ACAM would be considerably closer to workably competitive market outcomes (which would tend towards the SAC / IC in the short to medium term and, potentially in the long term).

102. However, the Commission rejects the ACAM approach on the basis it would result in an allocation at or beyond the SAC / IC boundaries and that this would be inconsistent with workably competitive markets compared to the default accounting-based approach (which would be within the SAC / IC range).

---

[47] Vector, *Post-Conference Cross-Submission*, 15 October 2009, paragraph 133.

[48] EDBs Draft Reasons Paper, paragraphs 3.2.73 and 3.2.75; GPBs Draft Reasons Paper, paragraphs 3.74 and 3.76.

[49] EDBs Draft Reasons Paper, paragraphs 3.2.78 and 3.2.79; GPBs Draft Reasons Paper, paragraphs 3.79 and 3.80.

103. Vector submits that the Commission's reasoning is not persuasive as:

(a) The Commission is wrong to suggest that ACAM would be beyond the SAC / IC range. ACAM with no double counting (as is proposed by the Commission and accepted by Vector) is clearly not beyond the ACAM range. Further, ACAM is accepted as a methodology that effectively addresses cross-subsidisation.

(b) As explained in the Synergies report, it is artificial to make a distinction between "at" or "within" the SAC / IC boundary. ACAM is within not beyond the SAC / IC range and so would be consistent with efficient workably competitive markets outcomes.[50]

(c) While a SAC / IC approach such as ACAM might be closer to the SAC / IC boundary than a cost allocation based on Ramsey principles, it would be considerably closer to an allocation based on Ramsey pricing (and outcomes consistent with workably competitive markets) than the default accounting-based approach.

(d) The default accounting-based approach has no economic basis as it is premised on an accounting framework with no regard to how the allocation will hinder or facilitate the achievement of economic efficiency across the regulated and unregulated services.[51] Further, it wrongly assumes that electricity and gas have relatively similar elasticities to unregulated services from the outset. This is inconsistent with Ramsey principles (and workably competitive markets outcomes) and risks socially inefficient allocation of costs to the unregulated businesses.[52]

(e) The Commission's approach appears largely to respond to the concern that, in the long term, cost allocation may move further within the SAC / IC boundary and that a SAC / IC would not allow for this. Vector does not agree that this provides a basis for adopting a methodology that is very likely to result in a suboptimal investment and outcomes in the short to medium term (contrary to the long term benefit of consumers), as:

i. The Commission cannot be sure if and when the allocation under Ramsey principles at or near the SAC / IC boundary will change. Vector notes that electricity and gas are currently highly inelastic products and have been so for the last 70 years and are likely to remain so for the foreseeable future.[53]

ii. The Commission would have an opportunity to amend or adjust the methodology in the future if and when there is evidence that that

---

50 Synergies Cost Allocation Report, page 25.

51 Synergies Cost Allocation Report, page 13. There has also been strong criticism of the fully distributed cost approach in economic literature: see Synergies Cost Allocation Report, page 24.

52 Synergies Cost Allocation Report, pages 20 to 23.

53 Synergies Cost Allocation Report, page 23, footnote 23.

demand characteristic have changed such that, applying Ramsey principles, a different approach is justified.

Long term contract analogy

104. The Commission refers to the long term contract analogy and argues that a contract involving informed consumers would likely provide for a mechanism for efficiencies from economies of scope to be passed on (although no evidence or examples are provided).

105. This position ignores the fact that the Government has set the terms of the regulatory compact in relation to cost allocation between regulated and unregulated businesses. As set out in the 2006 GPS, the Government considers that it is in the long term interests of the economy in general and consumers in particular that regulated businesses are able to utilise existing assets to reduce the cost of investing in new infrastructure and to take advantage of economies of scale and scope[54] (the 2006 GPS is now reflected in the Act and / or operates as an interpretative tool).

106. In any event, there are number of issues with the Commission's application of the long-term contract analogy as identified by Synergies, specifically:[55]

   (a) it is unlikely that an EDB / GPB operating in a workably competitive markets would have any commercial incentive to enter into such a contract;

   (b) even if there was such a commercial incentive for an EDB / GPB to contract to share scope efficiencies with regulated customers, the sharing would vary in accordance with conditions in regulated markets, including exposure to losses in those markets; and

   (c) it could also be expected that consumers under long term contracts would be expected to bear some of the downside risk if they also expected to share in the benefits (which is not recognised in the Commission's approach).

107. Synergies concludes that:[56]

> … [the] cost allocation rule would not be enshrined in a fixed FDC framework with some prescribed scope efficiency 'sharing' mechanism, but should simply allow cost allocations between IC and SAC boundaries, based on the Ramsey principles that the Commission appear to accept.

108. Vector further notes that long-term contracts are often negotiated through competitive processes (including auctions, tenders and significant commercial contracts where parties tend to have similar bargaining power) and that these processes are likely to result in cost allocation outcomes more consistent with SAC / IC than an FDC approach. This is because participants in such competitive

---

[54] 2006 GPS, paragraph 6.

[55] Synergies Cost Allocation Report, pages 18 to 20.

[56] Synergies Cost Allocation Report, page 20.

processes will be under competitive pressure to bid the lowest commercially viable price. As part of this, any assets or operations that a participant proposes to share would also likely be bid in at the lowest commercially viable price. This is incremental cost, or at least close to it, as this represents the lowest amount the business would be willing to accept for the shared use of assets or operations.

109. **[**

] VCI

Pole sharing between EDBs and Telecom

110. The Commission refers to the position in New Zealand where historically EDBs and Telecom have owned poles on opposite sides of the street and use each other's poles to carry lines to houses on the other side of the street without making payment. The Commission considers that this example demonstrates that ACAM can result in outcomes that do not promote the long-term benefit of consumers because:[57]

    (a) consumers are currently benefiting from these economies of scope;

    (b) under the current ACAM methodology, if Telecom and EDBs changed to financial payments, calculated regulatory asset base ("**RAB**") and maintenance costs could increase, yet corresponding receipts from Telecom would not be counted as regulated revenue; and

    (c) such a change "without corresponding changes in the underlying economics" would be inconsistent with outcomes observed in workably competitive markets".

111. Vector submits that this example (and the reasoning provided in support) does not provide a sound basis for concluding a SAC / IC approach is inconsistent with Part 4 purpose statement and / or that selecting an approach that will deter investment relative to the SAC / IC approach is warranted. Specifically:

    (a) the reasoning is based on the Commission's (incorrect) interpretation of section 52A(1)(c) and section 52T(3); and

    (b) in any event, while Vector considers that a disadvantage to consumers is a relevant consideration for the Commission, Vector does not consider the risk of disadvantage to consumers in this situation is sufficient to justify adoption of an accounting-based approach over SAC / IC and / or a proportionate response (given the likely detrimental impact of an accounting-based allocation on incentives to invest). In particular:

---

[57] EDBs Draft Reasons Paper, paragraphs 3.2.7 to 3.2.10 and 3.2.59 to 3.2.60; GPBs Draft Reasons Paper, paragraphs 3.2.7 to 3.2.10 and 3.2.59 to 3.2.60.

i. current sharing arrangements are the consequence of previous regulations which required sharing of poles:[58] as such the arrangements are a one-off anomaly, not "an example" of a wider issue;

ii. these arrangements have continued since the requirement was revoked in 1993 and there is no basis for considering that these arrangements will change in the foreseeable future (this is a perceived rather than real risk);

iii. in terms of any future arrangements where financial payments are agreed, consumers would be indifferent (compared to the situation where the arrangement was not entered into); and

iv. if the change did eventuate, consumers would not be disadvantaged because of the operation of the regulated and unregulated business together and / or the ACAM methodology, but because of a change in commercial / regulatory arrangements (noting that the 2006 GPS refers to the consumers of regulated businesses not being disadvantaged *by the investments of regulated businesses in other infrastructure and services*).

112. Further, the specific sharing arrangements referred to are the result of historical regulatory requirements and there is no basis for concluding that they would be likely to be observed in workably competitive markets. As set out above, any impact on consumers as a result of a change in commercial / regulatory arrangements is consistent with workably competitive markets.

Consistency with the Commission's other approaches

113. Vector notes that, in relation to asset valuation, the Commission concludes that workable competition provides limited guidance where there are a range of possible outcomes and that the Commission must then turn to section 52A(1)(a) to (d) (and further that "workably competitive market outcomes" arguably provide considerably more direction for asset valuation methodologies than for cost allocation methodologies).[59] As set out above SAC / IC would be considerably better in meeting section 52A(1)(a) to (d) than the Commission's proposed cost allocation input methodology.

114. In relation to the long term contract analogy as applied to asset valuation, the Commission argues that it is important to honour existing regulatory arrangements in order to incentivise investments. The Commission appears to be adopting an inconsistent approach in relation to cost allocation where honouring

58 Formal requirements for pole-sharing were last set out in regulation 112 of the Electrical Supply Regulations 1984 (a re-enactment of regulation 101 of the Electrical Supply Regulations 1976). The Electrical Supply Regulations 1984 were revoked by the Electricity Regulations 1993 (from 1 April 1993) and no similar rights are included in any current regulation.

59 EDBs Draft Reasons Paper, paragraphs 4.2.38 to 4.2.39; GPBs Draft Reasons Paper, paragraphs 4.2.38 to 4.2.39.

existing regulatory arrangements would require the adoption of an ACAM approach. In particular, the ACAM approach:

(a) Has been the required methodology for EDBs under Part 4A being prescribed by Electricity Information Disclosure Requirements and the Electricity Information Disclosure Handbook produced by the Commission. These requirements continue to apply pending new information disclosure requirements.

(b) In relation to GPBs, is the approach proposed as a mandatory disclosure requirement (to apply to most GPBs) by the Ministry of Economic Development in its review of the gas disclosure regulations. Standalone costs were proposed to be determined across regulated businesses jointly, as Vector endorses.

Experts review reports

115. The Commission's experts have each provided a report reviewing the Commission draft reasons[60] with the Commission's cost allocation approach covered at a relatively high rather than detailed level. These views are considered in the Synergies Cost Allocation report.[61]

116. None of the Commission's experts refer to the underlying New Zealand policy objectives and / or the 2006 GPS; broadly, that New Zealand needs to facilitate investment by regulated businesses in unregulated businesses in order to improve its economic performance. This may be because these objectives are not clearly discussed or applied by the Commission in the cost allocation chapter of its Draft Reasons Papers.

117. It is of particular note that Yarrow appears to take a contrary policy view where he states:[62]

> At the same time, I think that, in the light of regulatory history, there is more than enough evidence to indicate that regulators should be sceptical about arguments that an unduly high cost allocation to an unregulated business will substantially depress investment in unregulated services. **If these services are unregulated, that presumably means that they can be supplied without relying on a regulated incumbent at all. From a wider perspective, even if investment by a regulated incumbent, or by a company making use of the assets/services of a regulated incumbent, were deterred, that does not mean that investment in the**

---

60 Martin Cave, Michael Pollitt, John Small, George Yarrow, Experts' Reviews of the New Zealand Com*merce Commission's Draft Reasons Papers for Electricity Distribution and Gas Pipeline Services*, 13 July 2010.

61 For general comment on these reviews, see Synergies Cost Allocation Report, section 3.6.5.

62 George Yarrow, Expert Reviews of the New Zealand Com*merce Commission's Draft Reasons Papers for Electricity Distribution and Gas Pipeline Services*, 13 July 2010, page 8.

unregulated market will be inefficiently depressed. Some other supplier may make the investments.

[Emphasis added]

118. This view appears to suggest that it does not matter if the regulated business is deterred from investing in the regulated business as other businesses may invest, which appears to be directly contrary to the 2006 GPS policy position now reflected in the Act that it is in New Zealand's interest to encourage regulated businesses in particular to invest in other businesses. As set out above, it is not open to the Commission to adopt a different policy approach.

SAC / IC compliant with the Act and materially better in meeting the relevant purpose statement relative to the Commission's accounting -based approach

119. Vector submits that the Commission's approach is based on an incorrect interpretation of section 52A(1)(c) and section 52T(3). As set out above, the Commission's interpretation results in an approach that renders the relevant statutory provisions redundant (contrary to Parliament's intent), and generally fails to apply accepted statutory interpretation principles. Even if the Commission's interpretation was correct, a SAC / IC approach is more consistent with the promotion of workably competitive market outcomes, 52A(1)(a) to (d) and the 2006 GPS.

Consistent with 52A(1)(c) and section 52T(3)

120. The Commission's approach is inconsistent with section 52A(1)(c) as it aims to share efficiency gains arising from the provision of the regulated and unregulated business together (see paragraph 65 above).

121. The Commission's approach is inconsistent with the requirement of section 52T(3) as it will deter incentives to invest relative to the SAC / IC approach without good reason (ie unduly). As also set out above, the optional variation will not be effective in avoiding deterrence of incentives to invest.

Consistent with promotion of workably competitive outcomes

122. Even if the Commission was required to seek to share efficiency gains arising from regulated and unregulated businesses, Vector submits that while SAC / IC is a boundary approach, it is more likely than an accounting-based approach to promote outcomes consistent with workable competition for EDBs and GPBs (as explained above).

Consistent with section 52A(1)(a) to (d)

123. In relation to section 52A(1)(a) to (d) SAC / IC complies with the purpose statement relative to the Commission's approach:

(a) it would create strong incentives for regulated businesses to innovate and invest in regulated and unregulated services which will facilitate the achievement of net welfare gain to society in the long term interests of

consumers[63] (relative to the high risk that the default accounting-based approach will result in suboptimal investment).

(b) In relation to section 52A(1)(c), the Commission should not aim to share with consumers efficiency gains arising wholly from the existence of the regulated and unregulated business together. Even if this was not the correct interpretation, SAC / IC is more consistent with workably competitive market outcomes than the Commission's approach.

(c) Section 52A(1)(d) is of limited relevance unless there is a real risk of double counting or cross subsidisation, and Vector submits that an ACAM methodology (with a cap on double-counting) appropriately mitigates these risks. Further, cost allocation should reflect pricing principles and accordingly is irrelevant to assessing excessive profit.

Consistent with 2006 GPS

124. A SAC / IC cost allocation is significantly more consistent with the 2006 GPS and the policy underlying the Act than the default accounting-based approach (which is inconsistent with the 2006 GPS policy) as:

(a) It enables regulated businesses "to utilise existing assets to reduce the cost of investing in new infrastructure and to take advantage of economies of scale and scope" (2006 GPS paragraph 6);

(b) it provides regulated businesses with confidence that "they will not be disadvantaged in their regulated businesses if they invest in other infrastructure and services" (paragraph 7c); and

(c) it is consistent with the objective in paragraph 8 (that consumers of regulated businesses are not disadvantaged by the investments of regulated businesses in other infrastructure and services).

125. In line with the 2006 GPS, the current government has indicated that its wider strategy "to increase New Zealand's global competitiveness, particularly compared to other OECD countries" will be achieved through initiatives such as the Ultra Fast Broadband Initiative.

126. This policy was specifically noted by John Small at the Input Methodologies Conference (despite not being referred to in his subsequent review report):[64]

> MR SMALL: Can I just throw something in to start when you're talking about broadband and gas pipeline businesses. An observation from the Crown fibre investment company policy documents is very much that the policy on that side of the coin is really to leverage the cost models of the pipeline businesses for the advantage of promoting

---

[63] Synergies Cost Allocation Report, page 11. Also see page 12 of that Report, which notes that electricity consumers are ubiquitous in New Zealand and accordingly the loss of the provision of the unregulated service cannot be in their long term interests.

[64] Commerce Commission, *Transcript of Input Methodologies Conference: Gas Pipeline Services*, 16 September 2009, page 190, lines 17 to 26.

> broadband in New Zealand. It's very clear if you look at things from that side, that the intention is that only the incremental costs should go to the broadband and that's one of the essential features of the model and the competitive nature of it that are intended to make it work. So if you're looking about perhaps whether cost allocation should be from that side, I think that policy is quite clear.

127. Overall, a SAC / IC cost allocation approach is the best cost allocation method to enable EDBs and GPBs to participate in Government strategies and promote New Zealand's economic transformation and global competitiveness. Electricity and gas consumers will be no worse off from the application of SAC / IC, but New Zealand EDB / GPB companies will be incentivised to invest in other businesses at least cost for the benefit of the NZ economy and in the long term interests of consumers.

Cost Allocation Methodology Screening Criteria and Optional Variation Approach

CAMSC

128. Without prejudice to the views set out above, Vector supports the ENA submission in relation to the Commission's proposed CAMSC, including its submission that there are a number of areas where improvements must be made in order to ensure the cost allocation input methodology best meets the requirements of the Act.

129. Specifically, Vector agrees that:

    (a) The Commission's first two criteria will not, on their own, be effective in providing a more cost effective regime (as the Commission intends). It is highly likely that situations will arise where unregulated revenues and / or relevant asset-related costs or opex are material (so the business does not satisfy the CAMSC) yet the unregulated business unit remains unable to make a material contribution to shared costs. The cost allocation framework could result in considerable cost being expended in order to justify minimal unregulated business unit costs, notwithstanding the CAMSC. Further, in workably competitive markets, the portion of shared costs implicitly or explicitly borne by any given service would not exceed gross profit, as this is the maximum amount the service generates that is available to cover shared costs.

    (b) A third "gross profit" screening criterion is required to provide a test of whether or not each unregulated business is capable of making a material contribution to the recovery of shared costs. The adoption of this third criterion would also significantly improve the intended operation of the CAMSC (the modified flow chart in the ENA submission on cost allocation clearly sets out the order of scrutiny, the nature of the questions to be asked, and the proposed thresholds to be applied). A gross profit assessment provides a good first indicator of a service's ability to bear an allocation of shared costs and is a good indicator of materiality, and the

information required for the test is readily available and cost effective to obtain. Further, the third criterion:

i. would be materially better at approximating the cost bearing of unregulated businesses that would occur in workably competitive markets;

ii. would reduce the number of steps needed to be considered when assessing whether an unregulated service should receive an allocation of shared costs, and is therefore less administratively expensive;

iii. would avoid arbitrarily dividing unregulated business units into discrete services which, individually, would not have a material contribution to gross profit (through specification at a business unit level); and

iv. As set out in the example provided by ENA, the difference in earnings before interest, taxes, depreciation and amortization ("**EBITDA**") for the regulated service between the Commission's proposed method and the method proposed by ENA is not meaningful. However, the EBITDA, where such a service is screened out as unable to make a material contribution to the recovery of shared costs difference, is material to that service**.** Accordingly, this would make a significant difference for the economic attractiveness of investing in the unregulated service.

130. Accordingly, Vector submits that:

(c) The criterion 1 threshold for unregulated revenues should be greater than 20% of regulated revenues.

(d) The Commission’s 15% threshold for OPEX and 10% threshold for asset-related costs under criterion 2 are appropriate.

(e) The criterion 3 threshold for unregulated gross profit should have a threshold of greater than 10% of total gross profit, and should be applied to individual unregulated businesses. 10% aligns with the asset related threshold given both gross margins and asset costs assess the non-operating cost component of building block revenues.

Optional Variation

131. As set out above, Vector submits that the optional variation approach will not mitigate the deterring effects of the default accounting-approach and that the net deterring effect of the default position is undue or unwarranted.

132. Without prejudice to this position, Vector submits that:

(a) the operational variation methodology should provide that a Director can certify that material factors will result in the unregulated business ceasing to operate or not being invested, on the basis the application of an accounting-based cost allocation methodology is a significant factor (but not necessarily the sole factor); and

(b) if such a certification is made, ACAM should be able to be applied as it is applied for the CAMSC.

133. Further, if the approach is adopted, Vector submits that the Director's certification should be accepted by the Commission unless there is good reason to consider that the information may be false or if no supporting information is provided. This is because:

(a) A certification from a Director is a significant document and carries with it penalties if the Director provides false information.[65]

(b) The purpose of requiring Director's certification for the optional variation is to take advantage of these onerous duties and potential penalties. Directors are required to make accurate and robust judgments about the unregulated business and potential investment decisions within their company.

(c) There is little purpose in the Commission requiring this high standard of confirmation without a corresponding lessening of requirements regarding verification of the certification and / or information in support.

134. Given this, it is not appropriate for the Commission to substitute its view for that of the certifying Director(s), unless there is good reason to consider that the information may be false or no supporting information is provided with the certificate.

135. Vector further supports the ENA proposals regarding a mechanism to explicitly allow accumulated losses to be capitalised and taken account of when assessing profitability in unregulated businesses. Losses should be able to be capitalised in unregulated businesses and taken account of when assessing profitability under the optional variation.

136. Vector also supports ENA's view that:

(a) There is no indication how often the test set out under the optional variation would have to be undertaken during a regulatory period. If the test was required to be repeated annually for example then investments will continue to be unduly deterred.

(b) If the Director's certification is framed in terms of annual accounting profitability then it may result at any given point in time in ignoring sunk costs and focusing on revenues earned, costs incurred and profits on a forward-looking basis. This would mean that as soon as an investment begins to earn its cost of capital (as applied) it would receive an allocation of

---

[65] Directors have a general duty under section 137 of the Companies Act 1993 to exercise care, diligence and skill when exercising their powers (taking into account the nature of the decision and the nature of the responsibilities undertaken by him or her, both of which are onerous in this case). Failure to discharge this obligation can expose a Director to personal actions by shareholders. Further, it is a criminal offence under section 103 of the Act for a Director to attempt to deceive or knowingly mislead the Commission.

shared costs, thereby reducing the profitability of that unit from that point and reducing the returns earned from the investment.

137. Vector therefore proposes that optional variation certification should only be required once during the regulatory period:

(a) in relation to unregulated businesses already identified, at the start of the first regulatory period; and

(b) otherwise, as the particular impacts on an unregulated business crystallise during the course of a regulatory period.

138. Unregulated businesses would then be reviewed at the beginning of each subsequent regulatory period and certified with evidence by Directors. Any trigger point for a change in allocation should not be based upon an investment in an unregulated business beginning to earn its cost of capital, but rather on the Director's certification that such an unregulated business is capable of bearing its allocation of shared costs.

Cost allocation between regulated businesses

139. Vector views the Commission's proposal to apply an accounting-based cost allocation between regulated businesses as a pragmatic solution (subject to its proposal in relation to efficiency gains from mergers and acquisitions).

140. Price elasticities of demand for GPBs and EDBs services are likely to be sufficiently similar (although gas is likely to be more substitutable then electricity) such that Ramsey principles would suggest an allocation within the SAC / IC bounds. This is likely to be more consistent, from a pragmatic point of view, with an accounting based approach. Further, while ACAM applied to shared costs between regulated and unregulated businesses is very effective at ensuring regulated consumers are not disadvantaged, it is less applicable to the sharing of costs between two regulated businesses where costs for each are considered on a standalone basis.

Mergers and acquisitions

141. Vector agrees with the Commission that the sharing of efficiency gains that result from mergers and acquisitions after a period of retention is consistent with outcomes in workably competitive markets and maintains regulated suppliers' incentives to seek to achieve these efficiencies. However, the Commission has failed to set a realistic timeframe for the benefits to be retained by suppliers and then shared with consumers.

142. The result of the Commission's draft decision would be that major mergers and acquisitions will either not happen, or will only happen early in a regulatory period but suppliers will only capture small proportions of the possible synergy gains. Over time, this will distort investment decisions, by artificially lowering the potential synergy gains that can be kept by the supplier, and will increase costs for consumers by preventing synergy gains from being achieved. The

Commission's draft decision therefore clearly, and unduly, disincentivises mergers and acquisitions to the detriment of both suppliers and consumers.

143. For example, if a merger or acquisition occurred in year 1 of a regulatory period but the full efficiency gains were only captured in year 3 (e.g. through consolidation of the businesses and synergy gains, but only after the costs of the consolidation process are incurred) then the supplier only gets to keep efficiency gains for two years.

144. Economic theory suggests that in workably competitive markets suppliers should be able to keep efficiency gains in the short term, with these gains being shared with consumers in the long term as competitors adopt similar business structures that lower their own prices. However, the Commission has essentially defined the short-term as the remaining regulatory period, which could be as little as one or two years. This timeframe does not align with workably competitive markets, nor seems appropriate in the context of businesses with large initial sunk costs where investment decisions cannot be easily reversed or changed due to long asset lives.[66]

145. In economic terms, the long-run is the period in which all factors of production are variable. For electricity and gas network businesses, the long-run would therefore be approximately 50-60 years into the future. Accordingly, the short term for utilities must be considerably longer than the short term for normal consumer goods. Certainly, the short term must be longer than the remaining regulatory period after a merger or acquisition has taken place (a maximum of 5 years). This strongly suggests that the Commission needs to allow suppliers to retain efficiency gains over multiple regulatory periods to be consistent with workably competitive markets.

146. Vector supports the ENA view (for EDBs and GPBs) that a materially better approach is to adopt a modified IRIS mechanism to share efficiency gains resulting from mergers and acquisitions with consumers over 10 years.

Cost allocation methodology - other issues

Details of the accounting-based approach

147. If an accounting-based approach must be used, Vector is broadly comfortable with the Commission's proposals of how it would be implemented.

148. The Commission proposes that causal relationships should be assessed over an 18 month timeframe.[67] Vector submits that an annual timeframe of 24 months that aligns with, and draws from, annual information disclosure reporting would be more appropriate and would lower costs (as relevant information would not need to be separately calculated and audited for cost allocation purposes). Furthermore, EDBs / GPBs are characterised by long-lived assets and changes tend not to occur rapidly. As the Commission already intends to provide for the

[66] Synergies Cost Allocation Report, page 42.

[67] EDBs Draft Reasons Paper, paragraph 3.4.2; GPBs Draft Reasons Paper, paragraph 3.4.2.

use of more recent information where "step changes" occur within the 18 month timeframe, extending the timeframe to 24 months will not allow significant changes in cost causation to occur without the changes being captured by the allocators.

Arms Length Transactions

149. Vector agrees with the Commission that operating costs recouped through arms-length transactions should be allowed to be excluded from assessed operating costs for cost allocation purposes, and that arms-length operating costs will not be subject to accounting based cost allocation and will be excluded from any materiality test.[68] We also support the ENA proposal that this should be on a voluntary basis rather than a mandatory basis given arm-length transactions will not always be based on a cost-allocation model.

150. Vector submits that any arms-length shared asset costs should also be excluded from consideration for cost allocation purposes. The Commission reasoning for not excluding shared asset costs are that: [69]

(a) there may be differences in the way in which assets have been valued for arm's-length transactions and the Commission's valuation methodologies specified as part of its input methodology;

(b) annual payments are akin to a depreciation recoupment; and

(c) the cost allocation input methodology has been structured around allocating asset values rather than capital related costs.

151. Vector does not consider that these reasons are valid and submits that costs recouped through arm-length transactions should be excluded. Such exclusion is necessary in order to provide EDBs / GPBs with the flexibility to enter into negotiations on such agreements. Specifically:

(a) As an overarching point, it is unlikely that parties to a long-term contract in workably competitive markets would have negotiated and agreed different arrangements for operating and asset-related costs. It is therefore inconsistent to treat the two costs types differently.

(b) The presence of different valuation methodologies is irrelevant so long as parties are allocating shared asset costs between IC and SAC (based on the Commission's valuation methodologies). In our view, asset prices agreed in arm's length contracts are unlikely to breach SAC / IC as:

i. Parties are likely to enter into negotiations on shared assets with equal bargaining power. This would limit the extent to which EDBs / GPBs could charge higher than a fair allocation of RAB based SAC. As part of this, external parties would be unlikely to accept that they should have to pay

---

68 EDBs Draft Reasons Paper, paragraph 3.4.28; GPBs Draft Reasons Paper, paragraph 3.4.28

69 EDBs Draft Reasons Paper, paragraph 3.4.35; GPBs Draft Reasons Paper, paragraph 3.4.35.

for the full SAC cost of an asset, given the EDBs / GPBs own use, so some allocation below RAB based SAC is likely.

ii. External parties have access to RAB information disclosures and valuation handbooks which provides transparency over EDBs / GPBs asset valuations.

iii. An external party often has alternatives to using EDB / GPB assets which will constrain pricing to below a fair allocation of SAC. For example, the pricing of the use of ducts would be constrained by a party laying their own ducts.

iv. Pricing is likely to be constrained by the threat of specific access regulation on bottleneck infrastructure. For instance, the Telecommunications Minister, Steven Joyce (as part of the Ultra Fast Broadband Initiative) has indicated that he supports commercial negotiations for facilitating access to poles and ducts for the deployment of fibre but this would be backed by some form of arbitration (regulatory or otherwise) or access regulation should negotiations fail. Presumably arbitration/regulation would be instigated where contracting parties believed the assets were priced too high comparative to their cost or value.

(c) Vector disagrees that arm’s length annual payments for shared assets are only akin to a depreciation payment or that the cost allocation input methodology should ignore capital related costs:

v. Depreciation is only one component of a fair recovery of an asset. A fair return on capital and payment for asset specific costs that may legitimately be capitalised in the asset cost should also be allowed.

vi. Prices agreed under arm’s length contracts might not relate or be comparable to RAB valuations or the specific assumptions that were made in undertaking these valuations. For example, parties may require different asset configurations to those assumed in RAB valuations, or their specific requirements might lead to new assets being installed, higher maintenance costs or depreciation rates. These variations need to be legitimately allowed for in the cost allocation input methodology through excluding arm’s length contracts.

Use of cost allocation input methodology for DPPs and CPPs

152. As noted by the Commission, the cost allocation methodology has been designed with relatively little prescription so that EDBs have the flexibility to reflect their current circumstances (and, subject to its submissions above, Vector supports this principled based approach).[70]

---

[70] EDBs Draft Reasons Paper, paragraph 3.3.63; GPBs Draft Reasons Paper, paragraph 3.3.63.

153. The Commission then notes that this flexible approach potentially leads to inconsistency in cost allocation outcomes but that transparency in cost allocation can compensate for this as the Commission and other parties can make adjustments to make the comparisons more meaningful.[71]

154. Vector has no difficultly with adjustments being made for comparative purposes but emphasises that:

    (a) No such adjustments should be made to the disclosed information for DPP and CPP purposes. Doing so on an ad hoc / case by case basis would defeat the purpose of input methodologies, which is to provide clear rules up front and would undermine the certainty of the regime (contrary to incentives to invest).

    (b) In relation to alternative cost allocation approaches certified by Directors under the optional variation approach, the Commission's should specify in its cost allocation input methodology that these certified allocations applied by the EDBs will be used by the Commission for the reset of DPPs and for the setting of CPPs. (Vector fully supports the ENA submission in this regard and further submits that the ENA reasoning applies equally to GPBs).

155. More generally, as explained below, a methodology for determining and adjusting starting prices for DPPs should be included in either the pricing methodologies or rules and processes input methodologies (see paragraphs 181 to 194). It would not be acceptable for the Commission to apply adjusted information disclosure information unless this adjustment process was clearly specified in the appropriate DPP starting price input methodology.

156. Currently, the Commission's draft determinations do not include an input methodology for determining and adjusting DPP starting prices, including how disclosed cost allocation information will be used in the DPP context. This highlights how difficult it is for EBDs and GPBs to understand with any certainty the likely impact of methodologies such as cost allocation on their businesses (contrary to section 52T(2)).[72]

157. Finally, the Commission proposes that suppliers should not reapply the cost allocation input methodology when producing forecasts for a CPP proposal. Rather, the Commission proposes that forecasts should be driven off amounts disclosed in the most recent information disclosures made prior to submitting the CPP, when the cost allocation input methodology was last applied.[73] Vector supports the ENA submission (for both EDBs and GPBs) that:

    (a) The CPP application should reflect the best information about regulated businesses for the CPP period, and that cost allocations should not be locked-in to historical cost allocations. This would increase regulatory risk

---

[71] EDBs Draft Reasons Paper, paragraph 3.3.64; GPBs Draft Reasons Paper, paragraph 3.3.64.

[72] See paragraphs 188 to 194 below.

[73] EDBs Draft Reasons Paper, paragraph 3.5.14; GPBs Draft Reasons Paper, paragraph 3.5.14.

and is unsustainable in that it does not take into account changes in suppliers circumstances (e.g. divestments, mergers and acquisitions activity).

(b) A materially better approach would be to provide suppliers with flexibility to propose alternative cost-allocations for the CPP period that are reflective of business conditions and requirements over that period.

PART B: REGULATORY TAX

Overview

158. In this Part Vector:

(a) summarises the Commission's approach;

(b) sets out its support for the modified deferred tax approach for all EDBs and all GPBs other than MDL and provides comments on the detail of the Commission's approach; and

(c) comments on the MDL's apparent choice of methodology, supporting this as an approach that should apply to all EDBs and GPBs and to input methodologies generally.

159. Vector supports and refers to the submission of ENA and the supporting report prepared by PwC regarding the tax treatment input methodology draft decision.

The Commission's approach

160. Key Commission decisions are:[74]

(a) a supplier's tax obligations must be estimated using a 'deferred tax' approach, modified for NPV-equivalence with a tax payable approach by amortising the revaluations, and by amortising the difference between the initial RAB and the initial regulatory tax asset value, over the residual lifetime of the assets;

(b) accordingly regulatory taxable income should be determined with reference to regulatory profit by adjusting for any revenue or expenses not recognised as assessable or deductible under tax legislation, and adjusting for the amortisation of the revaluations and the amortisation of the difference between the initial RAB and the initial regulatory tax asset value;

(c) tax losses in a supplier's wider tax group must be ignored when estimating tax costs, and any tax losses generated in the supply of electricity distribution services should be notionally carried forward to the following disclosure year;

(d) the regulatory tax asset value of assets acquired from another supplier of a regulated service should remain unchanged in the event of an acquisition of assets used to supply services under Part 4;

(e) the initial regulatory tax asset value in 2009 should be the same as that recognised by the Inland Revenue Department (IRD) for the relevant assets or share of assets used to supply the regulated services, but must not exceed the initial RAB value;

(f) the initial regulatory deferred tax balance should be set to zero; and

---

[74] EDBs Draft Reasons Paper, page 182; GPBs Draft Reasons Paper, page 166.

(g) the asset value used for assessing profitability under information disclosure regulation, or setting allowable revenues under price–quality regulation should be the RAB value plus the deferred tax balance.

Support for deferred tax approach

161. Vector supports the Commission's decision to introduce a modified deferred tax approach for all EDBs and all GPBs other than MDL. In Vector's view, this is a materially better approach than the tax payable approach as it is superior in meeting the Purpose Statement and allows for consistency in the overall framework for measuring economic profits over time.

162. Vector therefore supports the Commission's overall approach to the tax treatment input methodology. The comments below relate to the detail of how the approach will be implemented.

Circular reference

163. It appears that there is a circular reference in the regulatory tax calculation. This is because:

(a) regulatory tax is an input into building blocks allowable revenue before tax;[75]

(b) regulatory tax is calculated as regulatory net taxable income multiplied by the statutory tax rate;[76] and

(c) regulatory net taxable income is derived from building blocks revenue less operating costs and depreciation.[77]

164. Vector recommends this is resolved by determining regulatory tax by starting with post-tax profit and "grossing" this up to determine pre-tax profit. This enables tax to be determined without reference to revenue.

Amortisations and Revaluations

165. Vector supports the Commission's intent of amortising the revaluations and amortising the difference between the initial RAB and the initial regulatory tax asset value over the residual lifetime of the assets. However, the Commission's proposed approach to these issues may not produce an NPV neutral outcome.

166. The amortisation of the opening asset difference and amortisation of the revaluation difference are included in the revenue requirement calculation through their inclusion in regulatory tax. However, the Commission's approach does not seem to recognise that the consequential increase in revenue will be taxed.

---

75 EDB Draft Determination, clause 5.3.3; GPB Draft Determinations, clause 5.3.3.

76 EDB Draft Determination, clause 5.3.21 (1)(a); GPB Draft Determinations, clause 5.3.21 (1)(a).

77 EDB Draft Determination, clause 5.3.21(2) – (4); GPBs Draft Determinations, clause 5.3.21(2) – (4).

Therefore, the actual increase in cash received by the EDBs will be the amortisations net of tax, which will be insufficient to ensure NPV neutrality (by the amount of the tax on the amortisation).

167. As PwC has modelled, the way to adjust for the initial asset value difference is to include the tax-affected amortisation in the calculation of revenue. The adjustment (increase) to revenue needs to be equal to the tax-effected amortisation "grossed-up" to a pre-tax amount.

168. The impact of the amortisation of revaluations has been effectively incorporated in the deferred tax balance by requiring timing differences to be calculated using RAB depreciation excluding all revaluation amounts. However, it is not clear how the Commission's approach deals with the deferred tax impact of amortisation of the initial asset value difference. This needs to be specified in detail.

Regulatory tax value of acquired assets

169. Vector does not support the Commission's proposed approach to establishing the regulatory tax value of acquired assets. While the Commission's approach does reflect Vector's previous position, in light of the application of the deferred tax approach as proposed by the Commission Vector has modified its view.

170. In Vector's view the Commission's treatment of tax on acquired assets should follow one simple rule: on acquisition the tax value of an asset in the purchaser's regulatory accounts should equal the RAB value. The Commission's requirement that the tax value of an asset remain unchanged in the event of an acquisition is inconsistent with the approach under tax legislation, as noted by the Commission.

171. Equating initial tax value with cost reflects the principle treatment arising from the application of tax legislation is broadly analogous to the real world and is representative of what occurs in workably competitive markets. Only in instances where the Commission's rules or decisions do not allow RAB to equate to cost would the tax value also deviate from cost through the application of the rule above. This approach simply recognises the inequity of the Commission seeking to pass onto consumers the benefit of a purchase price in excess of recognised RAB while not allowing the purchaser a return on the excess of purchase price over RAB.

172. This approach not only aligns with workably competitive markets and the principles of tax legislation, it also significantly simplifies the deferred tax methodology the Commission is proposing by ensuring that on acquisition the deferred tax balance on the acquired asset is always nil for regulatory accounting purposes. As noted below and in the submission from the ENA and supporting report from PwC, This additional complication to an already complex methodology seems to have eluded the Commission itself.

173. However, in the event that the Commission continues to require the tax value of an asset to remain unchanged in the event of an acquisition and to ensure that the purchaser is able to recover sufficient funds from customers to pay its tax, the

purchaser should not be required to establish a deferred tax liability for the difference between the RAB value and the tax written down value on acquisition and should be entitled to recover the tax effect of the difference between these two values over the life of the asset (i.e. through amortisation of the difference). This is the same treatment applying to the assets at commencement of the regulatory regime.

174. In any case, the approach to treating the initial asset value difference for acquired assets must be made explicit. Vector fully endorses PwC's view that the Determination be based on a template that demonstrates the various tax calculations or at least be accompanied by a template to assist with interpretation and implementation.

Choice of tax input methodology

175. In providing a tax payable approach for MDL and a deferred tax approach for all other suppliers, the Commission appears to have agreed that where a number of approaches are consistent with the Part 4 purpose statement, there can be variation between suppliers regarding which approach is taken. Vector submits that, as MDL has apparently been given the choice of which tax regime will apply, that same choice should be extended to other suppliers. Vector would also like to see this same principle of choice where a variety of approaches can achieve the purpose statement applied to other aspects of input methodologies and default/customised price-quality regulation.

PART C: PRICING METHODOLOGIES

Overview

176. In this Part Vector:

    (a) summarises the Commission's approach; and

    (b) submits that the Commission must include a DPP price methodology in its Pricing Methodologies input methodology (or alternatively in its Rules and Processes input methodology).[78]

177. In relation to the matters that are included in the Pricing Methodologies input methodology (which Vector broadly supports), comments on:

    (a) the applicability of pricing methodologies to CPPs;

    (b) the drafting principles for GPBs; and

    (c) alignment with the work of the Electricity Authority.

The Commission's approach

178. The Commission's draft decisions papers do not set out any rule or process for setting the starting prices for DPP. Instead, the Commission has indicated that it intends to release a separate "Starting Price Adjustments Discussion Paper" for August / September 2010 but as part of the DPP reset process.[79]

179. In relation to the input methodology setting out pricing methodologies (section 52T(1)(b)), the Commission's draft decision provides that:

    (a) The adoption of a principles based approach to pricing methodologies using the same set of principles for both GPBs and EDBs. These principles are based on the pricing principles developed under the Gas Authorisation with modifications for insights gained from the Electricity Commission's work on pricing methodologies.[80]

    (b) Pricing methodologies will not apply to DPPs, but will rather be required in information disclosures for monitoring purposes.[81]

    (c) Pricing methodologies will only be required as part of a CPP application where the Commission has identified in information disclosure reviews that a

---

[78] This section of the submission applies equally to Part D.

[79] See Commerce Commission, *Further Work on the Reset Default Price-quality Path for Electricity Distribution Businesses: Updated Process Paper*, 3 May 2010, Table 1.

[80] EDBs Draft Reasons Paper, paragraph 7.4.3; GPBs Draft Reasons, paragraph 7.4.3.

[81] EDBs Draft Reasons Paper, paragraphs 7.5.6 and 7.5.8; GPBs Draft Reasons, paragraphs 7.5.5 and 7.5.8.

supplier will be required to do so. If one is required, then it will be approved by the Commission as part of the CPP process.[82]

(d) Actual pricing methodologies must be disclosed and these must show compliance against the pricing principles.[83]

180. As far as can be determined, the Commission's proposal on Pricing Methodologies is the same for GPBs and EDBs. However, the Commission recognises that it does not need to develop pricing methodologies for EDBs under the proposed Electricity Industry Bill ("**EIB**") amendment to Part 4, s52D(1)(b), of the Commerce Act. Should this eventuate, then the Electricity Authority ("**EA**"[84]) will be responsible for setting EDB pricing methodologies. This outcome is likely and we would hope for this to be confirmed before the final decision, given that the EIB is almost in its third reading. Until then, the Commission has recognised that it has a current duty under the Act and will fulfil this until the EIB is passed.[85]

Inclusion of DPP pricing methodology in the Pricing Methodologies input methodology

181. Vector submits that the Commission is required to set out a DPP pricing methodology as an section 52T(1)(b) (pricing methodologies) or section 52T(1)(c)(i) (rules and processes) determination and that determining this methodology outside the input methodlogies process is unlawful. Further, without a DPP pricing methodology Vector is unable to reasonably understand the impact of the various input methodologies on its business.

182. This Part should be read in conjunction with the letter of 20 July 2010 from ENA to the Commission which was supported by Vector. This letter sets out the reasons why the DPP pricing methodology is a requirement under the Act with reference to the relevant statutory framework.

183. Additionally, Vector outlines below:

(a) the statutory requirements relating to the provision of a DPP pricing methodology;

(b) why Vector is unable to estimate the material impacts of input methodologies on its business in the absence of a DPP pricing methodology as an input methodology (including input methodologies for WACC, asset valuation, and CPP processes); and

(c) a proposed DPP pricing methodology and why this is materially better than the Commission's proposed approach.

---

[82] EDBs Draft Reasons Paper, paragraph 7.5.9; GPBs Draft Reasons Paper, paragraph 7.5.9.

[83] EDBs Draft Reasons Paper, paragraph 7.5.5; GPBs Draft Reasons Paper, paragraph 7.5.4.

[84] Which hereafter includes reference to the Electricity Commission.

[85] EDBs Draft Reasons Paper, paragraph 7.1.11.

Statutory requirements

184. Vector submits that the Commission is required under section 52T of the Act to set out its methodology for setting and adjusting starting prices as an input methodology determination and that determining this methodology outside the input methodology process is unlawful. This methodology should cover:

(a) how the current and projected profitability of each supplier will be determined and how the starting price will be adjusted based on the current and projected profitability of the suppliers (section 53P(3)(b));

(b) how the starting price is adjusted over the regulatory period (specifically the rate of change and the application of claw-back); and

(c) the rules and processes for determining whether the starting price should be the price at the end of the preceding regulatory period (s53P(3)(a)), or whether the starting price should be determined (or "adjusted") in accordance with s53P(3)(b).

185. This is because:

(a) the methodology for setting and adjusting starting prices and rates of change is a mandatory requirement under section 52T(1)(c)(i) (rules and processes) and / or section 52T(1)(b) (pricing methodologies);

(b) DPP price adjustments could not be lawfully implemented by the Commission in the current regulatory period in the absence of an input methodologies setting out the starting price methodology; and

(c) notwithstanding (a) and (b) above, sufficient detail of a DPP price methodology is required in order for EDBs to be able to reasonably anticipate the effects of this and other input methodologies on their businesses (section 52T(2) and to ensure consistency with section 52R (which provides that 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).

186. In relation (a) above:

(a) "Price" is defined as meaning any one or more of individual prices, aggregate prices, or revenues (whether in the form of specific numbers, or in the form of formulae by which specific numbers are derived) and includes any related terms of payment (section 52C). Starting prices under a DPP and the adjusted prices over the regulatory period (adjusted by the rate of change, claw-back or section 53P(8) adjustments) are aggregate prices so fall within this definition. Accordingly, the "specification of prices" under section 52T(1)(c)(i) includes a methodology for starting prices for a DPP (DPP prices being aggregate prices).

(b) "Pricing methodologies" is defined as methodologies for setting the prices of individual goods or services, or classes of goods or services, and includes methodologies for setting different prices for different customer groups (section 52C).

187. In Vector's view, DPP price adjustments could not be lawfully implemented in the absence of an DPP pricing methodology determined under sections 52T(1)(c)(i) or 52T(1)(b) as:

(a) The Commission has determined a DPP for EDBs for the current regulatory period (to 2015). 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 input methodologies applied at the time the DPPs were reset, a materially different DPP would have been set. Vector submits that the Commission would be unable to reset starting prices and rates of change under this section on the basis of the publication if there is no input methodology setting out how the DPP prices will be set and how the other input methodology will be applied.

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

(c) Generally amending the current DPP determination to include a starting price methodology would be unlawful as it would circumvent the intended statutory process (as set out above).

(d) Irrespective of (a) and (b), other than in response to the input methodologies being determined, the Commission is proposing to re-open the current DPP only if one of the re-openers set out in the rules and processes input methodology applies (e.g. material error, false or misleading information), and none of these re-openers would apply in the circumstances.

Vector is unable to estimate the material impacts of input methodologies on its business in the absence of a DPP pricing methodology

188. The Commission's failure to propose a methodology for determining starting prices for DPPs gives rise to a number of concerns. In particular:

(a) Until the rules and processes for setting the DPP starting prices have been established, it is difficult to assess how the various input methodologies will be applied in practice and, accordingly, how they will impact on Vector's business.

(b) By not setting out an input methodology covering the processes for setting starting prices, the Commission appears to be reserving for itself a broad discretion to set starting prices as it sees fit, and without the direction

provided by input methodology process requirements or the discipline of potential merits review.

189. As noted above, the purpose of input methodologies is to set out in advance the rules and processes that will determine this form of regulation. This is necessary to provide a certain and predictable regime (as set out in the Explanatory Note, a certain regime is critical for incentives to invest).[86]

190. DPPs are intended to be the primary form of regulation for EDBs (other than exempt EDBs) and GPBs with CPPs being the exception. Accordingly, starting prices and adjustments to starting prices (including by way of adjustment to rates of change and claw-back) will have a significant impact on the EDBs' businesses. If regulated businesses do not know how various input methodologies will be used when determining the starting prices (because it is not set out in advance), one of the key objectives of the regime would be undermined.

191. Input methodologies for asset valuation, WACC and cost allocation (among other things) will clearly inform the determination and adjustment of starting prices under DPPs. However, the extent of information regarding how asset valuation and WACC methodologies will be used to determine starting prices and starting price adjustments is provided at paragraphs 4.5.6 and 4.5.8 of the draft reasons papers.[87] Specifically that the Commission:

(a) notes that the asset valuation input methodology is a key input into the calculation of the return on investment ("**ROI**") in information disclosure and "a comparison of the WACC and the disclosed ROIs *may* inform starting price adjustments for DPPs, as under section 53P(3)(b) starting price adjustments can be based on current and projected profitability" and that accordingly the asset valuation input methodology will indirectly inform the determination of appropriate DPPs for suppliers.;

(b) in relation to the cost allocation methodology, does not specify how the disclosed information will be used for the purposes of determining DPP prices and / or that the disclosed information will be used without adjustment.

192. While the Commission acknowledges that the asset valuation and cost allocation input methodologies will inform the determination of DPP prices (through disclosed information) as set out above, the Commission then states elsewhere that these methodologies are not relevant to the DPP process. For example at table 1.1 page 6 of the EDB Draft Reasons, the Commission claims that only cost of capital is relevant to DPPs because other input methodologies "are only indirectly applicable to the DPP through the information used to set starting prices".

---

86 Explanatory Note to the Commerce Amendment Bill 2009, pages 3 - 4.

87 EDBs Draft Reasons Paper, paragraphs 4.5.5 and 4.5.8; GPBs Draft Reasons Paper, paragraphs 4.5.5 and 4.5.8.

193. Vector submits that it is not credible for the Commission to suggest that only the input methodology for WACC is relevant to the DPPs. How information disclosed by suppliers is used when determining and adjusting starting prices is clearly critical and without this link a regulated business cannot reasonably understand how the various input methodologies will impact on its business. In this regard The Commission appears to misunderstand the intent of input methodologies which is to provide certainty by setting out in advance how the form of regulation will apply to them.

194. Accordingly, Vector submits that the Commission must set out how information disclosed under the various input methodologies will be used by the Commission when determining or adjusting DPP starting prices.

Proposed alternative methodology

195. The DPP reset paper has only recently been released by the Commission. Vector will consider and include an alternative methodology in its amended draft determinations.

Applicability of pricing methodologies to CPPs

196. Conceptually, Vector supports the proposal of pricing methodologies only being required for CPPs where the Commission has identified issues under information disclosures.[88] However, the Commission needs to transparently define upfront what the criteria are for being "on the list" and the Commission needs to apply this criteria consistently across all EDBs / GPBs (should EDBs need to). Input methodologies need to provide upfront certainty such that suppliers can make informed decisions. It therefore makes sense to define when and why pricing methodologies are required for a CPP application.

197. For the purposes of determining whether a supplier is required to submit a pricing methodology for a CPP, Vector considers that suppliers should only be named in instances of significant non-compliance with the pricing principles. Under the Gas Authorisation, suppliers needed to show regard to and consistency with the pricing principles. This recognised that some principles share competing objectives and therefore needed to be weighted accordingly. In assessing compliance, Vector would expect that if a supplier showed no reasonable and robust consideration to a pricing principle at all then this would be considered non-compliant. However, if a principle was robustly considered but weighted lowly for objectively justifiable reasons then this should not constitute non-compliance.

198. A supplier should also be given the opportunity to remedy any concerns the Commission may have over its compliance with pricing methodologies by amending its pricing methodology or by providing further evidence of compliance. The supplier should be given an opportunity to respond before being put on the list and should be removed from the list at any time once these issues are resolved.

---

[88] EDBs Draft Reasons Paper, paragraph 7.5.9; GPBs Draft Reasons Paper, paragraph 7.5.9.

199. Vector proposes that the Commission detail the outlined criteria for its information disclosure review in a supplementary draft decision such that suppliers can comment before a final decision is made.

200. If a pricing methodology is required for a CPP application, then the Commission is proposing that it can amend or substitute an applicant's pricing methodology, where it considers a different pricing methodology would better meet the purpose of Part 4.[89] This creates a certain degree of uncertainty as a CPP applicant would not know whether its proposed pricing methodology would be substituted for an alternative, and if so, what that alternative might be (contrary to the section 52R purpose and section 52T(3)).

201. Vector supports the Commission's principles-based approach, and believes it needs to apply to CPPs as much as to information disclosures. Showing regard to and consistency with the pricing principles should therefore be sufficient for a CPP application and the Commission should only be able to challenge a CPP pricing methodology proposal where due regard or consistency has not been shown.

202. Vector therefore supports the ENA view, for both EDBs and GPBs, that any pricing methodology submitted as part of a CPP application should show regard to and be consistent with the pricing principles, but the choice of CPP pricing methodology (including reasonable and objectively justifiable weighting of principles) should remain with the applicant.

Draft Pricing Principles for GPBs

203. Vector notes that the draft pricing principles in table 7.1 of the Gas Pipeline Services Draft Reasons Paper align with the pricing principles applied under the Gas Authorisation. Vector is broadly in agreement with these pricing principles as being pitched at the appropriate level, reflecting good regulatory practice and experience from overseas jurisdictions and providing the appropriate level of guidance and flexibility for GPBs to construct appropriate tariff and pricing structures.

Alignment with Electricity Authority

204. Vector acknowledges that the Commerce Commission is unlikely to be required to implement EDB pricing methodologies under Input Methodologies due to the proposed Electricity Industry Bill. Under this likely scenario, the Electricity Authority will have the sole responsibility of setting pricing methodologies, meaning pricing methodologies will not be required for DPPs or CPPs and, Vector assumes, for information disclosure purposes either, given there is no input methodology that requires monitoring.

205. If it should eventuate that the Commission and Electricity Authority both require pricing methodologies, then Vector submits that these should be the same (or at least recognise the differences) to avoid conflicting requirements. Specifically:

---

[89] EDB Draft Determination, clause 5.4.2; GPB Draft Determination, clause 5.4.2.

(a) One set of principles between GPBs and EDBs is ideal, but it is better to have consistency between Electricity Authority and Commerce Commission EDB principles. That is, Vector is comfortable with the GPB pricing principles as proposed, but would be willing for the EDB principles to vary from these to seek greater alignment with Electricity Authority pricing principles to the extent that these differ from GPB pricing principles so that only one set of EDB pricing principles exist.

(b) Vector suggests the Commission should seek alignment with the Electricity Commission on minor stylistic language within the principles. The industry is likely to support these relatively minor amendments.

PART D: RULES AND PROCESSES

Overview

206. In this Part Vector:

    (a) First considers the intended operation of the CPP / DPP regulatory framework with reference to:

        i. the statutory provisions and underlying policy;

        ii. the extent to which this directs the Commission's discretion when determining the rules and processes input methodology; and

        iii. the extent to which the Commission's proposals are consistent with the legal requirements.

    (b) This framework will be addressed in further detail in Vector's submission in response to the CPP requirements.

207. Vector then outlines the Commission's proposals and Vector's response in relation the rules and processes covering:

    (a) reconsideration of price-quality paths;

    (b) IRIS methodology; and

    (c) specification of price.

208. In relation to reconsideration of price-quality paths, Vector submits that:

    (a) reconsideration of DPPs should be permitted in the same circumstances as reconsideration of CPPs;

    (b) In relation to reconsideration of CPPs:

        i. a transaction event should not trigger a re-opening of a CPP (or DPP);

        ii. following a catastrophic event, suppliers should not have to rely on the CPP proposal process to achieve a satisfactory response; and

        iii. there should be an alternative approval mechanism (either within the DPP or a more targeted approach within the CPP) that be available to EDBs and GPB's generally, rather than the contingent project approach.

        iv. the materiality threshold should be set at 1% of allowed revenues in the year(s) in which the cost are incurred (for DPPs and CPPs).

209. Vector broadly supports IRIS but submits that:

    (a) it should not be limited to controllable opex under a CPP only;

    (b) If an IRIS is limited to controllable opex, the Commission should provide clarity around what categories of opex costs will be determined as

controllable to provide suppliers with increased certainty and reduce unnecessary costs and rework in determining CPP forecasts;

(c) if an IRIS is to be limited to a CPP, suppliers should be able to propose how it could be implemented in their CPP application.

(d) the Commission's proposal for identifying costs that are within the control of suppliers will add additional costs and complexities to the CPP; and

(e) the Commission should specify the process for suppliers moving from one CPP to a new CPP or to a DPP.

210. In relation to specification of price, Vector submits that:

(a) before being able to make a judgment about whether a price or revenue cap is preferable, suppliers must be provided with detail about how the caps would be implemented;

(b) the Commission's view of pass-through costs is too narrow, and there should be a mechanism to allow a portion of the costs of new regulations that are imposed on suppliers to be passed through**;** and

it is not clear that the new category of Recoverable Cost is useful and these costs should be identified as pass-through costs.

Effective operation of the DPP / CPP framework

211. The DPP / CPP framework is a key mechanism for achieving the underlying intent and purposes of the Act, including Parliament's stated objective to "tailor the regime to New Zealand's small size (with small firms and limited resources)".[90] It is also a key mechanism for ensuring the regime is better at promoting incentives to invest than the previous regime. The effective operation of the DPP / CPP framework is finely balanced and relies on having the right incentives and mechanisms in place so that DPPs and CPPs operate together as intended. If the right balance is not achieved the effectiveness of the regime is likely to be significantly undermined.

212. Vector is concerned that the Commission is not engaging with the requirements of this framework and is consequently proposing approaches that are fundamentally inconsistent with the DPP / CPP regime requirements.

213. Vector sets out below the intended operation of the DPP / CPP regime and the implications for the Commission in its determination of input methodologies. This analysis is relevant not only to aspects of the Rules and Processes input methodology but to all input methodologies. Vector intends to set out these views again in greater detail in its submission on the CPP requirements.

---

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

Requirements of the DPP / CPP regime

214. In relation to the statutory guidance, section 53K sets out the purpose of default/customised price-quality regulation as follows:

> The purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.

215. The DPPs and CPPs are intended to work together to provide a regime that is low cost overall (and there would be no purpose in a low cost DPP regime if most suppliers were incentivised to apply for high cost CPPs because DPPs were too harsh or inflexible). This is reflected in the stated policy concern of the risk that "a large proportion of firms [might] propose customised terms, thereby undoing the cost-effectiveness benefits of [default paths]".[91]

216. Specifically, the effective operation of the DPP / CPP regime requires that:

(a) CPP proposals should be the exception to the rule. To achieve this, DPPs must be set in the way that meets the needs of most suppliers. If DPPs are too tough and / or too narrow in their application:

i. suppliers will be forced to apply for a CPP in order to receive satisfactory outcomes (and any more than a few CPP applications in one regulatory period is likely to undermine the intended low cost nature of the regime); and

ii. given CPP proposals are risky, expensive and time consuming[92], it is also possible that some suppliers will be forced to choose to remain on a defective DPP and receive sub-optimal returns which they would not receive if suitable DPP rules and processes were in place.

(b) Suppliers have incentives to apply for CPPs where this is appropriate to accommodate their specific circumstances and enable innovation and investment. CPP processes and rules that have the effect of discouraging CPP proposals could have the effect of deterring CPP proposals that are in the interests of long term consumers and / or, again, forces firms to remain on a defective DPP (contrary to the promotion of incentives to invest).

---

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

92 Under the Act, suppliers face a number of disincentives not to "game" the system by applying for a CPP, for example the proposal cannot be withdrawn, applicants must bear the costs of making the proposal, the Commission may apply claw-back once the price path is set, and the Commission may set a CPP which is lower than the DPP which otherwise would have applied.

217. Setting DPPs that are not too harsh is also consistent with the intent of the Act, which is to limit rather than eliminate monopoly rents (thereby avoiding too-tough control terms).[93]

Implications for the Commission

218. The Commission is required to set input methodologies in a way that promotes rather than undermines the purpose and effective operation of the default/customised design; that is, the Commission must seek to achieve the outcomes outlines in paragraph 215 and 216 above. Further:

   (a) the finely balanced nature of the DPP / CPP regime, and the consequences of the wrong incentives being put in place, only increases the obligation on the Commission to get the balance right;

   (b) in relation to CPPs, the Commission must achieve the right balance between certainty (providing the suppliers with sufficient comfort that there is a reasonable prospect that proposals will be accepted) and flexibility (the Commission should be careful not to overly prescribe requirements that precludes a supplier from putting forward a reasonable proposal that would benefit consumers in the long term); and

   (c) overall, these requirements considerably constrain the Commission's discretion when setting input methodologies.

219. Failure to properly consider these issues when setting input methodologies is likely to result in the purpose of Part 4 not being met (the design of the price paths being a key mechanism for achieving the purpose statement objectives).

Aspects of the Commission's approach in relation to Rules and Process input methodologies inconsistent with the DPP / CPP framework

220. As set out below, the Commission is adopting approaches that are inconsistent with the intended operation of DPPs / CPPs and the intent of the Act. While the Commission notes that DPPs are intended to be "low cost" and "generic"[94], it has adopted approaches that do not achieve a "low cost" DPP / CPP regime. For example:

   (a) the Commission proposes only limited circumstances in which DPPs can be reconsidered which is likely to force suppliers to apply for CPPs and / or remain within a DPP that is too harsh. The Commission has justified its view partly on the basis that a supplier "has the option to apply for a CPP in place of its DPP"[95] reflecting a failure to engage with the operation of the regime as a whole.

---

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

94 EDBs Draft Reasons Paper, paragraph 8.6.16; GPBs Draft Reasons, paragraph 8.6.16.

95 EDBs Draft Reasons Paper, paragraph 8.6.17; GPBs Draft Reasons, paragraph 8.6.17.

(b) The Commission has applied IRIS to CPPs but has not applied an efficiency carry over mechanism for DPPs.[96] This is likely to push firms, unnecessarily, to apply for CPPs.

(c) In relation to CPPs, the Commission's draft determinations appear to preclude any supplier from considering a revenue cap or an IRIS scheme that goes wider than controllable opex (suggesting that suppliers will have to propose a weighted-average price cap, noting there may be a revenue cap for gas transmission, and an IRIS scheme for controllable opex only).[97] Vector considers that the Commission should not seek to limit the scope of a CPP application in this way but rather allow suppliers a broad scope to propose the structure and mechanisms of a CPP. Prescribing what a CPP must contain to the level of detail that is set out in the draft decision is not required by the legislation and will only limit the ability of suppliers to utilise CPPs in the way intended. Vector will propose an alternative in its amended draft determination.

(d) There are other examples of the Commission not promoting the operation of the DPP / CPP regime which will be addressed as part of the Vector's CPP submission.

Reconsideration of price-quality paths

The Commission’s proposals

221. The Commission’s draft decisions are that:

(a) DPPs may be reconsidered if a material error is discovered in the determination or a supplier has provided false or misleading information to the Commission, which the Commission has relied on when making its decision.[98]

(b) CPPs may be reconsidered in the same circumstances as DPPs, plus if other events occur: material catastrophic event, change in legislative or regulatory environments that have a material impact on costs; or a transaction event that warrants reconsideration.[99]

(c) In addition, CPPs for GTBs may be reconsidered if there is a trigger event for a project on the contingent project list.[100]

(d) “Material” is defined as the impact over the remaining regulatory period is at least 5% of the allowed revenue in the year in which the event occurs.[101]

---

96 See paragraphs 248 to 252 below.

97 See paragraphs 245 to 247 below.

98 EDBs Draft Reasons Paper, paragraph 8.6.5; GPBs Draft Reasons Paper, paragraph 8.6.5.

99 EDBs Draft Reasons Paper, paragraph 8.6.6; EDBs Draft Reasons Paper, paragraph 8.6.6.

100 GPBs Draft Reasons Paper, paragraph 8.6.6.

101 EDBs Draft Reasons Paper, paragraph 8.6.9; EDBs Draft Reasons Paper, paragraph 8.6.9.

Commission's approach is inconsistent with the DPP / CPP framework and / or its reasons for adopting this approach are flawed

222. Overall, Vector considers that these proposals are inconsistent with requirements of the DPP / CPP framework (as set out above) and accordingly contrary to the Act.

223. Under the Commission's proposal, the circumstances where DPPs are able to be re-opened are very limited and it is inevitable that businesses will be forced to seek a CPP or stay on a defective DPP. The Commission suggests that concerns with its approach are mitigated by the availability of CPPs which disregards the impact of its approach on the DPP / CPP regime as whole.[102]

224. Further, the Commission is unlikely to be able to process in a timely manner the large number of CPP proposals that would likely be made where there is a catastrophic event or material regulatory change (and suppliers may need to adjust their price-quality path rapidly in response to an event) (see paragraph below).

225. The Commission stated reasons that a re-opener cannot be allowed in most cases because there is no baseline information that can be incrementally adjusted is flawed. Vector submits that this reasoning is not persuasive given:

   (a) A DPP is designed to approximate the recovery of a supplier's annual costs and, therefore, if an event changes those annual costs the DPP can be adjusted to reflect that change.

   (b) Where there is a catastrophic event or a change in legislative or regulatory requirements that have a material cost impact, the (likely) cost of the impact must be quantified to demonstrate that the cost is indeed material. In that case, it would be a straightforward matter to add the quantified cost (with suitable audit oversight to confirm it is accurate) as an increment to the supplier's price path for the remainder of the regulatory period. Such an approach would be in keeping with relatively low-cost price-quality regulation. It may also have benefits in terms of reducing the perceived riskiness of regulated suppliers as markets can be reassured that suppliers can adjust more quickly after a catastrophic event. This in turn could reduce costs for suppliers, delivering savings that will ultimately be shared with consumers.

   (c) As set out above, the relative consequences for the effective operation of the regime if the Commission's approach is adopted are substantial.

226. A materially better approach would be to provide for re-openers of DPPs in the same circumstances that re-openers of CPPs are permitted. This would promote the purpose of section 53K and would be materially better in promoting the Part 4

---

[102] For example, see EDBs Draft Reasons Paper, paragraph 8.6.17; GPBs Draft Reasons, paragraph 8.6.17.

Purpose. Specifically, it would ensure that the design of the regime is effectively operating which is required in order for the regime to effectively promote incentives to invest.

Reconsideration of CPPs

227. Subject to the comments below, Vector broadly agrees with the Commission's draft decision on the circumstances in which CPPs may be reconsidered. A material catastrophic event, material error in the determination, material change in legislative or regulatory requirements and a reliance on false or misleading information are all valid reasons for a CPP to be reconsidered.

Reconsideration due to a transaction event

228. In its Draft Reasons, the Commission proposes that, where a transaction event (i.e. merger or acquisition) occurs under a CPP, it will revoke the old price-quality path and substitute it with a new one. [103] However, this appears to be inconsistent with the Commissions' position elsewhere, specifically:

    (a) At paragraph 3.2.79 of the same EDBs Draft Reasons Paper, the Commission states that it will provide incentives for mergers / acquisitions by allowing the EDB to retain the potential efficiencies from such a merger (for a limited period) by "not re-opening the price-quality path set by a DPP or a CPP during the regulatory period in which the merger occurs".[104]

    (b) In clauses 3.3.1-3.3.3 of its draft determinations, the Commission provides an elaborate set of arrangements for amalgamating two or more price-quality paths.[105]

229. Vector supports the Commission's view referred to in (a) above. A transaction event should not trigger a re-opening of a CPP (or DPP), because doing so would be likely to eliminate the already limited incentives for suppliers to engage in a merger or acquisition. Given the contradictory positions, Vector asks that the Commission clarify its approach as soon as possible so that submitters have an opportunity to respond.

230. In relation to (b) above, Vector recommends a more straightforward approach in which two or more suppliers which merge may also merge their price-quality paths within their current DPP or CPP, but are not required to do so. Vector supports the ENA's submission on this issue.

CPP applications following a major catastrophic event

231. The Commission's undertaking to consider more than four CPP applications per year following a major catastrophic event is welcome. However, Vector submits

---

[103] EDBs Draft Reasons Paper, paragraph 8.6.8; GPBs Draft Reasons Paper, paragraph 8.6.8.

[104] EDBs Draft Reasons Paper, paragraph 3.2.79. Also see GPBs Draft Reasons, paragraph 3.2.80.

[105] EDBs Draft Determination, clauses 3.3.1 to 3.3.3; GPBs Draft Determination, clauses 3.3.1 to 3.3.3.

that this indication is insufficient to provide the required certainty for suppliers and may not provide a fast enough response.

232. Suppliers may need to be able to adjust their price-quality path rapidly in response to an event and the time involved in preparing a CPP and going through the approval process could mean that it is nearly two years before any adjustment can be made (even if the Commission considers the application as quickly as possible).

233. An adjustment to a DPP could, if permitted, be made much more quickly and have a lower cost for both the supplier and the Commission (and thus also, ultimately, for consumers) and allow a much faster adjustment to the price-quality path to respond to a material event (see paragraphs above 222 and 226 above).

GTB trigger event for CPPs contingent projects

234. For GTBs, there is one additional reconsideration event (under a CPP only). This is where a trigger event for a project on the contingent project list (as set out in a section 52P Determination) occurs.[106] Projects identified as contingent projects will be identified in a CPP determination. Vector supports this in principle but considers that the development of a set of contingent projects up front will be challenging and will not provide sufficient certainty to GTBs that large capital expenditure projects (which are largely customer driven and unforeseeable) will be included in their revenue path.

235. The contingent project mechanism is reasonable in so far as it addresses large projects that Vector knows are on the horizon (but which still require considerable agreements with shippers, land-owners, regulators etc before Vector can proceed). Examples of this include the northern network pipeline upgrade to relieve constraints (which will not proceed without certainty that Vector will be able to recover the cost); or the supply to the proposed gas-fired power station north of Auckland, which will require considerable pipeline work but for which no firm date has been set.

236. However, Vector is concerned that the contingent project mechanism does not deal with projects that Vector knows nothing about more than (at best) two years in advance, and that may form the majority of Vector's capital expenditure. Many of Vector's large capital projects arise from customer requests or major changes in customer consumption patterns, and Vector does not generally have visibility of this long in advance. Even if Vector does identify one or more contingent projects and applies for a CPP on this basis at the beginning of the regulatory period, further projects may be identified by consumers during the course of the regulatory period that should be included in the contingent project list. Under the current arrangements vector would not be able to apply for a second CPP in order to capture these subsequent projects. Requiring vector to defer investment in these circumstances to the following regulatory period may have a material impact on the investment decisions of its consumers.

[106] GPBs Draft Reasons Paper, paragraph 8.6.6.

237. Vector 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. Further consideration is required of an alternative approval mechanism (either within the DPP or a more targeted approach within the CPP) and consideration will be given to the merits of this process being available to EDBs and GPB's generally. Vector will consider this in more detail in our CPP submission and will seek to engage with the Commission on how it plans to test the prudency of investments in the CPP process.

Materiality threshold for reconsideration

238. The Commission's draft decision is that, in most circumstances, a CPP may only be reconsidered if the impact of an event is "material". The Commission's draft decision is that "material" means that the impact of the event over the remainder of the regulatory period is at least 5% of the allowed revenue for the year in which the event occurs.[107]

Vector does not support this definition of "material" as it does not create a level playing field. For an event that happens in year one, an effect of 1% of annual revenue per year would be sufficient for a re-opener as it would reach 5% by the end of the regulatory period. By the end of the regulatory period, an event would need to have an effect of 5% of annual revenue per year to justify reconsideration. As a result, where an event occurs in year three or four, the EDB GPB may be forced to accept a reduction in revenues until the reset whereas if the same event happened in year one or two, the EDB / GPB would secure a re-opener. A better approach would be to assess the impact as a percentage of revenue in the year in which the event occurs only.

239. The AER approach is to set the materiality threshold at 1% of allowed revenues in the year(s) in which the costs are incurred. That is a materially better approach than the Commission's draft decision as it treats all events equally regardless of the year in which they occurred.

240. In determining the extent of any amendment in response to a catastrophic event, the Commission proposes taking into account the extent to which any works can be delayed without having a materially adverse impact on quality outcomes. While this is a reasonable proposal, any delay could have significant consequences for suppliers. Vector's "just-in-time" approach to investment means that there would almost always be adverse impacts on quality outcomes from a delay.

---

[107] EDBs Draft Reasons Paper, paragraph 8.6.9; GPBs Draft Reasons Paper, paragraph 8.6.9.

IRIS methodology

The Commission's proposals

241. The Commission's draft decisions are that:[108]

    (a) The Commission will implement an IRIS under a CPP for controllable opex only.

    (b) Efficiency gains will be retained for five years (including across regulatory periods).

242. Vector supports the principle of a rolling incentive methodology. Vector agrees with the Commission that, in a scenario where all efficiency gains must be shared with consumers at the following reset, suppliers face distorted incentives to make efficiency gains early in regulatory periods and could delay them towards the end of a regulatory period. It makes more sense to allow suppliers to retain efficiency gains for a full five years (or longer in the case of mergers and acquisitions) irrespective of when in a regulatory period the efficiency gains were created.

243. Vector also supports that:

    (a) the IRIS will be slightly asymmetric in nature as only positive net balances will be carried forward; and

    (b) efficiency gains will be retained for five years, including across regulatory periods.

244. However, Vector does not agree with the Commission's draft decisions to limit the application of the IRIS to a supplier's controllable operational expenditure under a customised price-quality path proposal.

Controllable opex

245. The Commission proposes to limit the IRIS to controllable opex only. Vector does not agree that the practical difficulties the Commission has identified in relation to gains and losses are real issues or justify this limitation.[109] Specifically, Vector submits that:

    (a) Some gains and losses that occur may be outside the control of a supplier but over a five-year period these should generally balance out.

    (b) Gains and losses not entirely within the control of suppliers is not a problem isolated to this issue. For example, a large proportion of a supplier's SAIDI and SAIFI for a year is outside their direct control but that does not prevent the Commission setting quality standards based on these metrics.

---

108 EDBs Draft Reasons Paper, paragraph 8.8.9 to 8.8.12; GPBs Draft Reasons Paper, paragraph 8.6.9 to 8.8.12.

109 EDBs Draft Reasons Paper, paragraph 8.8.15; GPBs Draft Reasons Paper, paragraph 8.8.15.

(c) The Commission is concerned that extending the IRIS further within a CPP to non-controllable opex and capex would result in gains that may be the result of deferral of expenditure rather than genuine savings. This concern is misplaced. Suppliers who apply for a CPP will have identified a clear need for investment to be made under the CPP and will generally have to make that investment if they are to meet the quality standards within the CPP. Also, if IRIS is extended to apply to DPPs as well, there is no identified and approved expenditure within the price-quality path that could be deferred but any supplier would still need to invest sufficiently to meet their quality standard requirements.

(d) In any event, the process proposed by the Commission of identifying costs that are within the control of suppliers will add additional costs and complexities to the CPP application, as will the data and audit requirements for compliance. The Commission should provide clarity around what categories of opex costs will be determined as controllable to provide suppliers with increased certainty and reduce unnecessary costs and rework in determining CPP forecasts. Given that operational expenditure is generally smaller than capital expenditure, Vector questions whether the added complexity of the limited IRIS will be worth the benefits.

246. If an IRIS is to be limited to a CPP, suppliers should be able to propose how it could be implemented in their CPP application. Suppliers may be able to develop approaches that resolve the Commission's concerns and should not be prevented from innovating in their CPP application.

247. Finally, it is not clear from the Commission Draft Reasons or Draft Determinations what will happen when a supplier moves from a CPP back to a new CPP or to a DPP. Vector recommends that the IRIS gains be added as an increment to allowable revenue in the years of the DPP as under a DPP there will be no opex forecasts/allowances to adjust through the IRIS.

Implementing IRIS for a DPP

248. Vector disagrees with the Commission's reasons why IRIS should be limited to a CPP.[110] The problem identified by the Commission of suppliers being incentivised to delay efficiency gains until the start of the next regulatory period applies equally to CPPs and DPPs. Further, applying an IRIS to a CPP only is contrary to the effective operation of the DPP / CPP as it may drive suppliers to apply for CPPs where they would not apply otherwise. Further, given CPP has costs and risks, there are limited incentives for a supplier to seek efficiencies.

249. As a solution in the context of a low-cost DPP, it would be reasonable to assume that suppliers generally make steady efficiency gains over a regulatory period and

[110] EDBs Draft Reasons Paper, paragraph 8.8.14 and 8.8.17; GPBs Draft Reasons Paper, paragraph 8.8.14 and 8.8.17.

thus profits in excess of the WACC at the end of each regulatory period should be assumed to represent efficiency gains made during the regulatory period. Vector has previously outlined a workable mechanism for implementing an efficiency carryover mechanism within a DPP[111] and Vector continues to recommend that the Commission implement it. Vector's previously recommended mechanism is attached at Appendix 3 for ease of reference.

250. Alternatively, Vector supports the proposal put forward by the ENA regarding the implementation of IRIS under a DPP. This is similar to Vector's earlier proposal and Vector would support its implementation if the Commission does not accept Vector's proposed mechanism.

251. In addition, an efficiency carryover mechanism under a DPP is a regulatory rule or process; section 52T therefore requires that it is set as an input methodology. Implementing such a mechanism under a DPP provides greater incentives to improve efficiency and to innovate and invest. It is therefore a materially better way of meeting the Purpose Statement than the alternative of not having an efficiency carryover mechanism in a DPP.

252. It should also be noted that the Commission's use of a cost of capital estimate at the 75th percentile of the range of possible outcomes and the application of an ROI band as proposed in the DPP Starting Prices Discussion paper[112] are not factors designed or intended to address efficiency carryover issues. As such, they should not be conflated with the efficiency carry over issue, especially in the context of a DPP.

IRIS and mergers and acquisitions

253. An IRIS mechanism could also be used effectively to provide meaningful incentives for suppliers to engage in mergers and acquisitions (noting that such transactions will generally be in the long-term interest of consumers as they will facilitate rationalisation of the energy supply sector and reduce costs over time). Vector submits that an IRIS with a carry-over period of 10 years will provide sufficient incentives for suppliers to engage in mergers and acquisitions while still ensuring that consumers benefit from the merger. Vector fully supports the ENA's submission in this regard, which provides more detail on how this arrangement could work.

Specification of price

The Commission's proposals

254. The Commission's draft decisions are that:

---

[111] Vector Submission to Commerce Commission on Electricity Default Price-Quality Path Discussion Paper, 17 July 2009, pages 27-30.

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

(a) The price for EDBs and GDBs will be specified by a weighted-average price cap. [113]

(b) The price for GTBs will be specified by either a weighted-average price cap or a revenue cap.[114]

(c) Initial pass-through costs will be local authority rates, Commerce Commission levies, levies under the Electricity Act and Gas Act and levies under Gas Control Regulations.[115]

(d) Pass-through cost criteria are that the costs must be: (a) outside the control of the supplier; (b) unable to be accurately forecast; and (c) approved as a pass-through cost by the Commission.

(e) In addition to pass-through costs there will be recoverable costs that will be treated similarly. The initial list of these is: (a) costs associated with CPP applications; (b) the net incremental carry forward amount under the IRIS; (c) transmission charges; (d) new Investment Contract charges; and (e) avoided transmission charges.

Price cap or revenue cap

255. As Vector has noted in previous submissions, it is difficult to make a judgement on whether a price cap or revenue cap is preferable and more aligned to the Purpose Statement when the Commission has not provided any information on how the caps would be implemented, including whether each provides incentives appropriate to the circumstances of the business. In order for regulated suppliers to determine the likely outcomes from DPP and CPP regulation, this detail must be provided. Suppliers must be given the opportunity to comment on fully developed price cap and revenue cap proposals before a final decision is made.

Pass-through costs

256. Vector agrees that the proposed pass-through costs should be pass-through costs but makes the further comments below.

<u>Criterion</u>

257. Vector agrees with the first pass-through criterion ("outside the control of the supplier"), and we note that this applies to costs other than those identified as pass-through costs by the Commission.

258. Vector does not agree:

---

[113] EDBs Draft Reasons Paper, paragraph 8.3.4.

[114] GPBs Draft Reasons Paper, paragraph 8.3.4.

[115] EDBs Draft Reasons Paper, paragraph 8.4.4; GPBs Draft Reasons Paper, paragraph 8.4.4.

(a) with the second pass-through cost criterion ("unable to be accurately forecasted"). If electricity industry levies or transmission costs were able to be forecast with 100% accuracy they would still need to be passed through. As an alternative, Vector recommends the following as a new criterion:

> "that have not otherwise been recovered under a DPP, or were not otherwise included in the derivation of a CPP".

This would allow for the recovery of new costs that are incurred by suppliers but which were not included in suppliers' cost structures under a DPP or CPP.

(b) with the third pass-through criterion ("approved as a pass-through by the Commission"), unless it is amended to read "approved as a pass-through cost by the Commission, such approval not to be unreasonably withheld in relation to costs that comply with criteria (1) and (2)".

<u>Levies</u>

259. Vector notes that there may be future levies created by government to gain funds from industry and a catch-all provision to allow similar additional levies to also be passed through should be included.

<u>Costs of regulation</u>

260. The Commission is correct that suppliers have some control over the costs of new regulations but this control is solely limited to implementation, which can mitigate the costs but not avoid them entirely.

261. Also there is a risk that, where regulators know that suppliers must bear the full costs of complying with new regulations (unless they apply for a CPP), refusing to pass through costs of new regulations gives regulators a free hand to introduce new, costly regulation in the knowledge that consumers will not pay for it (at least until the next reset). Recent work by the Electricity Commission on "more standardisation" of distribution use-of-system rules (that may force EDBs to take on significant new risks) would seem to fit within this category.

262. Vector strongly disagrees with the Commission's view that it is not necessary to provide for pass-through of the costs of new legislation and regulation.[116] The Commission explains that this is because the DPP implicitly provides for general regulatory costs by taking account of operating expenditure, including the historical costs of regulations. Vector submits that:

(a) The Commission's statement can only be accurate if the cost of meeting old regulations disappears as the cost of meeting new ones is created and, therefore, the cost of meeting regulations stays constant in real terms over time.

---

[116] EDBs Draft Reasons Paper, paragraph 8.4.10; GPBs Draft Reasons Paper, paragraph 8.4.11.

(b) However, in general, regulations are created at a far faster rate than they are repealed. Existing regulations remain in force and new ones are added so compliance requirements and costs tend to increase over time. Accordingly historic average cost of compliance with regulations will always be lower in real terms than future cost, unless there is a significant change of approach by regulators (which seems unlikely in the present environment).

(c) The Commission recognises that the cost of new regulation could be material and significantly above DPP baseline expenditure, proposing that, under a CPP, the supplier will have the ability to seek a re-opener when the cost of a new regulation is material.[117] Clearly the impact on DPPs could be considerable, and the Commission's approach will again unnecessarily drive suppliers to apply for CPPs.

263. Vector recommends that a proportion of the costs of new regulations is allocated to the supplier and a proportion is passed through. As the degree of avoidable cost will vary from regulation to regulation, it is unlikely that any non-arbitrary fixed allocation could be derived. Vector recommends that the Commission establish a negotiation framework whereby suppliers can identify new and unexpected costs that arise during a DPP (including any new regulations and legislation passed during a DPP) and, where the costs are material, negotiate a percentage of the costs that can be passed through with the Commission.

Recoverable costs

264. Vector agrees that the costs classified as “recoverable costs” by the Commission should be passed through. However, Vector considers that it is unclear what benefit is achieved by the creation of this new category. The Commission appears to have realised that its view of pass-through costs was too narrow but, instead of widening the definition appropriately, has created what seems to be a set of second-class pass-through costs with less certainty that they will continue to be passed through in future years. This arrangement will not promote certainty for suppliers.

265. Indeed, the Commission’s approach claims a wide degree of discretion and provides no detail on how or when Recoverable Costs will be less than 100% passed through, contrary to section 52T(2) of the Act.

266. The Commission notes that the recoverable costs may become better able to be forecast or controlled in future and, at that stage, they could be re-categorised for future regulatory periods.[118] Vector submits that if a cost is not currently forecast-able or controllable then it meets the criteria to become a pass-through cost. If in future it became forecast-able or controllable, then it should cease to meet the definition of a pass-through cost and will therefore be re-classified at

---

[117] EDBs Draft Reasons Paper, paragraph 8.4.11; GPBs Draft Reasons Paper, paragraph 8.4.12.

[118] EDBs Draft Reasons Paper, paragraph 8.4.22; GPBs Draft Reasons Paper, paragraph 8.4.22.

that time. As a result, the value of the new recoverable cost category is unclear and it seems to add an unnecessary layer of complexity.

267. Vector supports the inclusion of avoided transmission costs as a recoverable cost (or as a pass-through cost). However, we note that the compliance requirement to demonstrate that the transmission charges are being avoided as a result of reducing the overall cost of supply of electricity lines services appears contrary to the mechanism provided for in Transpower's transmission pricing methodology (as determined by the EA under their jurisdiction in this area), and will add costs and risk for EDBs, therefore making it less likely that such initiatives will be undertaken. Vector suggests the Commission needs to go further in order to actually incentivise avoided transmission investments.

268. In its draft reasons, the Commission has not provided for avoided transmission charges that the distributor pays to distributed generators as a pass through or recoverable cost. This is despite avoided transmission charges being outside of the distributor's control (being a requirement of the *Electricity Governance* (*Connection of Distributed Generation*) *Regulations* 2007). Vector submits that the Commission must re-instate this into the pass-through cost / recoverable cost category.

269. The Commission does not specify what is to happen to recoverable avoided transmission charges costs arising from an EDB purchasing transmission assets from Transpower after the end of a five year period. An adjustment is required to the EDB's DPP so that the EDB can recover the ongoing operating and capital costs associated with the investment, which now form part of its cost base. Any such DPP adjustment is best undertaken at the reset of a DPP. To facilitate this, Vector recommends that the five year period (for recovering avoided transmission charges) be extended to the greater of five years or until the next DPP reset. Vector also proposes that assets would transfer to the EDB's RAB at their value in Transpower's RAB as at the date of the transaction.

Price structure flexibility and energy efficiency incentives

270. Vector strongly disagrees with the Commission's view that providing EDBs with the flexibility to adjust their pricing structures promotes incentives and avoids imposing disincentives for EDBs to invest in energy efficiency, consistent with section 54Q of the Act.[119] Vector submits that the Commission's proposal fails to meet the requirements of section 54Q. Specifically:

    (a) Simply allowing EDBs to adjust their price structures (within an overall cap) does not provide incentives to invest in volume-reducing energy efficiency initiatives.

    (b) Making such investments will reduce revenues under a price-cap regime and providing price structure flexibility is not sufficient to mitigate the revenue loss.

---

[119] EDBs Draft Reasons Paper, paragraph 8.3.11.

(c) Recent work by the Electricity Commission and section 45(2)(e) of the Electricity Industry Bill suggests that the Electricity Authority may move to standardise EDB tariff structures. This would undermine the Commission's intention of providing flexibility in price structures, even if that flexibility was sufficient to provide incentives and avoid imposing disincentives for EDBs to invest in energy efficiency.

(d) Furthermore, EBDs face limitations on their ability to be flexible in their pricing methodologies due to requirements under the low fixed user charge regulation and the requirement to maintain price parity between rural and urban customers.

271. Vector strongly believes it is time for the Commission to heed the direction set out in section 54Q of the Commerce Act and, using the pricing methodology input methodology, properly incentivise EDBs to deliver energy efficiency solutions. Section 54Q, if properly implemented, can be the vehicle to achieve a step change in the delivery of energy efficiency and demand side solutions within New Zealand. Vector is committed to rolling out demand side and energy efficiency solutions on our network, subject to the regulatory settings being right.

272. However, Vector is not able to progress these investments as the Commission's approach to meeting the requirements of section 54Q has been and continues to be deficient and inadequate. In addition, by failing to provide incentives for investment in energy efficiency, the Commission is failing to provide a complete package of input methodologies.

273. Vector's preferred means of giving effect to section 54Q would be straightforward and low-cost and available under both DPP and CPP regulation. It would avoid imposing disincentives on investment in energy efficiency by allowing EDBs to recover foregone revenue resulting from energy efficiency investment. It would also promote incentives for EDBs to invest in energy efficiency by providing a clear framework and source of funds for such investments. Vector will provide details of our preferred approach in our submission on the Customised Price / Quality Path Draft Decision.

Load control

274. The service to which the price applies (electricity lines service) is not currently tightly defined and it is not clear whether the existing form of load management is part of the regulated service. This needs to be resolved because if load control is part of the regulated service then the associated assets fall within the RAB but if it is not then they do not. Vector believes that load control forms an integral part of how electricity distribution networks have been configured and are operated in New Zealand, and thus the existing load management service is part of the regulated service and the associated assets form part of the RAB. Vector recommends that the Commission take this approach, which is consistent with the DPP as the DPP essentially reflects pre-existing price and quality metrics.

Transmission pipeline balancing

275. Vector notes that the Commission will consider costs associated with transmission pipeline balancing further once the GIC makes its formal recommendation on the issue to the Associate Minister of Energy and Resources. Vector's strong preference is for an independent balancing agent, established separately from the Transmission System Owners (TSO). Vector does not consider that the administrative task associated with pipeline balancing, including any direct costs, or indirect or potential costs such as indemnification costs, should form part of the regulated service as such administrative services can be provided independently of the TSO.

276. In the event that the administrative tasks associated with pipeline balancing are determined to form part of the regulated service, Vector and other pipeline owners should not bear any costs associated with administering balancing arrangements. Such costs should be able to be passed on to shippers (pipeline users) through tariffs which is the efficient and equitable approach because imbalances are caused by shippers. Such a causer-pays approach would ensure that the incentives placed on parties are correct which will assist the attainment of an efficient level of pipeline balancing.

Appendix A: Vector's proposed efficiency carryover mechanism for DPPs

1. In the following bullet points we suggest an approach that is consistent with the Purpose of Part 4, by providing for consistent incentives to increase efficiency over the entire regulatory period before they are shared with consumers. For ease of exposition, in the following example, we illustrate the sharing concept using five years as the period that EDBs can retain efficiency gains before they are provided to consumers, however, this clearly provides only minimal benefits to the EDB as a percentage of the total present value of efficiency improvements, and some longer period should be provided. Vector's proposed approach is as follows:

    (a) Establish an estimate of WACC that is required to reasonably ensure efficient investment: e.g., the 75th percentile.

    (b) Assume EDBs, in general, can make relatively even improvements in efficiency over time;

    (c) Accordingly, at the end of a five year regulatory period profits in excess of the regulatory WACC should be assumed to represent:

        i. Four years of an efficiency gain made in year one of the prior regulatory period;

        ii. Three years of an efficiency gain made in year two of the prior regulatory period;

        iii. …and so on.

    (d) Ideally, to ensure that there are consistent incentives to improve efficiency over the period, an X-factor should be set to consistently share efficiency gains with consumers, so that:

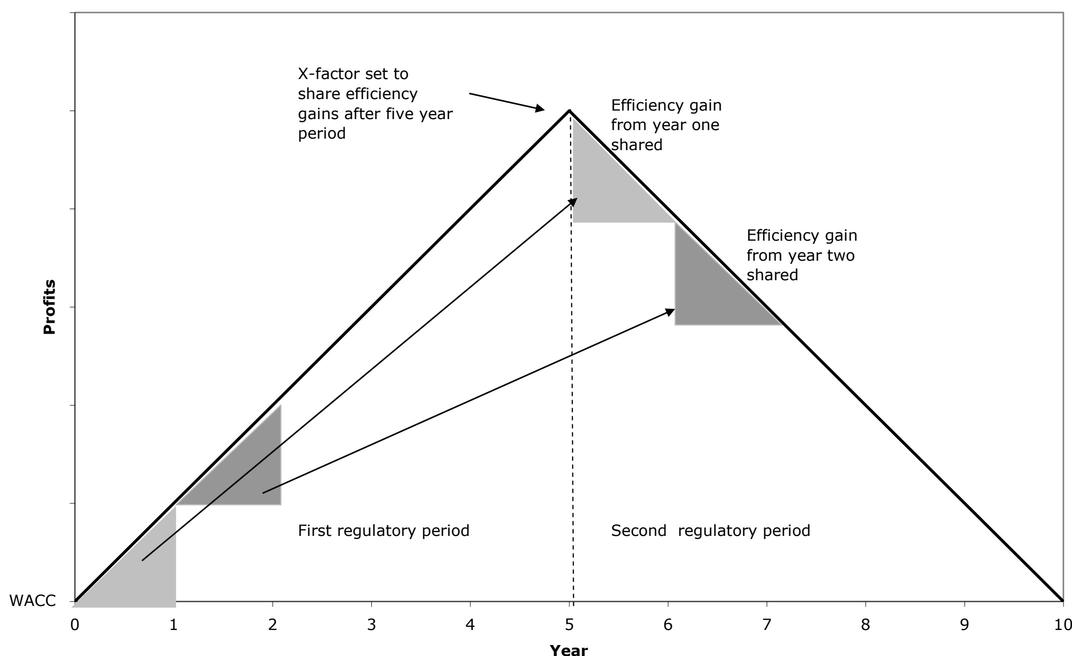
        i. In the first year of the new regulatory period the efficiency gains from the first year of the prior regulatory period are shared with consumers (assuming there is a five year sharing rule);

        ii. In the second year of the new regulatory period, the efficiency gains from the second year of the prior regulatory period are shared with consumers;

        iii. … and so on.

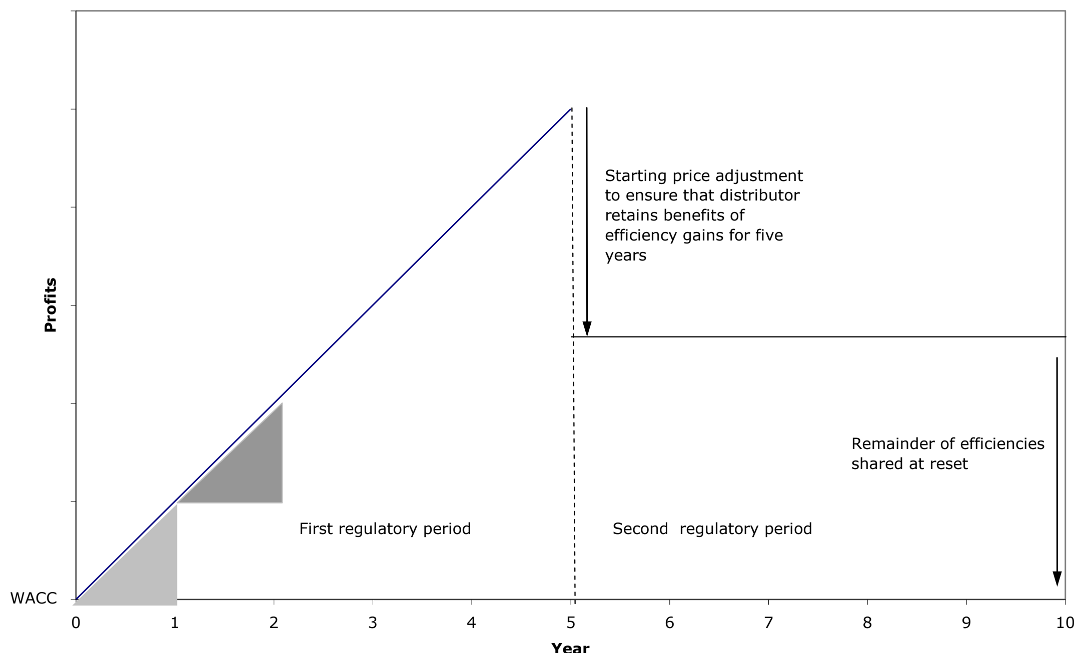
(e) In this ideal sense, this would give rise to the following pattern of efficiency-improvement / profits and subsequent sharing, which would ensure that EDBs can retain efficiency improvements for the five year period used in this example:

Figure 1: Profile of efficiency improvements and sharing over time (smooth X-factor)



(f) The Commission is, however, constrained to an approach that (generally) requires starting price adjustments rather than smooth, company-specific X-factors (section 53P(5)). It is necessary, therefore, to design starting price adjustments to give an NPV-equivalent outcome that preserves the ability of EDBs to retain efficiency gains. The starting price adjustment would therefore deliver the following stylised return profile;

Figure 2: Profile of efficiency improvements and sharing over time (NPV-equivalent P_0 adjustments)



(g) The calculation of the starting price adjustment will depend on the percentage of the efficiency gain that EDBs should receive the WACC that applies, and therefore the years that the EDB should benefit from the efficiency improvement. It is then a straight-forward calculation to derive a single percentage price adjustment that would provide the same NPV as a smooth X-factor-based sharing with consumers.

(h) In year 11 (the first period of the subsequent regulatory period) a further sharing adjustment is made to share the remainder of the efficiency gain with consumers.

2. The advantage of following this approach is that it is straight-forward to apply: all that is required is a calculation of the revenue/price reduction required to equate returns with the regulatory WACC, and then multiplying this by a percentage to ensure that the EDB retains the benefits of efficiency gains achieved through the previous regulatory period. This is consistent with the intent of DPP regulation being low-cost.

3. Vector submits that this approach should be followed in the first reset under the Part 4 regime. Part 4A contained a similar efficiency sharing requirement under section 57E(c). So following this approach would ensure consistency between regimes, as the objective has not changed, and to preserve investors’ reasonable expectations that they would be able to benefit from recent efficiency improvements.

Assumptions

Pattern of Efficiency Gains

4. To avoid unnecessarily complicating the example we assume a very simple structure of costs and savings associated with the merger or acquisition:

   1.1. In the first year there are additional costs of $1m relative to the baseline, resulting from factors such as lost productivity, contract restructuring and buyouts, etc;

   1.2. In the second year there are savings of $2m relative to the baseline; and

   1.3. From year three onwards there are savings of $3.5m per year relative to the baseline.

   These savings are assumed to be in real dollars and therefore must be assessed with a real discount rate.

Discount Rates

5. For the purpose of this analysis we adopt two discount rates:

   1.4. A nominal discount rate of 6.5%, which is broadly consistent with the midpoint of the range derived using the Commission's proposed Cost of Capital IM. Applying an inflation forecast of 2.0% per annum yields a real discount rate of 4.4%;[120]

   1.5. A nominal discount rate of 8.5%, set slightly higher than that estimated by the Commission. Applying an inflation forecast of 2.0% per annum yields a real discount rate of 6.4%.[121]

2. The real discount rates of 4.4% and 6.4% are indicative only, but do serve to illustrate the likely range of value retained by the regulated supplier.

A.1 Value of Efficiency Gains over Time

3. Table below shows the total value of efficiency gains achieved over time, expressed in net present value (NPV) terms and as a proportion of the total value of efficiency gains. The value of efficiency gains over the first 5 years amount to only 13%-18% of the total value of efficiency gains generated. The value of efficiency gains over 10 years amount to 30%-40% of the total value of efficiency gains generated. It is only over 15 years that the value of efficiency gains is approximately equal to half of the total value of efficiency gains generated.

4. The higher discount rate produces a lower total value of efficiency gains because gains achieved in the future have a lower value. This also means that near-term efficiency gains are a greater proportion of the total.

Table 2: Value of Efficiency Gains over Time

---

120 (1 + 6.5%)/(1 + 2.0%) – 1 = 4.4%.

121 (1 + 8.5%)/(1 + 2.0%) – 1 = 6.4%.

	Discount Rate = 4.4%		Discount Rate = 6.4%	
	NPV	**Proportion of Total**	**NPV**	**Proportion of Total**
5 Years	$9.72	13%	$9.04	18%
10 Years	$22.13	30%	$19.76	40%
15 Years	$32.13	44%	$27.62	56%
20 Years	$40.19	55%	$33.40	68%
30 Years	$51.92	71%	$40.76	83%
In Perpetuity	$73.65	100%	$49.37	100%

A.2 Baseline Operating Expenditure

5. Consistent with our proposals for the calculation of baseline operating expenditure under a DPP, the Year 0 allowed opex for the merged firm is calculated as the average of the sum of the Year 0 baseline opex for the two individual firms. This is shown in Table 3. The opex from two years prior to the merger is rolled forward to the year of the merger using the relevant CPI-X values. The opex from the year prior is also rolled forward using the relevant CPI-X value. The two rolled forward values are then averaged to provide the Year 0 baseline opex.

6. Efficiency gains are then calculated as the difference between the baseline opex and the actual opex. Incremental efficiency gains are calculated as the difference between the current year's efficiency gains and the previous year's efficiency gains, just as in the Commission's proposed IRIS. The incremental efficiency gains are then rolled through IRIS and treated as recoverable costs.

Table 3: Calculation of Baseline Operating Expenditure and Incremental Efficiency Gains

Regulatory Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**
			→ Post-merger				
CPI-X	1.00 %	1.20 %	2.00 %	2.50 %	2.75 %	2.00 %	1.00 %
Disclosed Operating Expenditure							
Firm 1	200.0	220.0					
Firm 2	80.0	83.0					
Combined			315.0	310.0	310.0	316.2	319.4
Initial Baseline = Average of Previous 2							

Regulatory Year	1	2	3	4	5	6	7
Years							
Firm 1							
Roll-forward 1st year	200.0	202.4	206.4				
Roll-forward 2nd year		220.0	224.4				
Baseline Opex = Average			215.4				
Firm 2							
Roll-forward 1st year	80.0	81.0	82.6				
Roll-forward 2nd year		83.0	84.7				
Baseline Opex = Average			83.6				
Merged Firm							
Firm 1 Baseline Opex			215.4	220.8	226.9	231.4	233.7
Firm 2 Baseline Opex			83.6	85.7	88.1	89.8	90.7
Combined Baseline			299.0	306.5	314.9	321.2	324.5
Actual Opex			315.0	310.0	310.0	316.2	319.4
Efficiency Gains			-16.0	-3.5	4.9	5.0	5.1
Incremental Gains			-16.0	12.5	8.4	0.1	0.1

A.3 Efficiency Gains under a DPP and 5-Year IRIS

7. For this example we assume that the merger occurs in the first year of a DPP, ensuring that the maximum possible efficiency gains are recovered under the DPP. Table 4 shows the incremental efficiency gains carried forward and how those gains are recovered first under the DPP and then as recoverable costs under a 5-year IRIS.

Table 4: Incremental Efficiency Gains recovered via DPP and 5 Year IRIS

		Regulatory Period 1 (DPP)					Regulatory Period 2 (recoverable costs)				
Regulatory Year		1	2	3	4	5	6	7	8	9	10
incremental gains/losses carried forward											
Year	1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0				
	2	-	3.0	3.0	3.0	3.0	3.0	3.0			
	3	-	-	1.5	1.5	1.5	1.5	1.5	1.5		
	Total	-1.0	2.0	3.5	3.5	3.5	3.5	4.5	1.5	-	-
Recovered via:											
DPP		-1.0	2.0	3.5	3.5	3.5	-	-	-	-	-
IRIS		-	-	-	-	-	3.5	4.5	1.5	-	-

8. Note that incremental efficiency gains that occur in the first year of the DPP are only recovered in the first year of the IRIS in the subsequent regulatory period. Incremental efficiency gains that occur in the second year of the DPP are recovered for the first two years of the IRIS in the subsequent regulatory period. Incremental efficiency gains that occur in the third year of the DPP are recovered for the first three years of the IRIS in the subsequent regulatory period. By this progression an incremental efficiency gain that occurs in the final year of a five year DPP will be recovered via IRIS for all five years of the subsequent regulatory period.

9. The NPV of the efficiency gains retained by the firm is summarised in Table 5. As per Table , the value of the savings achieved under the DPP is between 13% and 18% of the total savings achieved. The additional recovery via the IRIS mechanism allows regulated suppliers to retain an additional 10% to 13% of the value of savings, for a total retention of 23% (low discount rate) to 31% (higher discount rate).

Table 5: NPV of Efficiency Gains Retained with DPP and 5-Year IRIS

	Discount Rate = 4.4%		**Discount Rate = 6.4%**	
	NPV	**Proportion of Perpetuity**	**NPV**	**Proportion of Perpetuity**
From DPP	9.7	13%	9.0	18%
From IRIS	7.1	10%	6.3	13%
Total	16.8	23%	15.3	31%

A.4 Efficiency Gains under a DPP and 10-Year IRIS

10. In this example we extend the recovery of incremental efficiency gains under the IRIS from 5 years to 10 years. Table 6 shows the incremental efficiency gains carried forward and how those gains are recovered first under the DPP and then as recoverable costs under an IRIS that extends over two five-year regulatory periods.

Table 6: Incremental Efficiency Gains recovered via DPP and 10 Year IRIS

		Regulatory Period 1 (DPP)					Regulatory Period 2 (recoverable costs)				
Regulatory Year		1	2	3	4	5	6	7	8	9	10
incremental gains/losses carried forward											
Year	1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
	2	-	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
	3	-	-	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
	Total	-1.0	2.0	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Recovered via:											
DPP		-1.0	2.0	3.5	3.5	3.5	-	-	-	-	-
IRIS		-	-	-	-	-	3.5	3.5	3.5	3.5	3.5

		Regulatory Period 3 (recoverable costs)				
Regulatory Year		11	12	13	14	15
incremental gains/losses carried forward						
Year	1	-1.0				
	2	3.0	3.0			
	3	1.5	1.5	1.5		
	Total	3.5	4.5	1.5	-	-
Recovered via:						
DPP		-	-	-	-	-
IRIS		3.5	4.5	1.5	-	-

11. Incremental efficiency gains that occur in the first year of the DPP are recovered via IRIS for the full length of the second regulatory period and the first year of the third regulatory period. Incremental efficiency gains that occur in the second year of the DPP are recovered via IRIS for the full length of the second regulatory period and for the first two years of the third regulatory period. By this progression an incremental efficiency gain that occurs in the final year of a five year DPP will be recovered via IRIS for the full length of both the second and third regulatory periods.

12. The NPV of the efficiency gains retained by the firm is summarised in Table 7. As per the above tables, the value of the savings achieved under the DPP is between 13% and 18% of the total savings achieved. The additional recovery via the 10-year IRIS mechanism allows regulated suppliers to retain an additional 25% to 31% of the value of savings, for a total retention of 38% (low discount rate) to 49% (higher discount rate).

Table 7: NPV of Efficiency Gains Retained with DPP and 10-Year IRIS

	Discount Rate = 4.4%		**Discount Rate = 6.4%**	
	NPV	**Proportion of Perpetuity**	**NPV**	**Proportion of Perpetuity**
From DPP	9.7	13%	9.0	18%

From IRIS	18.1	25%	15.3	31%
Total	27.8	38%	24.3	49%