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Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
Commerce Commission
Wellington

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

Dear Keston,

Input methodologies review – emerging view on form of control

- 1 This is Vector's submission to the Commerce Commission's (the Commission) Input Methodologies (IM) review emerging view (EV) on form of control, dated 29 February 2015.
- 2 Vector's contact person for this submission is:

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- 3 No part of this submission is confidential and we are happy for it to be publicly released.
- 4 The Commission's emerging view (EV) on form of control discusses its preference of changing the current form of control applying to electricity distribution businesses (EDBs) from a weighted average price cap (WAPC) to a pure revenue cap. Pure in this context enables an over or under recovery of revenue in one period to be washed up in future years.
- 5 Vector supports the principle of the Commission reviewing the form of control to see whether it provides a credible solution to some of the problems observed with the current DPP framework for the EDB and gas pipeline sectors. Nevertheless, Vector is not able to commit to supporting changing the form of control to a pure revenue cap until the Commission provides more detail on the design of the pure revenue cap and how it would interact with the other Input Methodologies (IMs) under review.

Issues relevant to changing the form of control

Weighted average cost of capital

- 6 A key issue is whether the Commission would amend its approach to the weighted average cost of capital (WACC). The Commission has stated the impact of changing the form of control on the WACC could be recognised through the Commission's estimation of the relevant asset beta. To this end, Vector believes the Commission's affirmation of Dr Lally's expert report position that "there is no empirical study that

provides a clear conclusion on the effect of regulation on beta” provides guidance on the treatment of this interaction.

- 7 Vector’s view is that the Commission now has enough evidence not to undertake further work on this issue. Vector considers a change in the Commission’s view on the interaction of WACC and the form of control IM would undermine the strength of this consultation given stakeholders are presuming there is likely to be no impact.

Demand forecasting

- 8 The Commission’s EV acknowledges a WAPC requires it to forecast demand for EDBs as part of setting the default price quality path (DPP). Any error in the Commission’s forecast will result in gains or losses for suppliers. Demand forecasting is a necessary feature of the WAPC but does not need to apply to the design of a pure revenue cap.
- 9 In the 2012-2015 default price-quality path (DPP) the Commission’s forecast of demand for Vector’s network resulted in Vector’s MAR being significantly lower than had actual demand been used to set the MAR. Vector recognises the DPP is meant to be a low cost type of regulation, and modelling techniques are not meant to be precise.
- 10 Where there are systematic errors in forecasting demand we believe there is opportunity to improve these within the low touch framework. We do recognise that an alternative form of control does eliminate this risk.

Tariff restructuring

- 11 The requirements for tariff restructuring under the WAPC does impede tariff innovation by EDBs that are not present under a pure revenue cap. Tariff innovation is not impossible in the current framework. Rather the level of information and detail involved with the current tariff change process makes it onerous for suppliers to undertake. Going forward the cause for innovating network tariffs will become more frequent as the impact of emerging technology becomes more significant.

Demand-side management

- 12 The Commission also recognises a WAPC does not lend itself to encouraging suppliers to invest in demand-side management (DSM). Under a WAPC where revenues are linked to volume growth, DSM result in suppliers not meeting the demand assumptions assumed in starting prices.
- 13 In the 2015-2020 DPP reset the Commission introduced a D-factor scheme in recognition of the disincentive the WAPC form of control has for investing in DSM.
- 14 The D-factor does provide some form of redress for suppliers that are adversely impacted by volume growth from investing in DSM. However, the process for compensation could be improved. A pure revenue cap could provide an opportunity to refocus the D-factor from being about nullifying the current disincentive to invest in DSM to providing incentives for investing in energy efficiency/DSM which is more consistent with the intent of section 54Q of the Commerce Act.

Absence of detail to support a shift in the form of control

- 15 While a pure revenue cap form of control conceptually provides a better model to deal with issues mentioned in the Commission's EV such as inaccurate demand forecasting, tariff restructuring and incentives for DSM. The relative merits of changing from the current form of control depends on the detail for how the pure revenue cap would operate.
- 16 Vector notes there is significant detail omitted from the Commission's EV on form of control. For example there is no detail on the principles that will govern inter-period price volatility nor does it discuss any issues or processes the Commission would follow when transitioning from a WAPC to a pure revenue cap.

Conclusion

- 17 Vector supports the Commission investigating the shortcomings with the current form of control – particularly the issue of demand forecasting. However, the recent reforms to the DPP have improved the operation of the WAPC for suppliers, such as the introduction of the pass-through balance (reducing exposure of suppliers to price path breaches from forecasting pass-through and recoverable costs). It would be a setback if such reforms were not given consideration in the design of any new form of control. Without further details on the proposed pure revenue cap model, Vector cannot provide definitive support that it will be an improvement on the status quo.
- 18 Vector recommends the Commission provide more detail and certainty to industry before concluding a preference on the form of control.

Yours faithfully
For and on behalf of Vector Limited



Richard Sharp
Head of Regulatory