COMMERCE COMMISSION

Regulation of Electricity Lines Businesses

Targeted Control Regime

Reasons for Not Declaring Control

Vector Limited

30 May 2008

CONTENTS

EXECUTIVE SUMMARY

Overview

i The Commerce Commission (Commission) has received an administrative settlement offer (Offer) from Vector Limited (Vector) that includes commitments concerning the future performance of the company's electricity lines business. Vector's electricity lines business is the largest in New Zealand, providing electricity distribution services to consumers in its Auckland, North Auckland (Northern), and Wellington regional electricity distribution networks. Vector's Offer (dated 13 October 2006 and updated on 23 January 2007) followed the publication in the *New Zealand Gazette* of the Commission's intention to make a declaration of control in respect of the electricity distribution services supplied by Vector, under the targeted control regime set out in Part 4A of the Commerce Act 1986 (Act).

ii In its reasons paper supporting its intention to declare control (Intention Paper), the Commission explained it had found evidence that:

- the majority of Vector's consumers were not subject to cost-reflective pricing, with there being a wide variation of over-charging and some under-charging;
- Vector had not been making significant progress at tackling the excessive pricing across its seven customer groups in each of its three regional networks;
- Vector's pricing strategy was primarily benefiting those consumers who were also the beneficiaries of its majority shareholder—the Auckland Energy Consumer Trust (AECT)—at the expense of its other customer groups; and
- Vector would continue to earn excess returns.

iii Vector's Offer is intended to address the key concern raised in the Commission's Intention Paper, namely that Vector's pricing strategy is inefficient, with some customer groups being significantly over-charged. The Offer involves the company rebalancing its line charges to different regions and customer groups—subject to its existing price path threshold—so that the prices paid by consumers better reflect underlying costs, demands and service quality. Vector has already implemented the first two stages of the rebalancing programme set out in the Offer, through price changes made on 1 April 2007 and 1 April 2008.

iv The purpose of this paper is to set out the Commission's reasons for deciding not to declare control in respect of Vector's electricity distribution services, and why it has accepted Vector's Offer. This decision follows the Commission seeking the views of interested parties on its draft reasons for not declaring control, as well as on Vector's Offer and explanatory material, which were issued in December 2007 (Draft Decision Paper).

Net benefits of accepting and implementing Vector's settlement

v In sum, the Commission considers that the following net benefits to consumers will be realised from accepting and implementing Vector's settlement:

- Vector's line charge rebalancing programme will provide allocative and dynamic efficiency benefits in a less intrusive and costly manner than under control;
- Vector's compliance with its existing thresholds, and its commitment to addressing the pricing inefficiencies identified in the Commission's Intention Paper, will promote behaviour consistent with s 57E(a)-(c) of the Purpose Statement at a lower administrative and compliance cost than control;
- Vector's incentives to invest in order to maintain network performance will be preserved over the settlement period, as is evidenced by the company's commitment to providing a secure, reliable and safe electricity supply in its distribution networks;
- any forgone short-term benefits to Vector's consumers, from potentially lower prices under control, will likely be more than offset over time by the positive impacts on investment incentives for Vector (and the wider industry), which stem from the Commission reinforcing its commitment to setting medium-term price paths;
- allowing Vector to retain any additional efficiency gains it makes over the settlement period will increase the level of benefits available to be shared with its consumers when the thresholds are reset;[1] and
- while with any settlement there is a possibility of non-compliance, the Commission considers it will be straightforward to monitor the implementation of the settlement, and if Vector were to contravene any of the provisions of the Settlement Deed, the Commission may in its discretion enforce the Deed in the manner and form that it considers appropriate.

Background to Vector's Settlement Offer

Targeted control regime

vi Part 4A of the Act establishes a targeted control regime for all 28 electricity distribution businesses—including Vector—as well as Transpower New Zealand Limited (Transpower). Unlike regulatory regimes for electricity lines businesses in overseas jurisdictions, in New Zealand such businesses are not automatically subject to control of their prices, revenues and/or service quality. Lines businesses are only potentially subject to control if they have breached one or more performance thresholds set by the Commission.

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[1] The Commission notes that the Government recently announced a proposed package of changes to the regulatory provisions in the Commerce Act, including Parts 4A and 5. The Commerce Amendment Bill which is to give effect to these changes is currently before the Commerce Select Committee. Should the Bill pass in its present form, then "default price-quality paths" under an amended Part 4 of the Act would become the equivalent regulatory instrument to the thresholds under Part 4A. Given current legislative requirements, the remainder of this paper refers to resetting the thresholds.

vii The overall purpose of the targeted control regime is to promote the efficient operation of electricity distribution and transmission markets for the long-term benefit of consumers. There are three key steps to the targeted control regime. The first is for the Commission to set performance thresholds for all lines businesses; the second is for the Commission to identify businesses that breach those thresholds; and the third is for the Commission to determine whether or not to control particular services supplied by identified lines businesses. In exercising its statutory powers under Part 4A, the Commission must also have regard to the August 2006 Government Policy Statement (GPS) relating to the incentives of regulated businesses to invest in infrastructure.

viii A breach of the thresholds enables the Commission to investigate the recent, current and future performance of an identified lines business. This "post-breach inquiry" is directed at determining whether the performance of the lines business is consistent with the specific objectives of the regime—namely, that the business is limited in its ability to earn excessive profits, faces incentives to improve efficiency and to provide services at a quality that reflects consumer demands, and shares the benefits of efficiency gains with consumers, including through lower prices. Should the performance of the identified business not be consistent with these objectives and the long-term benefit of consumers, then the Commission will need to decide whether control would be necessary for the objectives of the regime to be achieved.

Administrative settlements

ix The Commission has indicated that it may be possible for a breach of the thresholds to be resolved by an "administrative settlement", which involves an identified business voluntarily reaching an agreement with the Commission on an appropriate course of action. If, following consultation with interested parties, the Commission and a lines business agree on a settlement, then the Commission would cease its inquiry and publish its reasons for not declaring control—referring to the terms of the settlement. In May 2007, the Commission accepted an administrative settlement from Unison Networks Limited (Unison), and in May 2008 the Commission accepted an administrative settlement offer from Transpower.

The thresholds and Vector's threshold breaches

x The Commission set its initial thresholds for distribution businesses from 6 June 2003, and these were reset for a five-year regulatory period from 1 April 2004. The thresholds comprise a price path threshold and a quality threshold.

xi The price path threshold allows businesses to increase their average distribution prices each year, without breaching the threshold, by the consumer price index (CPI) less an "X factor". It is conceptually similar to the CPI-X incentive mechanisms that regulators commonly use in overseas jurisdictions. Setting a CPI-X price path recognises that distribution businesses face inflationary and other increasing cost pressures, but it also places incentives on businesses to improve their efficiencies in real terms by X percent each year. For the initial thresholds, all distribution businesses were set an X factor equivalent to the CPI. For the reset thresholds, X factors were assigned to distribution businesses on the basis of their relative efficiency and relative profitability, ranging from +2% to –1%. Vector was assigned an X factor of 0%, meaning that the company has been able to increase its average prices by inflation since 1 April 2004 without breaching the reset price path threshold.

xii The price path threshold represents the average price increases that distribution businesses like Vector can make annually, thereby limiting the ability of the businesses to earn excessive profits while also providing strong incentives for improved efficiencies. The price path threshold reflects expected industry-wide improvements in efficiency, and therefore some efficiency gains are shared with consumers *during* the regulatory period. More significantly however, businesses have an incentive to outperform the efficiency expectations implied by their price path threshold because, during the regulatory period, businesses get to keep the additional profits which arise from any efficiency improvements that exceed those implied by their price path. This, in turn, increases the level of benefits that are potentially available to be shared with consumers from the *end* of the regulatory period (i.e., when the thresholds are reset).

xiii The quality threshold requires distribution businesses to demonstrate no material deterioration in reliability—measured against average SAIDI and SAIFI performance from 1998 to 2003—and also that they have meaningfully engaged with consumers to determine their demand for service quality.

xiv Vector breached the price path threshold at both the second and fifth assessment dates. In addition, Vector breached both the SAIDI and SAIFI criteria of the quality threshold at the second, fourth and fifth assessment dates.

Vector's pricing behaviour

xv In assessing Vector's threshold breaches at the second assessment date in 2004, the Commission became aware that there were significant differences in how Vector was recovering revenue from its different customer groups. The key difference was in the profit (i.e., return on investment) component of the total line charge that each customer group pays.

xvi Vector explained to the Commission that these differences in returns arose mainly due to the company's acquisition of the Northern and Wellington networks from UnitedNetworks Limited (UNL) in November 2002. Vector indicated it had decided to implement a staged programme of tariff rebalancing, over the four year period from April 2005 to March 2009, to ensure its line charges better reflected the cost of service and price/quality trade-offs across customer groups. The tariff rebalancing programme was intended to achieve balanced returns across Vector's regions and customer groups, with the target returns (in percentage terms) being 7.4% and 10% for the residential and industrial/commercial customer groups respectively. (These targets were calculated on a post-tax basis in accordance with NZ GAAP, and are therefore not directly comparable to Vector's weighted average cost of capital). Vector argued that its industrial and commercial customer groups should be subject to this higher target return because of greater risks associated with the volatility of industrial and commercial electricity demand.

xvii Although the Commission accepted that Vector's acquisition of the Northern and Wellington networks was likely to have contributed to the pricing disparities between customer groups, the Commission emphasises that there were also significant differences in returns contributed by consumers in Vector's original Auckland network. For instance, Vector's own estimates for 2003/04 showed that the largest differential in returns existed between its residential and industrial customer groups in its original Auckland network (i.e., 2.3% and 33.5%, respectively).

xviii Following price adjustments made by Vector in May 2005 and April 2006, the Commission reviewed the company's progress with its tariff rebalancing programme. The Commission concluded that, despite prior assurances from Vector, limited progress had been made, with the returns for a number of customer groups diverging even further from Vector's targets. The Commission acknowledges that Vector's move to increase the number of customer groups used for rebalancing purposes from nine to 21 may, among other factors, have contributed to some of the apparent reversals in progress. (For each of its three networks, Vector split the Residential, Commercial and Industrial customer groups into Un-metered, Residential, Small Commercial, Medium Commercial, Large Commercial, Small Industrial and Large Industrial). However, the Commission highlights that, even at some aggregate levels—such as the returns contributed by the Wellington network as a whole—there did not appear to have been substantive progress.

Intention to declare control of Vector

xix In the Commission's view, the significant uneconomic over-charging across regional networks and customer groups was not conducive to promoting the efficient operation of the distribution services market in the regions supplied by Vector. Most significantly, the Commission emphasised it was of particular concern that many of the customer groups disadvantaged by Vector's pricing strategy were commercial and industrial consumers. As the supplier of around one-third of New Zealand's electricity distribution services, Vector's pricing strategy affects the costs for many businesses in the productive sector which have to compete nationally and/or internationally in markets for tradable goods. There was a further concern that such overcharging could be used to provide an implicit dividend to Vector's consumer owners, given that the group contributing the lowest return was Auckland residential customer group, which represents Vector's majority shareholders through the AECT.

xx Consequently, given evidence available at the time, the Commission published an intention to declare control of Vector's electricity distribution services. In its Intention Paper, the Commission set out its preliminary view that control would bring benefits to consumers by:

- preventing the over-charging of some customer groups for the benefit of some shareholding customers, and limiting the ability of Vector to earn excess revenue;
- improving efficiencies by aligning charges more with the underlying costs of providing that service, and the sharing of efficiency gains with consumers; and
- ensuring that the prices charged were commensurate with the quality of service that reflects consumer demands.

xxi The Commission invited submissions from interested parties on its intention to declare control. However, on 13 October 2006, the Commission suspended the consultation process when it received an administrative settlement offer from Vector which it considered was, in principle, consistent with the Purpose Statement. On

23 January 2007, Vector provided the Commission with an amended offer (Offer) reflecting a number of minor changes to the cost of supply (COS) model it uses to derive the tariff levels for each customer group.

Vector's Settlement Offer

Key settlement terms

xxii Vector's Offer was made in respect of the company's breaches of its price path and quality thresholds at the second assessment date. Vector is not seeking to resolve its 2006 quality breach under the terms of the Offer, or subsequent breaches which have occurred since the Offer was submitted to the Commission.

xxiii Under the Offer, Vector commits to making price adjustments in order that the returns contributed by each of its 21 customer groups are less than or equal to Vector's target returns for the year ending 31 March 2009. For each customer group, half the necessary rebalancing (in distribution revenue terms) is intended to be achieved in each of the two years of the settlement period (i.e., the years beginning 1 April 2007 and 1 April 2008). If, by 31 March 2009, any residual rebalancing is required to achieve the target returns, Vector would achieve these through a further round of price changes on 1 April 2009. The table below shows the estimated impact on average line charges for the first year of rebalancing. The changes for each customer group in 2008/09 are at a similar level.

Estimated Changes in Average Line Charges (2007/08)

	Auckland			**Wellington**			**Northern**		
Customer Group	ICP*	($/ICP)	Change	ICP*	($/ICP)	Change	ICP*	($/ICP)	Change
Unmetered	1,371	107	6%	170	1,271	8%	147	2,959	28%
Residential	286,536	71	15%	145,006	-5	- 1%	181,384	64	12%
Small Commercial	20,298	-128	- 6%	14,943	-556	- 25%	20,776	-11	- 1%
Medium Commercial	1,904	819	12%	634	-1,312	- 7%	651	424	5%
Large Commercial	875	-1,926	- 14%	359	-5,805	- 16%	151	-6,252	- 30%
Small Industrial	1,031	-4,355	- 10%	36	-7,111	- 11%	308	-4,886	- 12%
Large Industrial	196	21,724	15%	29	-4,552	- 2%	23	15,957	8%

* ICPs as at 31 March 2007

xxiv Vector's price adjustments under the Offer are to be made within its existing CPI-0% price path threshold, and Vector will remain subject to its existing quality threshold. Vector acknowledges the price path threshold was set to encourage efficiency gains and to provide incentives for investment, and highlights that its investment programme to date and its asset management plans have been predicated on the basis of its existing thresholds. Vector's Offer states that the company will continue this investment programme to provide a secure, reliable and safe electricity supply in its three network regions. In addition, Vector states that it will continue to seek efficiency gains in its electricity distribution business, with the expectation that the Commission would consider whether and how these efficiency gains should be shared with consumers at the 2009 threshold reset. Finally, Vector's Offer also includes a number of monitoring and compliance provisions, including audit reporting.

Vector's Cost of Supply (COS) model

xxv Vector's approach to developing its overall pricing strategy underpinning the Offer, as well as its COS model and tariff structure, has been to ensure that consumers face price signals that better reflect the costs of supply as well as differing service quality levels. For each of Vector's 21 customer groups, the level of distribution revenues needed to equate with costs (which include the target returns) has been established using this COS model. The model allocates costs, and apportions a share of asset value on an optimised deprival value (ODV) basis, to each customer group. Vector's target returns (in percentage terms) include a 1.5% differential between residential and commercial/industrial customer groups, which Vector justifies on the grounds that commercial and industrial consumers have a higher level of service quality and a higher risk profile than residential consumers.

Evaluation of Vector's Offer

xxvi The Commission acknowledges Vector's justification for the 1.5% differential in targeted returns, and considers that the proposed 1.5% differential is reasonable. Overall, the Commission considers that the principles and assumptions underpinning Vector's COS model are broadly consistent with high-level principles for efficient pricing, and are reasonable given Vector's circumstances at this point in time. While there is always room for debate on the appropriate cost allocators to apply in any COS model, it is apparent that in developing its model Vector has been mindful that legitimate factors for differentiating prices on an efficient basis include cost, demand and service quality.

xxvii As the Commission noted in its final decisions on the Unison administrative settlement, wider consultation on distribution pricing methodologies will be appropriate in the context of the Electricity Commission's work on developing distribution pricing guidelines for the electricity distribution industry. In the meantime, the Commission does not intend prescribing a particular pricing methodology for Vector in the context of its administrative settlement (or for other electricity distribution businesses). Rather, the Commission is seeking to ensure that Vector's proposals are consistent with high-level principles for efficient distribution pricing, and have been tested and made transparent through consultation with interested parties.

xxviii The Commission considers that the proposed auditing and information provision processes in the Offer are sufficient for it to adequately monitor Vector's compliance with the terms of the settlement. The Commission also highlights that Vector has demonstrated its commitment to the Offer by implementing the first two stages of proposed price changes. In addition, the terms of settlement have been formalised in a Settlement Deed signed by Vector and the Commission.

xxix In sum, the Commission considers that the steps Vector proposed in the Offer—and has mostly implemented through price changes in April 2007 and April 2008—will, by April 2009, largely remove the significant disparities which have been prevalent in Vector's line charges, and which were clearly inconsistent with efficient pricing principles. Most importantly, as is summarised above, the Commission considers that there will be net benefits to consumers from implementing Vector's settlement, and that the settlement is consistent with the Purpose Statement.

Decision Not to Declare Control of Vector

xxx In its Intention Paper, the Commission outlined its view at the time that control of Vector's electricity distribution services would be consistent with the Purpose Statement. Having now evaluated Vector's Offer, and taken into account the views of interested parties, the Commission's view is that control is not necessary to address the s 57E concerns identified in the Intention Paper, because these concerns would be appropriately addressed through acceptance and implementation of the settlement.

Preventing over-charging of various customer groups

xxxi The Intention Paper indicated that control would prevent the over-charging of many customer groups, which has been for the benefit of some shareholding consumers (i.e., particularly Auckland residential consumers), and also limit the ability of Vector to earn excess revenue. Since the Commission's intention to declare control was published, Vector has implemented the first two stages of price reductions to those customer groups that were being significantly overcharged. Under the settlement, the tariff rebalancing programme will effectively be completed by March 2009, with any minor residual rebalancing undertaken in a final stage from 1 April 2009 to 31 March 2010. While control would likely further limit Vector's ability to extract excessive profits, Vector's voluntary compliance with its existing price path threshold as part of the settlement would, in the Commission's view, promote the same objective at lower administrative and compliance costs.

xxxii Had Vector not committed to address the key s 57E concern regarding the inefficiencies inherent in its electricity pricing strategy and tariff structures, then control of Vector's distribution services might still have been warranted. If control had been imposed, then Vector's excess profits and/or efficiency gains over the current regulatory period would potentially have been able to be shared with its consumers earlier than the end of that period. Appropriate incentives for ongoing efficient capital and operating expenditure would have then been re-established, as a result of setting the controlled price path for a reasonable period (e.g., five years).

xxxiii On balance, the Commission considers that, given Vector has committed to address the key s 57E concern regarding the inefficiencies in its pricing, any additional but forgone short-term benefits to its consumers—from potentially lower prices under control—are likely to be more than offset by positive impacts on investment and efficiency incentives for the company (and the wider industry), as a result of Vector retaining its existing price path threshold. In the Commission's view, reinforcing the regulatory commitment to such a medium-term price path will significantly contribute to regulatory certainty and stability. In addition, Vector will be able to retain any additional efficiency gains it makes during the settlement period, thereby increasing the level of benefits available to be shared with its consumers when the thresholds are reset.

Improving efficiencies

xxxiv The Intention Paper indicated that control would improve efficiencies by aligning charges more with the underlying costs of providing that service, thereby sharing efficiency gains with consumers. Vector's tariff rebalancing programme, as set out in the Offer, espouses cost-reflective pricing principles. In the Commission's view, implementing the rebalancing programme through the settlement will likely provide allocative and dynamic efficiency benefits in a less intrusive and costly manner than would be the case under control.

System reliability

xxxv The Intention Paper also indicated that control could ensure that the prices charged were commensurate with the quality of service that reflects consumer demands. However, the Paper highlighted that, irrespective of Vector's past quality threshold breaches, the Commission considered it had sufficient grounds for forming an intention to declare control based on Vector's pricing behaviour alone.

xxxvi Vector's settlement acknowledges that the company would remain subject to its existing quality threshold, and makes a commitment to operating and maintaining its electricity networks to achieve the reliability targets specified in that threshold. Aside from the settlement, which would only relate to Vector's threshold breaches in 2004, the Commission will still be able to consider Vector's quality performance further as part of its assessment of Vector's breaches of the quality threshold in 2006 and 2007.

Commission's decision

xxxvii In conclusion therefore, the Commission considers that the likely outcomes associated with implementing Vector's administrative settlement are consistent with the Purpose Statement. Furthermore, over the relatively short settlement period from now until the threshold reset, implementation of the settlement would be at least as advantageous to the long-term interests of consumers as would control.

xxxviii As a result, at this stage, a declaration of control in respect of Vector's electricity distribution services is not necessary to promote the objectives of the targeted control regime. Therefore, the Commission's decision is not to make a declaration of control in respect of the electricity distribution services supplied by Vector.

Next steps

xxxix Vector's Offer has now been formalised through a Settlement Deed that incorporates the terms of that offer. Consequently, the Commission is able to close its post-breach inquiry into Vector's breaches of the initial thresholds. In accordance with s 57H(d)(ii) of the Act, the Commission will shortly publish an overview of its reasons for not making a control declaration in the *Gazette*.

INTRODUCTION

Purpose and Scope

1 The Commerce Commission (Commission) published in the *New Zealand Gazette* (*Gazette*) its intention to make a declaration of control under Part 4A of the Commerce Act 1986 (the Act), in respect of electricity distribution services supplied by Vector Limited (Vector).[2] Vector supplies electricity distribution services to consumers in the Auckland, North Auckland (Northern) and Wellington regions.[3]

2 Since publishing that intention and its reasons for forming that intention (Intention Paper),[4] the Commission has received an administrative settlement offer (Offer) from Vector (dated 13 October 2006, and updated on 23 January 2007) that contains commitments from Vector regarding its performance for the period until 1 April 2009.[5] Vector also provided explanatory material in support of that Offer.[6]

3 The purpose of this paper is to set out the Commission's reasons for deciding not to declare control in respect of Vector's electricity distribution services, and why it has accepted Vector's Offer.

4 Acceptance of Vector's Offer—through a Settlement Deed that incorporates the terms of that offer—means that the Commission can close its post-breach inquiry into Vector's breaches of the initial thresholds, and can therefore publish its reasons for not making a control declaration in the *Gazette*, in accordance with s57H(d)(ii) of the Act.

5 Part 4A came into effect on 8 August 2001 and, among other things, requires the Commerce Commission (Commission) to implement a *targeted control regime* for the regulation of large electricity lines businesses (lines businesses)—namely the 28 distribution businesses (one of which is Vector) and the state-owned transmission company, Transpower New Zealand Limited (Transpower).

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2 *Commerce Act (Intention to Declare Control: Vector Networks Limited) Notice 2005, New Zealand Gazette*, Issue No. 94, 9 August 2006.

3 The Commission notes that on 28 April 2008, Vector announced the sale of its Wellington electricity distribution network. The sale is still subject to a number of conditions, including the approval of Vector's shareholders. Should approval be given, and the transaction finalised, Vector's Wellington network would become a distinct electricity lines business and would not be a party to the Settlement Deed. This raises a number of issues, such as the appropriate thresholds for that new business, and the Commission would need to consult on those thresholds. The Settlement Deed would continue to apply to the remaining parts of Vector's electricity lines business. The Commission highlights that Vector has already implemented the two main sets of price changes on 1 April 2007 and 1 April 2008 that were needed to address pricing inefficiencies across all three of Vector's networks, including the Wellington network (paragraph 203 below). Any residual rebalancing for the Auckland and Northern networks as at 1 April 2009 will still be covered by the Deed (paragraph 156 below), and any related issues associated with the new Wellington electricity lines business can be considered during consultation on the new thresholds for that business.

4 Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Intention to Declare Control, Vector Networks Limited*, 9 August 2006.

5 Vector, *Vector Limited, Offer of Administrative Settlement*, 23 January 2007.

6 Vector, *Price Rebalancing: Explanatory Material to Support Vector's Offer of Administrative Settlement of 23 January 2007*, 7 December 2007.

6 Under subpart 1 of Part 4A (ss 57D to 57N of the Act), the Commission must set thresholds for the declaration of control of goods or services provided by lines businesses. The thresholds are a screening mechanism for the Commission to identify lines businesses whose performance may warrant further examination, and if necessary, control of their prices, revenues and/or service quality.

7 The Commission must assess lines businesses against the thresholds it has set, identify any lines business that breaches the thresholds, and determine whether or not to declare control in relation to the goods or services supplied by an identified lines business, taking into account the purpose statement contained in s 57E of the Act (Purpose Statement). In determining whether to declare control in relation to any lines business breaching the thresholds, the Commission may conduct a "post-breach inquiry".

8 Vector breached the initial price path threshold and quality threshold at the second assessment date (31 March 2004). The Commission's decision to publish an intention to declare control, pursuant to s 57I of the Act, followed investigations and analysis undertaken by the Commission into Vector's past and planned performance in the context of the Purpose Statement.

9 Vector's Offer, which was provided to the Commission following the publication of the intention to declare control, involves the company voluntarily rebalancing its line charges to different regions and customer groups, so that the prices paid by consumers better reflect underlying costs, demands and service quality. The Offer is intended to address the key concern raised in the Intention Paper, namely that Vector's pricing strategy is inefficient, with some customer groups being significantly over-charged.

10 On 14 December 2007, having reviewed Vector's Offer, the Commission issued its draft decision to not make a declaration of control in respect of Vector's distribution services (Draft Decision Paper).[7] The Commission invited interested parties to give their views on that draft decision, as well as on Vector's Offer and the explanatory material provided by Vector.

11 The Commission has now taken into account the views of interested parties, and has decided not to declare control of Vector's distribution services. An overview of the Commission's reasons for not declaring control will shortly be published in the *Gazette* (Decision Notice). In sum, those reasons are that the Commission considers Vector's performance during the settlement period—if in compliance with the terms of the administrative settlement—would be consistent with the Purpose Statement. Consequently, the objectives of the regime can be achieved without a declaration of control being made, provided the settlement is implemented. (The Commission's acceptance of Vector's Offer would not affect its ability to continue to investigate Vector's subsequent threshold breaches, particularly its 2006 and 2007 quality breaches).

12 This paper supplements the Decision Notice by presenting the Commission's reasons for not making a control declaration, and responds to the points raised in submissions and cross-submissions by interested parties. The paper is structured as is shown in the table below.

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[7] Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Draft Decision: Reasons for Not Declaring Control, Vector Limited*, 14 December 2007.

Section Heading	Content
Introduction	▪ Purpose and scope of this paper ▪ Statutory framework and process
Background to Vector's Settlement Offer	▪ Vector Limited ▪ Vector's breaches of the thresholds ▪ Evaluation of Vector's pricing behaviour ▪ Decision to publish an intention to declare control ▪ Vector's administrative settlement offer
Framework for Evaluating Administrative Settlements	▪ Statutory framework and basis for not declaring control ▪ Relevant factual and counterfactual for evaluating settlement offers ▪ Net benefits of accepting and implementing a settlement ▪ Views of interested parties
Evaluation of Vector's Settlement Offer	▪ Overview of Vector's Offer ▪ Customer group pricing proposals ▪ Monitoring compliance with the settlement ▪ Net benefits assessment ▪ Views of interested parties
Decision Not to Declare Control	▪ Decision not to declare control of Vector ▪ Next steps

Statutory Framework and Process

Targeted control regime

13 The targeted control regime for lines businesses is outlined in subpart 1 of Part 4A of the Act. The purpose statement of the targeted control regime, contained in s 57E of the Act (Purpose Statement), is:

> to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers –
>
> (a) are limited in their ability to extract excessive profits; and
> (b) face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
> (c) share the benefits of efficiency gains with consumers, including through lower prices.

14 The targeted control regime comprises a number of distinct elements as follows:

- *setting thresholds*, in which the Commission must set and publish "thresholds" for lines business performance, following consultation as to possible thresholds with participants in the electricity distribution and transmission markets and with consumers (paragraphs 16-32 below);
- *assessment and identification*, in which the Commission must assess lines businesses against the thresholds it has set, and must identify any lines businesses that breach those thresholds (paragraphs 34-37 below);

- *post-breach inquiry*, in which the Commission must determine whether to declare all or any of the goods or services supplied by all or any of the identified lines businesses to be controlled (paragraphs 38-40 below); and
- *control*, in which the Commission applies the regime under Part 5 of the Act for authorising the prices, revenues and/or quality of the controlled goods or services supplied by a lines business for which a declaration of control has been made by the Commission (paragraphs 41-45 below).

15 Control is *targeted*, in the sense that it is not universal, by virtue of the processes set out in subpart 1 of Part 4A. None of the lines businesses is to be automatically subject to control of prices, revenues or service quality. A business may only be controlled by the Commission if it has breached a threshold, and after the Commission has followed the process outlined in s 57I of the Act.

Price path threshold

16 After consulting with interested parties on possible thresholds, as is required under s 57G of the Act, the Commission set two thresholds on 6 June 2003: a CPI-X price path threshold and a quality threshold.

17 The price path threshold is of the form CPI-X, where CPI is the consumer price index, and the ‘X’ factor represents the expected annual reduction in lines business average prices (i.e., line charges) in real terms, net of certain allowable pass-through costs—most notably, transmission charges (in the case of distribution businesses).

18 For a distribution business, the price path threshold therefore effectively acts only on the distribution component of its line charges, (i.e., “distribution charges” or “distribution prices”) and not the combined price for all lines services, including transmission services. This is because the transmission charges are themselves subject to the distinct price path threshold applicable to Transpower. Consequently, any distribution business whose average distribution price changes at an annual rate exceeding the change in the CPI, less than the annual rate of X percent set by the Commission for that business, will breach the price path threshold. For a typical residential customer, distribution charges can range from 20-40% of the total power bill. The thresholds do not apply to the wholesale or retail components of electricity prices, as these are not subject to regulatory oversight under Part 4A.

19 The price path threshold is conceptually similar to the various forms of CPI-X price control that regulators in overseas jurisdictions commonly use for regulating utilities. However, the price path threshold is not an instrument of control, but a screening mechanism. Nevertheless, like CPI-X instruments applied in regulatory regimes in other countries, the price path threshold is intended to provide incentives consistent with the underlying statutory objectives. In the case of the thresholds, those objectives are set out in the Purpose Statement contained in s 57E of the Act.

20 Setting a CPI-X price path recognises that distribution businesses face inflationary and other increasing cost pressures, but it also places incentives on businesses to improve their efficiencies in real terms by X percent each year. However, businesses face even stronger incentives to improve efficiencies, because they keep the benefits of efficiencies greater than those implied by their CPI-X price path for a number of years. These efficiency gains are realised by the business in the form of higher profits, but are

shared with consumers over the long term through prices lower than would otherwise be the case.

Quality threshold

21 The quality threshold has two sets of criteria:

- *reliability criteria*, requiring no material deterioration in reliability, measured in terms of SAIDI and SAIFI, with the current year's reliability performance compared against average SAIDI and SAIFI from 1999-2003;[8] and
- *consumer engagement (or customer communication) criteria*, requiring meaningful engagement with consumers to determine their demand for service quality.

22 The Commission has indicated that lines businesses which have breached the reliability criteria of the quality threshold may offer some explanation or background information, explaining, for example, that the breach was attributable to:

- a rare but high impact event (i.e., an "extreme event"), such as a very severe storm;
- normal variation in the reliability performance measure; or
- increased frequency and/or duration of planned outages associated with major development or refurbishment of the network.[9]

Initial thresholds

23 The thresholds were initially set by a notice in the *Gazette* to apply to distribution businesses from 6 June 2003 until 31 March 2004,[10] and were explained in a decisions paper published on the same day.[11] All distribution businesses were assessed against the initial price path threshold as at 6 September 2003 (first assessment date) and against both the price path and quality thresholds as at 31 March 2004 (second assessment date).

24 The assessment criteria set in relation to the initial price path threshold were set to be generally consistent with a CPI-X price path, in which distribution prices at the end of each assessment period were not to be greater, in nominal terms, than the distribution prices at the start of that period. Hence, the initial X factor was equivalent to the CPI.

Reset thresholds

25 After further consultation with interested parties, the Commission reset the thresholds for distribution businesses from 1 April 2004 for a five-year regulatory period. The

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8 SAIDI is the system average interruption duration index, which measures the annual average length of time for a power outage, measured in minutes of lost electricity supply per consumer. SAIFI is the system average interruption frequency index, which measures the average number of power outages experienced by a consumer each year.

9 Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Assessment and Inquiry Guidelines*, 19 October 2004, paragraph 167.

10 *Commerce Act (Electricity Lines Thresholds) Notice 2003*, Supplement to *New Zealand Gazette*, Issue No. 62, 6 June 2003.

11 Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime: Thresholds Decisions*, 6 June 2003.

reset thresholds (or "revised thresholds") are of the same form as the thresholds set by the Commission on 6 June 2003. However, for the price path threshold, new X factors applied, with businesses assigned to four groups (i.e., X = -1%, 0%, 1%, or 2%), based on their relative efficiency and relative profitability.

26 Each X factor reflects a combination of:

- expected industry-wide improvements in efficiency (which was found through total factor productivity analysis to be a 1% gain per annum for all businesses);
- the relative performance of each group of businesses compared to the industry-wide average, based on
  - a relative productivity (i.e., efficiency) component (which was determined using multilateral total factor productivity analysis, and set to -1%, 0% or +1% for above-average, average and below-average performance, respectively), and
  - a relative profitability component (which was determined by comparing residual rates of return, and set to -1%, 0% or +1% for below-average, average and above-average profitability, respectively).

27 The reset thresholds for distribution businesses were set by a notice in the *Gazette* (Distribution Thresholds Notice),[12] and explained in an accompanying decisions paper.[13] All distribution businesses have been required to submit threshold compliance statements reporting their self-assessments against both the reset price path threshold and the quality threshold as at 31 March 2005 (third assessment date), 31 March 2006 (fourth assessment date) and 31 March 2007 (fifth assessment date).

Incentives provided by the thresholds

28 The price path threshold provides incentives for distribution businesses to improve efficiency while limiting their ability to extract excessive profits. Although the price path threshold is not intended to share all the benefits of efficiency gains with consumers in the *short term*, consumers will benefit in the *long term* from prices lower than they otherwise would be, and from an appropriate level of service quality.

29 First, all distribution businesses face an X factor which partly reflects expected industry-wide improvements in efficiency. Therefore, there will be some sharing of efficiency gains with consumers *during* the five-year regulatory period.

30 Second, and more significantly, businesses have an incentive to outperform the efficiency expectations implied by their price path threshold, thereby increasing the level of benefits that are potentially available to be shared with their consumers from the *end* of the regulatory period, when the thresholds are reset.[14] These additional

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12 *Commerce Act (Electricity Distribution Thresholds) Notice 2004*, Supplement to *New Zealand Gazette*, Issue No. 37, 31 March 2004.

13 Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime: Thresholds Decisions (Regulatory Period Beginning 2004)*, 1 April 2004.

14 The Commission notes that the Government recently announced a proposed package of changes to the regulatory provisions in the Commerce Act, including Parts 4A and 5 (Media Statement by the Ministers of Commerce and Energy, *Greater Certainty for Businesses after Commerce Act Review*, 21 November 2007). The Commerce Amendment Bill which is to give effect to these changes is currently before the

benefits arise because, during the regulatory period, businesses get to keep the additional profits which arise from any efficiency improvements that exceed those implied by their CPI-X price path. Furthermore, allowing a distribution business to retain this higher level of returns preserves the incentives for that business to make ongoing efficiency gains in subsequent periods.

31 Finally, at the end of the regulatory period, the CPI-X price path will be reset in a manner intended to share the benefits of the additional efficiency gains made during that past period with consumers over the next regulatory period.

32 The quality threshold provides incentives for distribution businesses not to allow their reliability to fall as a means of reducing their costs in response to the price path threshold, and to supply services at a quality that reflects consumer demands.

Assessment and Inquiry Guidelines

33 In October 2004 the Commission published its Assessment and Inquiry Guidelines (the Guidelines) which outline the broad process and analytical framework that the Commission intends to use in deciding whether to impose control on a lines business that has breached the thresholds.[15] The Guidelines describe the statutory framework and outline both the statutory and discretionary process steps the Commission proposes following in the assessment, identification and post-breach inquiry elements of the targeted control regime. These processes are illustrated in Figure 1, in which the various statutory and discretionary process steps are grouped and labelled.

Assessment and identification

34 Before determining whether to declare control in relation to any lines business, ss 57H(a) and 57H(b) of the Act require that the Commission must:

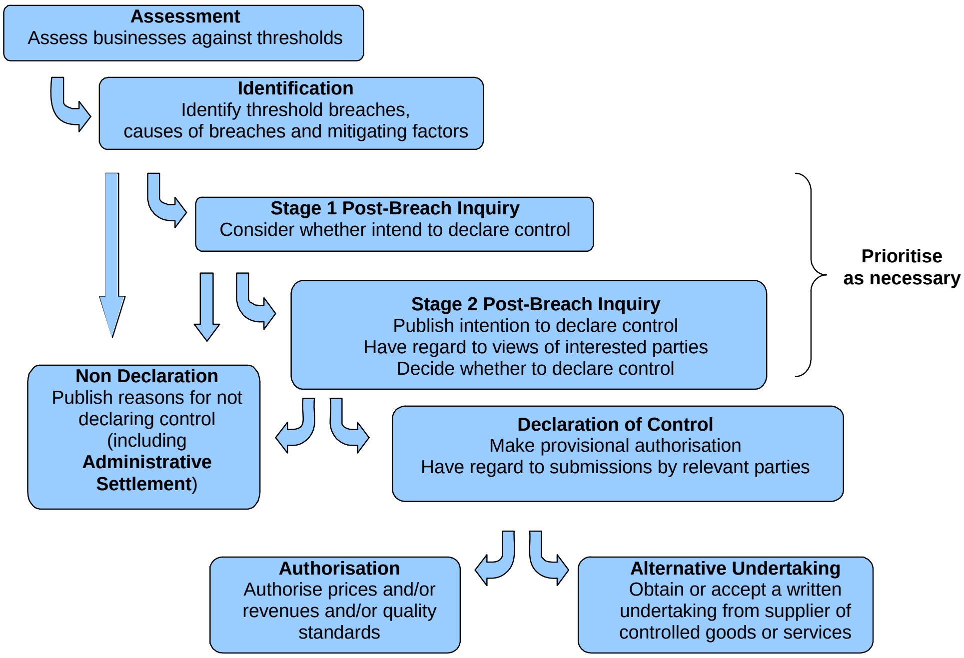
- assess large electricity lines businesses against the thresholds set under subpart 1 of Part 4A; and
- identify any large electricity lines business that breaches the thresholds.

35 Consequently, each lines business is annually required to provide the Commission with a threshold compliance statement in accordance with the notice in the *Gazette* which specifies the threshold assessment criteria. Each compliance statement must provide a self-assessment, with sufficient supporting evidence, of whether or not the lines business complies with the thresholds that the Commission has set.

Commerce Select Committee. Should the Bill pass in its present form, then “default price-quality paths” under an amended Part 4 of the Act would become the equivalent regulatory instrument to the thresholds under Part 4A. Given current legislative requirements, the remainder of this paper refers to resetting the thresholds. However, the same principle in respect of sharing efficiency gains applies in either case. The Commission also notes that clause 54K of the Bill provides that its enactment would not limit or affect any existing administrative settlement that applies for electricity lines services.

15 Commerce Commission, supra n 9. These Guidelines have recently been supplemented: Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Supplementary Guidelines for Investigating Breaches of the Reliability Criterion of the Quality Threshold*, 2 November 2007.

Figure 1: Targeted Control Process Steps



36 Where the Commission has identified a breach, it may request further information from the lines business concerned to identify the cause of the breach, as well as any mitigating factors pertaining to the breach. This additional information may be sufficient for the Commission to determine that taking further action would not be necessary for the long-term interests of consumers. Alternatively, in its assessment the Commission might find information that the business's current performance is not consistent with s 57E of the Act—in particular, the outcomes sought under (a) to (c) of s 57E (paragraph 13 above) are not being achieved in a material aspect.

37 Under s 57K of the Act, the Commission may prioritise its duties under subpart 1 of Part 4A to investigate a lines business that has breached a threshold. In so prioritising, s 57K(2) provides that the Commission must have regard to the s57E purpose, and may also have regard to any other factors that it considers relevant, including (without limitation) all, any, or none of the following:

(a) the size of the business;
(b) the recent performance of the business, including prices charged and the extent of any excess profits;
(c) the quality of the information provided to the Commission;
(d) the extent to which businesses have breached the thresholds set by the Commission.

Post-breach inquiries

38 Under s 57H(c) of the Act, the Commission must determine whether or not to declare all or any of the goods or services supplied by all or any of the identified lines businesses to be controlled, taking into account the purpose of subpart 1 of Part 4A. The Commission terms this decision-making process a "post-breach inquiry".

39 In addition, s 57I(1) states that, before making any declaration of control under s 57F, the Commission must:

- publish its intention to make a declaration and invite interested persons to give their views on the matter;
- give a reasonable opportunity to interested persons to give those views; and
- have regard to those views.

40 The Commission therefore has considered it convenient to divide post-breach inquiries into two-stages:

- **Stage 1** comprises investigations and analysis prior to the Commission forming an intention to declare control; and
- **Stage 2** comprises further investigations and analysis subsequent to the Commission publishing its intention to declare control (during which the Commission must invite and consider the views of interested persons).

Control

41 Under s 57J of the Act, a declaration of control under subpart 1 of Part 4A means (as with a declaration of control by Order in Council under Part 4 of the Act) that a lines business may not supply the controlled services unless an authorisation or an undertaking has come into effect in respect of those services and the services are supplied in compliance with the authorisation or undertaking.

42 Section 57M(1) provides that in exercising its powers under ss 70 to 72 concerning goods and services supplied by a large electricity lines business, the Commission must have regard only to the Purpose Statement, and not to the matters stated in s 70A, and ss 70 to 72 apply with necessary modifications.

43 Section 70 of the Act provides for the Commission to make an authorisation in respect of all or any component of the prices, revenues or quality standards that apply in respect of the supply of controlled services, using whatever approach it considers appropriate (having regard to the Purpose Statement). Section 71 provides for the Commission to make a provisional authorisation pending the making of a final authorisation.

44 The authorisation process under Part 5 is, like the declaration of control process under Part 4A, a consultative process. Before making a final authorisation, s 70B(3) requires the Commission to have regard to submissions made to it by the lines business concerned and the consumers of the controlled services. Under s 73, the Commission has the discretion to hold a conference as part of this process and it may allow other interested parties to be involved in the consultation.

45 Under s 72, the Commission may instead of making an authorisation in respect of controlled services, obtain or accept a written undertaking from the supplier of those services in relation to those services.

Relationship between post-breach inquiries and control

46 The fact that there is a further consultative process under Part 5 has implications for the Commission's process under Part 4A. The Commission's view is that, in deciding whether or not to declare control, it should not pre-determine the form and nature of control. Post-breach inquiries under Part 4A are therefore limited to assessing whether

control should be imposed and do not involve determining the specifics of any authorised prices, revenue and/or quality standards following a declaration of control.

47 However, in order to calculate the likely costs of control—as is required in forming an intention to declare control—the Commission must select a form of control for that purpose, but only to the extent that it is necessary for the Commission to assess whether control would be to the long-term benefit of consumers.

48 Any hypothetical form of control—and any prices, revenues and/or quality standards considered during the entire declaration of control process—will accordingly be preliminary and will not pre-empt any decision the Commission may be required to make in future regarding control, should that be necessary under Part 5.[16]

Administrative settlements

49 The Commission has indicated that it may be possible for a breach to be resolved by an "administrative settlement" between the Commission and the business concerned. (The evaluation of such a settlement offer from Vector, in the context of a decision whether to declare control, is the subject of this paper). Because a settlement would involve the business voluntarily reaching an agreement with the Commission on an appropriate course of action, a better outcome may be achievable than would be the case through control. An administrative settlement option is a well-established way of resolving Commission investigations in relation to Parts 2 and 3 of the Act and in relation to the Fair Trading Act 1986.

50 Administrative settlements could be agreed during either a Stage 1 or Stage 2 post-breach inquiry process, but, in the case of the latter, the Commission has indicated in the Guidelines that it may only be inclined to do so after formally considering the views of interested parties. It should be noted that the Commission would continue with its inquiry to determine whether or not to declare control alongside any negotiations in respect of a proposed administrative settlement.

51 If the Commission and a lines business agree on an administrative settlement, the Commission would cease its inquiry and publish its reasons for not making a control declaration. Those reasons would refer to the terms and conditions of the administrative settlement.

52 To date, the Commission has accepted administrative settlements from Unison Networks Limited (Unison)[17] and from Transpower.[18]

Government Policy Statements (GPS)

53 On 7 August 2006, the Government provided the Commission with a statement of its economic policy relating to the incentives of regulated businesses (including electricity

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16 This relationship between the Commission's Part 4A and Part V processes is conceptually equivalent to the relationship between Part IV and Part V, as described in: Commerce Commission, *Gas Control Inquiry, Final Report*, 29 November 2004, pp 2.14-2.16.

17 Commerce Commission, *Reasons for Not Declaring Control: Unison Networks Limited*, 11 May 2007.

18 Commerce Commission, *Decision and Reasons for Not Declaring Control of Transpower New Zealand Limited & Decision to Reset Transpower's Thresholds*, 13 May 2008.

lines businesses) to invest in infrastructure (the August 2006 GPS).[19] The August 2006 GPS was passed to the Commission under s 26 of the Act. Section 26 provides:

Commission to have regard to economic policies of Government

(1) In the exercise of its powers under … this Act, the Commission shall have regard to the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister.

(2) The Minister shall cause every statement of economic policy transmitted to the Commission under subsection (1) of this section to be published in the Gazette and laid before Parliament as soon as practicable after so transmitting it.

(3) For the avoidance of doubt, a statement of economic policy transmitted to the Commission under this section is not a direction for the purposes of Part 3 of the Crown Entities Act 2004.

54 The meaning of s 26 was considered by the Commission in *Re NZ Kiwifruit Exporters Assn (Inc)/NZ Kiwifruit Coolstorers Assn (Inc)* [(1989) 2 NZBLC (Com) 104,485] and by the High Court in *NZ Co-op Dairy Co Ltd v Commerce Commission* [[1992] 1 NZLR 601]. In the Kiwifruit case, the Commission stated (at page 104):

"..having regard to the general policy discretion in the Act to promote competition s 26 may be used to advise the Commission of Government policy or policies or to be more specific in relation thereto. It is not to influence or determine the decisions which the Commission must make. Thus, fully preserving the discretions given to the Commission in the Act, the Commission is required only to have regard to such statements in reaching its decisions. The Oxford Dictionary defines the word 'regard' as meaning 'attention, heed and care'."

55 In the High Court case in NZ Co-op Dairy Co (at p 612 and 613), the Court observed:

"As with any other evidence it is for the tribunal to assess the weight to be given to each item of evidence and in the case of a statement of this kind, which in our view is simply an evidential statement of Government policy - it is certainly not a direction - it remains for the tribunal to assess the weight to be given to it as an expression of official perception of, in this case, the public benefit. We do not think there is any magic in the words 'have regard to'. They mean no more than they say. The tribunal may not ignore the statement. It must be given genuine attention and thought, and such weight as the tribunal considers appropriate. But having done that the tribunal is entitled to conclude it is not of sufficient significance either alone or together with other matters to outweigh other contrary considerations which it must take into account in accordance with its statutory function: *NZ Fishing Industry Association v MAF* [1988] 1 NZLR 544, at p 566, *Ishak v Thowfeek* [1968] 1 WLR 1718 (PC), at p 1725. In the end, however weighty the statement may be as an expression of considered Government policy, it does not have any legislative effect to vary the nature of the duties which the Tribunal must carry out."

56 The August 2006 GPS provides, in material part, the following:

Economic policy objectives

7. The Government's economic policy objective is that regulated businesses have incentives to

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19 New Zealand Government, *Statement to the Commerce Commission of Economic Policy of the Government: Incentives of Regulated Businesses to Invest in Infrastructure*, 7 August 2006. In addition, on 26 October 2006, the government provided the Commission with an updated statement of its economic policy on electricity governance (October 2006 GPS) pursuant to s 26 of the Act (New Zealand Government, *Government Policy Statement in Relation to Electricity Industry Governance*, 26 October 2006). The October 2006 GPS sets out statutory objectives for the Electricity Commission and the Government's expectations and intentions regarding the interrelationship between the Commerce Commission and the Electricity Commission with regard to the regulation of electricity lines businesses. In particular, the October 2006 GPS recognises that the two Commissions have developed and published a Memorandum of Understanding on their respective roles. The Commission notes that the Government is currently consulting on further revisions to this GPS to bring the statement into line with the *New Zealand Energy Strategy* published in October 2007.

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:

a. regulatory stability, transparency and certainty giving businesses the confidence to make long-life investments;

b. regulated rates of return being commercially realistic and taking full account of the long-term risks to consumers of underinvestment in basic infrastructure; and

c. regulated businesses being confident they will not be disadvantaged in their regulated businesses if they invest in other infrastructure and services.

8. The Government also considers that it is important that regulatory control ensures 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.

57 The Commission has carefully assessed and considered each statement in the August 2006 GPS for the purposes of evaluating Vector's administrative settlement offer, in conjunction with the considerations it must take into account in accordance with its statutory functions and powers. The Commission considers that it has given proper and genuine attention to the GPS in reaching the draft decisions outlined in this paper.

BACKGROUND TO VECTOR'S SETTLEMENT OFFER

Vector Limited

Overview of the company

58 Vector owns and operates the electricity distribution networks in the Auckland, Northern, and Wellington regions. Auckland networks cover Auckland City, Manukau City and parts of Papakura District. Northern networks cover the North Shore City, Waitakere City, and Rodney District. Wellington networks cover Wellington City, Porirua, Lower Hutt and Upper Hutt. The Northern and Wellington networks were acquired from UnitedNetworks Limited (UNL). During October 2002, Vector acquired 100% of the shares of UNL, including three geographic networks—Eastern, Northern, and Wellington. In November 2002, Vector subsequently sold the Eastern network to Powerco and Unison.[20]

59 As a result of this acquisition, Vector is the largest electricity distribution business in New Zealand, measured by regulatory asset value, system length or consumer connections. As at 31 March 2007, Vector disclosed it had 671,678 consumer connections (with around 46% in the Auckland region; 30% in the Northern region; and 24% in the Wellington region), 21,744 km of lines and cables (excluding streetlighting), and a supply area covering 5,200 square kilometres. Vector alone accounts for around one-third of total industry system assets at optimised deprival value (ODV) and distributes more than one-third of New Zealand's total electricity demand.

60 Vector is listed on the New Zealand Stock Exchange. Its majority shareholder, with a shareholding of 75.1%, is the Auckland Energy Consumer Trust (AECT). The balance of 24.9% is held by a number of individual shareholders through publicly listed shares. The AECT was formed in 1993 and is managed by five publicly elected trustees. The Trust represents its beneficiaries who are the electricity customers in Vector's Auckland network. The Trust distributes the dividend it receives from Vector each year to its beneficiaries.

61 Vector also has a range of other business activities, including the following:

- natural gas distribution in the North Island (Vector and NGC), with the non-NGC gas pipeline services subject to control by the Commission under Part 5 of the Act;
- natural gas transmission, processing, wholesaling and retailing in the North Island;
- LPG operations;
- energy metering services;
- telecommunications network businesses in the Auckland CBD, Wellington CBD and other areas (Vector Communications); and
- interests in a tree and vegetation management company (Treescape).

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20 As noted above (paragraph 3), Vector recently announced the planned sale of its Wellington network.

Vector's price path and quality thresholds

62 Under the initial CPI-X price path threshold, all distribution businesses were effectively set the same X factor. To comply with the price path threshold, businesses were required to ensure that, at the first and second assessment dates (i.e., 6 September 2003 and 31 March 2004 respectively), average prices (i.e., distribution charges) were at or below levels in August 2001 (i.e., when Part 4A was enacted).

63 As part of resetting the initial thresholds, the Commission undertook a relative productivity and profitability analysis of all distribution businesses, allocating businesses to above-average, average and below-average groups for both productivity and profitability. Vector's electricity distribution business was found to fall in the above-average productivity group based on its performance from 1 April 1999 to 31 March 2003. The business was also found to fall in the average profitability group, based on its performance from 1 April 1999 to 31 March 2002—in other words, prior to the company's acquisition of the UNL networks.[21]

64 As a result, the Commission assigned Vector an overall X factor of 0%, meaning that, from 1 April 2004, Vector was able to increase its average prices by the CPI over the five-year regulatory period without breaching the reset price path threshold.

65 For the quality thresholds, the Commission decided to set the reliability criteria at the five-year average levels over the period 1999-2003. For Vector, the SAIDI criterion of its quality threshold was set at 85.5 minutes, and the SAIFI criterion was set at 1.313 outages.

Vector's Breaches of the Thresholds

Price path threshold

66 From reviewing Vector's respective compliance statements, the Commission identified Vector as having breached the initial price path threshold at the second assessment date (31 March 2004), by approximately $77,000 or 0.028% of notional revenue.[22] In its compliance statement, Vector stated that this price path threshold breach was due to small variances between actual pass-through charges incurred by Vector (primarily transmission charges) and forecast pass-through charges.

67 Vector has met its reset price path threshold in every year, except 2007. Since breaching the price path threshold in 2003/04, Vector put in place a buffer of 25 basis points (i.e., 0.25%) in its revenue targets to mitigate the risk of breaching the price path

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[21] Given the disclosed information available at the time of resetting the thresholds, it was not possible to estimate the UNL revenue for 2002/03 attributable to Vector, Unison and Powerco following their acquisition of various UNL networks. Refer: Commerce Commission, supra n 8, p 59; and Meyrick and Associates, *Regulation of Electricity Lines Businesses, Analysis of Lines Business Performance – 1996-2003*, 19 December 2003, p 61.

[22] Notional revenue is the annualised revenue that would result from applying each set of line charges to the same set of "base" quantities, net of pass-through costs (i.e., transmission charges, local authority rates and Electricity Commission levies). It does not reflect the actual revenue amount of the breach, but provides an approximation to the additional revenue above that permitted by the price path threshold that would be collected by the business if current charges for distribution services were sustained for a full year, in the absence of demand growth.

threshold, should the actual CPI and pass-through costs differ from forecasts. Using this approach, Vector has complied with the price path threshold by recovering less than the notional revenue allowance under the price path threshold (by $6.4 million in the year ended 31 March 2005 and by $2.2 million in the year ended 31 March 2006).

68 In 2007, Vector breached its price path threshold by 3.5%. Vector states that this non-compliance was solely due to its transmission charges for 2006/07 being materially lower than originally advised by Transpower, as a result of the interim transmission charge rebate introduced by Transpower in March 2006. (This interim rebate was introduced by Transpower when it announced it was seeking an administrative settlement with the Commission, following the Commission's intention to declare control of Transpower on 22 December 2005).

69 In its threshold compliance statement for 2007, Vector noted that the Commission had acknowledged some distribution businesses might breach the price path threshold as a result of these transmission charge rebates. In particular, Vector highlighted the Commission's announcement on 4 December 2006 that the Commission "would take no further action where businesses breach their price path thresholds solely as a result of responding appropriately" to the increase in transmission charges announced by Transpower.[23]

Quality threshold

70 The Commission has identified Vector as having breached both the SAIDI and SAIFI criteria of the quality threshold by:

- 22% and 10.2% respectively, in 2004;
- 38.1% and 15.5% respectively, in 2006; and
- 35% and 8% respectively, in 2007.

71 For all three breaches of the quality threshold, Vector stated that the breaches were due to extreme events, such as storms, and reported that, in its view, if the impact of such events were removed it would not have exceeded its reliability criteria.

72 The Commission has applied its recently published extreme event criteria to Vector's reliability data relating to the 2004 quality threshold breach. Desktop analysis indicates that, even after adjusting for a number of "major event days" occurring during the 2003/04 year, Vector's SAIDI performance in that year would still have exceeded the SAIDI criterion of the quality threshold by about 5.5%.[24]

Evaluation of Vector's Pricing Behaviour

Initial information provided by Vector

73 Following Vector's breaches of both the price path and quality thresholds at the second assessment date, the Commission sought further information from Vector on the nature of the 2004 quality breach. The Commission also sought information from Vector

23 Commerce Commission, *Transpower Proposes New Prices*, Media Release 70, 4 December 2006.

24 Refer: PB Associates, *System Reliability: Final Recommendations for Identifying Extreme Events*, 15 March 2007, p 32.

concerning the company's prices across its networks and customer groups. In response to this request, Vector provided information which identified that there were significant differences in how Vector was recovering its revenue from different customer groups. As explained below, the key difference was in the profit (i.e., return on investment) component of the total line charge that each customer group pays.

74 Vector has developed seven broad customer tariff groups in each of its Auckland, Wellington, and Northern networks: Un-metered, Residential, Small Commercial, Medium Commercial, Large Commercial, Small Industrial, and Large Industrial. (Appendix 2 of Vector's Offer contains Vector's description of the different customer tariff groups).[25] In terms of the number of end-users, the Auckland region is the largest network and the Residential group in Auckland is the largest customer group, representing around 90% of Vector's Auckland connections.

75 Vector defined the after-tax return on investment (ROI) in dollar terms associated with each customer group as being the difference between the sum of the costs allocated to that customer group and the total revenue which that group was contributing. The costs allocated by Vector to each customer group comprised: transmission charges, maintenance and operations, administration, depreciation, as well as tax expense and the interest tax shield. The remaining return component was intended to compensate Vector for the financial capital it had invested in the networks.

76 In percentage terms, Vector's ROI figures for each customer group were found by dividing the derived return in dollar terms, by the value of the assets that Vector considered were employed to supply that customer group. The corresponding value of these assets was determined by attributing a share of the overall optimised deprival value (ODV) of Vector's networks to each customer group.

77 Based on this approach, Vector's own figures showed that significant differentials in returns existed both between regions and between customer groups within each region. Vector explained to the Commission that the disparity in returns was a "legacy" issue inherited by Vector through its acquisition of the UnitedNetworks' Northern and Wellington electricity networks in November 2002. Vector also advised that it had decided in November 2004 to implement a programme of price rebalancing and rationalisation to reflect the cost of service and price/quality trade offs across customer groups more accurately.

78 Vector explained that its tariff rebalancing process was expected to occur over the four year period from 1 April 2005 to 31 March 2009, with staged adjustments each year to achieve balanced returns across the regions and customer groups. Vector stated that its overall target ROI (in percentage terms) was 8.4% on average after-tax, comprising a target ROI of 7.4% for residential customer groups and 10% for industrial/commercial customer groups (both calculated on a post-tax basis in accordance with NZ GAAP). Vector considered that its industrial and commercial customer groups should be subject to a higher target return because of associated higher risks due to the volatility of industrial and commercial electricity demand.

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25 For the purposes of Vector's pricing plans, these customer tariff groups are further split into a number of load groups.

Post-breach inquiry

79 As a result of the Commission's evaluation of Vector's past and planned pricing behaviour, and the information available to the Commission at that stage, the Commission decided to initiate a post-breach inquiry into Vector's performance. In prioritising whether to select Vector for further inquiry (paragraph 37 above), the Commission considered Vector's performance against the Purpose Statement. Despite the extent of Vector's breach of the initial price path threshold being relatively small, the Commission took particular account of the fact that Vector is the largest electricity distribution business in New Zealand, and its performance affects around one-third of all electricity consumers.

80 The Commission notified Vector of its concerns on the extent of the return differentials, noting that customers who contributed higher than a reasonable rate of return were being over-charged. The Commission accepted that the acquisition of the UNL networks was likely to have given rise to regional differentials. However, the Commission also highlighted that there were significant differentials in returns between customer groups within Vector's original Auckland network as well, which could not be attributed to the UNL acquisition (e.g., refer paragraph 171 below).

81 In the Commission's view, such significant uneconomic over-charging across regional networks and customer groups was not conducive to promoting the efficient operation of the distribution services market in the regions supplied by Vector. There was a further concern that such overcharging could be used to provide an implicit dividend to Vector's consumer owners, given that the customer group contributing the lowest return was the Auckland Residential group, which represents the majority shareholders in Vector through the Auckland Energy Consumer Trust.

82 In July 2006, in response to requests for additional information, Vector provided the Commission with its estimates of the progress it had made with tariff rebalancing during 1 April 2005 to 31 March 2007, as a result of price adjustments made on 1 May 2005 and 1 April 2006. This information (Table 1 below) showed that progress had been limited and quite varied across the 21 customer tariff groups (i.e., seven customer groups in each of the three network regions). In some cases the returns had diverged further from Vector's targets.

83 For example, the over-charging experienced by Vector's Northern Large Commercial customers had increased, with that group's ROI estimated to have increased from 42.9% to 54.4% as a result of the most recent round of tariff changes on 1 April 2006. In Vector's original supply area, Auckland Small Industrial customers were to contribute to an ROI of 16.2% for the 2006/07 year. By contrast, Auckland Residential customers were contributing a return of only 4.6% in that year. Consequently, the Commission's preliminary view—as set out in the Intention Paper—was that Vector's limited progress during 2005 and 2006 in implementing its tariff rebalancing programme indicated the company was still able to take advantage of its monopoly market power and over-charge some of its customer groups.

84 Therefore, despite prior assurances from Vector that it was taking steps to rebalance its prices more efficiently, the Commission concluded Vector had failed to address its pricing issues satisfactorily, as the situation had deteriorated for many customer groups.

Table 1: Estimated Progress (as at 25 July 2006) toward Tariff Rebalancing between 1 April 2005 and 31 March 2007[26]

	Actual ROI (%) 2004/05	Estimated ROI (%) 2005/06	Estimated ROI (%) 2006/07	Target ROI (%) 2008/09	Estimated Movement in ROI 2004/05 to 2006/07	Difference to Target ROI at 31 Mar 2007
Auckland						
Un-metered	5.4	4.8	**4.1**	**10.0**	-1.3	**5.9**
Residential	1.9	3.1	**4.6**	**7.4**	2.6	**2.8**
Small Commercial	9.2	7.9	**9.7**	**10.0**	0.5	**0.3**
Medium Commercial	8.1	9.1	**7.1**	**10.0**	-1.0	**2.9**
Large Commercial	15.7	13.3	**12.6**	**10.0**	-3.1	**-2.6**
Small Industrial	15.2	17.6	**16.2**	**10.0**	1.0	**-6.2**
Large Industrial	7.2	4.7	**3.9**	**10.0**	-3.3	**6.1**
Total	**5.8**	**6.1**	**6.8**		**0.9**	
Wellington					0.0	
Un-metered	12.9	14.2	**8.9**	**10.0**	-4.0	**1.1**
Residential	7.3	9.1	**9.4**	**7.4**	2.2	**-2.0**
Small Commercial	30.0	29.3	**23.1**	**10.0**	-6.9	**-13.1**
Medium Commercial	19.2	12.9	**15.8**	**10.0**	-3.5	**-5.8**
Large Commercial	26.1	21.4	**27.5**	**10.0**	1.5	**-17.5**
Small Industrial	28.5	23.3	**29.7**	**10.0**	1.3	**-19.8**
Large Industrial	21.0	13.1	**9.8**	**10.0**	-11.2	**0.2**
Total	**13.7**	**13.7**	**13.3**		**-0.4**	
Northern						
Un-metered	5.3	6.2	**3.6**	**10.0**	-1.6	**6.4**
Residential	7.8	6.1	**5.4**	**7.4**	-2.4	**2.0**
Small Commercial	14.5	13.1	**12.0**	**10.0**	-2.4	**-2.0**
Medium Commercial	13.0	12.2	**13.0**	**10.0**	0.0	**-3.0**
Large Commercial	42.9	46.9	**54.4**	**10.0**	11.5	**-44.4**
Small Industrial	24.9	18.7	**23.2**	**10.0**	-1.8	**-13.2**
Large Industrial	8.0	6.0	**9.0**	**10.0**	0.9	**1.0**
Total	**9.9**	**8.1**	**7.7**		**-2.2**	

Decision to Publish an Intention to Declare Control

Intention to declare control

85 Having reviewed the information provided by Vector, the Commission formed an intention to make a declaration of control. The Commission gazetted its intention to declare control on 9 August 2006, and released an Intention Paper setting out its reasons for forming that intention to declare control on the same day (paragraphs 1-2 above).

86 In the Intention Paper, the Commission explained the evidence before it indicated that, among other things:

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26 Commerce Commission, supra n 4, p 7.

- the majority of Vector's customers were not subject to cost-reflective pricing, with there being a wide variation of over-charging and some under-charging;
- Vector had not been making significant progress at tackling the excessive pricing across its seven customer groups in each of its three regional networks; and
- Vector's pricing strategy was primarily benefiting those customers who were also the beneficiaries of its majority shareholder (i.e., the AECT) at the expense of its other customers; and
- Vector would continue to earn excess returns.[27]

87 In particular, the Commission indicated that it considered earning post-tax nominal returns of up to 54% for certain customer groups (based on Vector's own analysis) was not consistent with the Purpose Statement, which requires that lines businesses are limited in their ability to extract excessive profits and should share the benefits of efficiency gains with consumers through lower prices.[28]

88 In conclusion, the Commission was satisfied that, on the basis of available evidence and analysis, the long-term benefits to consumers of controlling Vector's electricity distribution services would exceed the costs of imposing control (as summarised in paragraphs 94-100 below). Initially, the Commission invited submissions from interested parties by 4 September 2006 on its preliminary views as set out in the Intention Paper. In response to requests from interested parties, the Commission extended the deadline for receiving submissions until 30 October 2006. However, on 13 October 2006 the Commission suspended the consultation process on the Intention Paper when it received an administrative settlement offer from Vector which it considered was, in principle, consistent with the Purpose Statement (paragraphs 103-105 below).

Commission's analytical framework

89 In deciding whether or not to declare control of a business that has breached one or more thresholds, the Commission must take into account the Purpose Statement. As set out in the Commission's Guidelines (paragraph 33 above), the Commission will form an intention to declare control if it is satisfied that, on the basis of available evidence and analysis, the forward-looking benefits of control to consumers in the long term are likely to exceed the costs.

90 The Intention Paper explained that control is generally intended to realign prices to more efficient levels. Over time such prices will:

- aim for allocatively efficient price levels, commensurate with the level of service quality consumers demand and based on productively/dynamically efficient costs;
- encourage dynamic efficiency, by sending appropriate signals for investment; and
- allow for "normal" returns to be earned, calculated from an appropriate asset base and risk-adjusted rate of return, and covering only efficient operating costs.[29]

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[27] ibid, paragraph 95.
[28] ibid, paragraph 205.
[29] ibid, paragraph 121.

91 The Intention Paper explained that the potential net benefits of control to consumers over time are the benefits of control, less the direct and indirect costs of control. Potential benefits may arise from:

- net gains in allocative, productive or dynamic efficiency; and
- "transfers" to consumers, resulting from any excessive profits reduced by control.[30]

92 The direct costs of control include the compliance costs of the regulated lines business and other market participants involved in the regulatory process, plus the incremental administrative costs of the Commission. The indirect costs of control, which may arise if control were to lead to some forms of inefficient behaviour, are more difficult to quantify.[31]

93 Determining the benefits of control to consumers involves comparing the prices (and/or quality) of services that would apply in the absence of control (the *counterfactual*) with those that might apply if control realigned prices to more efficient levels (the *factual*).[32]

Net benefits of control

94 Consistent with this analytical framework, the Intention Paper set out the Commission's preliminary view that control of Vector's electricity distribution services would bring benefits to consumers by:

- preventing the over-charging of some customer groups for the benefit of some shareholding customers, and limiting the ability of Vector to earn excess revenue;
- improving efficiencies by aligning charges more with the underlying costs of providing that service, and the sharing of efficiency gains with consumers; and
- ensuring that the prices charged were commensurate with the quality of service that reflects consumer demands.[33]

95 In particular, the Intention Paper set out the Commission's estimates of the average reduction in annual distribution charges (i.e., line charges net of transmission charges) under control, for consumers in those customer groups which were contributing a higher return than Vector's target return for that group. For example, Vector's Large Commercial customers in its Northern network were estimated to need the highest price reductions in percentage terms—39%, corresponding to more than a $9,000 reduction in the annual power bill for those customers, on average. The Commission noted however, that under control Vector might also be able to increase its distribution charges for those consumers that were currently contributing low returns.[34]

96 The Commission also indicated it considered Vector had not provided sufficient justification for the 2.6% differential in target returns between its residential and commercial/industrial customer groups (paragraph 78 above). Also, the Intention Paper explained that, given the average level of Vector's target return—8.4% across all customer groups (using NZ GAAP)—its electricity distribution business could be

[30] ibid, paragraph 123.
[31] ibid, paragraphs 140-141 and 239.
[32] ibid, paragraph 143.
[33] ibid, paragraph 8.
[34] ibid, paragraphs 203-204 and Table 7.

earning excess returns overall.[35] For an estimated post-tax nominal weighted average cost of capital (WACC) range for Vector's electricity distribution business of 7.35%-8.45% at the time, the Commission's preliminary view was that the removal of excess returns overall would result in significant benefits to consumers over the period up until the thresholds are reset. In particular, the Commission's sensitivity analyses presented in the Intention Paper suggested that, depending on the assumptions made, further price reductions of up to 2%-11% per annum could be achieved under control in the two years leading up to the reset of the thresholds.[36]

97 Apart from having direct benefits to many of Vector's customer groups in the form of lower prices, the Intention Paper indicated that allocative and dynamic efficiency would also be improved under control, as a result of aligning prices more closely to costs. When consumers are faced with a price that is above (or below) the cost of providing that service they may choose to consume too little (or too much) of that service, resulting in an inefficient allocation of resources in the economy. Consequently, such pricing distortions may also have an adverse effect on dynamic efficiency, to the extent that they affect investment decisions, either by the business that is overcharging, or by customers that are being overcharged. The kinds of decisions that may be distorted include decisions by consumers as to which form of energy supply to use, which type of technology to adopt, and where to locate a new business or plant.

98 Most significantly, the Intention Paper emphasised it was of particular concern to the Commission that many of the customer groups disadvantaged by Vector's pricing strategy were commercial and industrial customers. The Commission highlighted that the wider policy objective for infrastructure, as reiterated in the August 2006 GPS, is to "enhance infrastructure's net contribution to economic growth and societal well-being over time." As the supplier of around one-third of New Zealand's electricity distribution services, Vector's pricing strategy affects the costs for many businesses in the productive sector which have to compete nationally and/or internationally in markets for tradable goods.[37]

99 The Intention Paper noted that, at that stage of its post-breach inquiry, the Commission had not examined Vector's quality performance in depth. However, the Commission indicated that, in its view, there were sufficient grounds for forming an intention to declare control based on Vector's pricing behaviour alone, given that Vector had not attempted to justify its pricing behaviour on the basis of improving service quality.[38] The Commission noted that further benefits could arise from the imposition of control if control were to ensure that distribution services are supplied at a level of quality reflective of consumer preferences.

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35 ibid, paragraph 198. Vector indicated to the Commission that under New Zealand International Financial Reporting Standards (NZ IFRS)—which have since become mandatory from 1 April 2007 for statutory financial reporting purposes—the equivalent overall target return would be 9.1%, comprising a target return of 8.0% for residential consumers and a target return of 10.8% for commercial/industrial consumers. These changes were primarily due to differences in tax treatment under NZ GAAP and NZ IFRS. Vector also indicated that, using a tax payable approach (which more closely reflects Vector's tax liabilities to the Inland Revenue Department on an annual basis, and is more comparable with Vector's WACC), would result in an equivalent overall target return of 9.6% (ibid, paragraphs 183 and 189).

36 ibid, paragraph 229.

37 ibid, paragraph 206.

38 ibid, paragraph 56.

100 Consequently, the Commission's preliminary view was that controlling Vector's electricity distribution services was necessary to resolve the s 57E concerns that had been identified by the Commission. After taking into account the potential benefits from control, combined with the possible costs of control, the Commission concluded that the net benefits of control were likely to be significant.[39]

Vector's Administrative Settlement Offer

Dialogue with Vector on an administrative settlement offer

101 The Intention Paper noted that Vector had already entered into discussions with the Commission in respect of a possible administrative settlement. These discussions explored ways Vector might be able to address the extent of over-charging of certain customer groups.[40] The Paper indicated that discussions were continuing with Vector, and that the Commission remained open to the possibility of resolving the identified s 57E concerns through an administrative settlement.

102 The Commission stated that, in its view, under any administrative settlement offer, Vector ought to re-focus its pricing strategy to be more efficient, in a manner consistent with the long-term interests of all its customer groups, as opposed to the short-term interests of its majority shareholders. The Commission considered that the release of the Intention Paper would aid Vector's understanding of the appropriate balance to reflect the long-term interests of its consumers, and would add transparency to the process of removing the over-charging experienced by many of Vector's customer groups.[41]

103 Following the release of the Intention Paper, discussions continued between Vector and the Commission on the possible terms of an administrative settlement. On 13 October 2006, the Commission announced that it had received an administrative offer from Vector which was, in the Commission's preliminary view, consistent in principle with the objectives of the targeted control regime, and that it intended to seek the views of interested parties on that offer. The key features of the offer were that Vector would comply with its price path threshold for the remainder of the regulatory period until March 2009, and it would rebalance its tariffs over the two years from April 2007 so that the prices paid by consumers would better reflect the costs of supplying them.[42]

104 Subsequently, Vector indicated to the Commission that it proposed amending its 13 October 2006 administrative settlement offer slightly, in order to reflect a number of minor changes to the Cost of Supply (COS) model it was using to derive its target tariff levels for each customer group (paragraphs 170-175 below). Specifically, Vector proposed updating the forecast information in its COS model with actuals, where these had since become available, and to refine the treatment of forecast kWh demand information in its COS model. The Commission received Vector's revised administrative settlement offer on 23 January 2007 (the Offer).[43]

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39 ibid, paragraphs 233-242.

40 ibid, paragraphs 176-177.

41 ibid, paragraph 178.

42 Commerce Commission, *Vector proposes settlement and agrees to rebalance prices*, Media Release No. 58, 13 October 2006.

43 Vector, supra n 5.

Commission's Draft Decision Paper

105 The Commission reviewed Vector's Offer of 23 January 2007 and formed the preliminary view that, in complying with the terms of the administrative settlement, Vector's performance during the settlement period would be consistent with the Purpose Statement. Consequently, the objectives of the regime could be promoted without a declaration of control needing to be made, provided that the settlement would be implemented. Moreover, in the Commission's view, the Offer formed a suitable basis for consultation with interested parties.

106 On 14 December 2007, the Commission issued its Draft Decision Paper to not make a declaration of control in respect of Vector's distribution services (paragraph 10), and invited interested parties to give their views on that draft decision and on Vector's Offer and related explanatory material (publicly released along with the Draft Decision Paper).

107 Submissions were due on 11 February 2008 and were received from three interested parties: PwC (on behalf of 21 electricity distribution businesses), the Major Electricity Users' Group (MEUG), and Mighty River Power (MRP).[44] Cross-submissions were due on 25 February 2008, but none were received.

Commission's final decision

108 The Commission has now taken into account the views of interested parties, and has decided not to declare control of Vector's distribution services. The following sections of this paper outline the Commission's framework for evaluating Vector's administrative settlement offer, summarise the Commission's specific review of Vector's Offer, respond to the points raised in submissions by interested parties on the Draft Decision Paper and the Offer, and provide the Commission's reasons as to why no declaration of control in respect of the electricity distribution services supplied by Vector needs to be made at the present time.

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[44] PwC, *Submission on the Intention to Declare Control on Vector Limited*, 8 February 2008; MEUG, *Submission on Draft Decision for Not Declaring Control of Vector's Electricity Line Business*, 11 February 2008; Mighty River Power, *Draft Decision NOT to Declare Price Control on Vector's ELB*, 11 February 2008.

FRAMEWORK FOR EVALUATING ADMINISTRATIVE SETTLEMENTS

109 This section sets out the framework which the Commission has used for evaluating Vector's offer of administrative settlement offer (the Offer). This framework forms the basis for the Commission's preliminary view that it can accept Vector's Offer and decide not to declare control. The framework is consistent with that applied in its decision not to declare control of Unison Networks Limited, which the Commission applied in May 2007, following consultation with interested parties.[45]

Statutory Interpretation

Purpose statement of the targeted control regime

110 As described above (paragraph 89), in determining whether or not to declare control, the Commission must have regard to the overall purpose of the targeted control regime, which is contained in s 57E (Purpose Statement).

111 The Purpose Statement may be broken into three parts:

(i) the statement of purpose—to promote the efficient operation of markets directly related to electricity distribution services;

(ii) the means of achieving that purpose—through targeted control for the long term benefit of consumers; and

(iii) the amplification of that means—in the form of ensuring that the objectives set out in paragraphs (a) to (c) of s 57E are achieved.[46]

112 Sections 57E(a) to (c) have been identified by Parliament as central aspects of the long-term interests of consumers and are central, though not exclusive, goals for the Commission in the performance of its duties under subpart 1 of Part 4A.[47]

113 Under s 57E(a), the goal is to ensure that lines businesses are limited in their ability to earn profits in excess of their WACC. Differently put, the aim is to limit the ability of lines businesses to earn greater than normal profits.

114 The s 57E(b) aim requires the Commission to direct its actions toward the goals of ensuring that lines businesses do not incur unnecessary or wasteful costs, and make appropriate trade-offs between increased quality and cost. Expenditure should be restricted to meeting quality standards required by consumers.

115 Section 57E(c) requires the Commission to ensure that efficiency gains when achieved, are shared with customers. Implicit in "sharing" is that the lines business can retain

[45] Commerce Commission, supra n 17, paragraphs 3.1-3.48.

[46] *Unison Networks Limited v The Commerce Commission & Powerco Limited*, Unreported, High Court (Wild J), Wellington, CIV 2004 485 960, 28 November 2005, paras [110]–[112].

[47] ibid, para [59].

some of the gains. The sharing could take the form of lower prices or of improved quality of service or a combination of the two.[48]

Steps of the targeted control regime

116 There are three key steps in implementing the targeted control regime and achieving the objectives set out above. The first step is to set the thresholds for declaration of control (s 57G). Step two requires the Commission to assess compliance with the thresholds and identify whether any lines business is in breach of the thresholds (s 57H). The third step requires the Commission to work through a process for deciding on whether or not to declare control (s 57H and s 57I). Each of these three steps allows the Commission to achieve the "purposes" of Part 4A.[49]

Basis for and scope of post-breach inquiries

117 A breach of the thresholds gives the Commission a basis on which to investigate the business in question to determine whether the performance of the business warrants control. The extent to which the threshold is breached is one of the criteria the Commission may take into account in prioritising its duties under s 57K. Other criteria include the size and recent performance of the business, and the Purpose Statement in s 57E. Once a business has breached a threshold, the Commission may then decide to prioritise its investigation into whether or not the business should be controlled (paragraph 37 above).

118 In order to determine whether a business should be controlled, the Commission considers it should have regard to the overall conduct of the business, when considered in light of the Purpose Statement. Accordingly, the Commission is of the view that its basis for declaring control may be unrelated to the specific cause of the breach, where the Commission identifies behaviour that is inconsistent with the s 57E purpose.

119 The High Court, by upholding the Commission's ability to undertake a forward-looking inquiry,[50] supports the Commission's position that it can make a declaration of control for a reason that may be unrelated to the circumstances of the threshold breach(es) that led to the business being identified. (However, s 57E concerns would still need to be present). The Supreme Court also supported this position by recognising that thresholds are not necessarily indicative of individual s 57E concerns. It is at the final stage of the process, when examining a particular business, that the Commission is obliged to take into account all aspects of the statutory purpose of promoting efficiency that s 57E covers.[51]

120 The Commission considers that subpart 1 of Part 4A is clearly forward-looking. Section 57E provides that targeted control is "for the long-term benefit of consumers". Furthermore, Part 5 price authorisations made following a declaration of control would be made in relation to on-going prices. A business's future pricing proposals are therefore highly relevant to any declaration of control and it is appropriate therefore for

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48 ibid, para [60]. Justice Wild's observations in relation to section 57E were not disturbed by the Supreme Court in *Unison Networks Limited* v *Commerce Commission*, Unreported, SC/12/2007, 10 September 2007.

49 ibid, para [25].

50 HC, supra n 46, paras [171]–[174].

51 SC, supra n 48, para [69].

control decisions to be made in the light of such information. Control is not a backward-looking punishment for a threshold breach but a forward-looking measure to fulfil the s 57E criteria for the long-term benefit of consumers.[52]

121 In carrying out a post-breach inquiry and deciding whether or not to impose control on a lines business under Part 4A, the Commission considers whether the business was extracting excessive profits, or inefficient, or failing to share the benefits of efficiency gains with consumers over the period in which the breach occurred. If s 57E concerns are present, the Commission needs to consider whether price control, with its associated costs, is needed to ensure the s 57E goals are achieved.[53]

122 The Commission's investigation should end if the lines business demonstrates that none of the s 57E(a)-(c) concerns exist.[54] However, simply because a business's current performance is not consistent with the Purpose Statement, control is not necessarily the only remedy.[55]

Basis for Not Declaring Control

123 Consequently, the Commission considers that, in a general sense, control is not necessarily required to ensure that lines business performance and behaviour is consistent with the Purpose Statement. If the objectives of the Purpose Statement outlined in s 57E can be achieved by other means, then a declaration of control may be unnecessary. Such an outcome may arise, for instance, if compliance with the terms of an administrative settlement would achieve those objectives. Hence, the Commission considers it has the ability to enter into an administrative settlement with a business that has breached the thresholds, in order to further the objectives of the targeted control regime.

124 If, instead of making a declaration of control, the Commission decides to accept an administrative settlement in relation to a business that has breached a threshold, then that will involve the Commission deciding not to make a control declaration under s 57H(c) of the Act, and the Commission must publish its reasons for that decision under s 57H(d)(ii).

125 If an intention to declare control has already been published (i.e., a Stage 2 post-breach inquiry is underway)—as is the case with Vector—then the Commission considers that its decision whether to accept the settlement should be made in the context of that process. Hence, the Commission's reasons for not declaring control would need to explain why the Commission is satisfied that settling a post-breach inquiry is at least as advantageous as control in terms of achieving the objectives in the Purpose Statement.

Relevant Factual and Counterfactual for Evaluating Settlement Offers

126 As described above (paragraph 93), in forming an intention to declare control the Commission compares the likely outcomes under a scenario of control (i.e., the factual)

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52 Justice Wild accepted the Commission's submissions in this regard (HC, supra n 46, paras [167] and [174]).

53 ibid, para [70].

54 See: ibid, para [170].

55 See: ibid, para [70].

with a scenario representing the likely outcomes in the absence of control (i.e., the counterfactual). In assessing the benefits to consumers of an administrative settlement, the factual becomes the outcome under the settlement, and the "no control" situation remains a counterfactual scenario. Clearly acceptance and implementation of the settlement must be demonstrated to be preferable to the Commission taking no action at all.

127 In addition, as is implied by the preceding discussion, if the settlement offer is received after the publication of an intention to declare control (i.e., during a Stage 2 post-breach inquiry), then the factual of accepting the settlement should also be compared with possible outcomes under control. Control would therefore be transformed from a factual scenario in respect of an intention to declare control, to an additional counterfactual scenario in the context of evaluating the settlement.

128 The Intention Paper explained that the Commission is mindful not to incur unnecessary administrative and compliance costs by undertaking analysis that might not be particularly material to the decision required at a particular stage of a post-breach inquiry. The Commission considers that such a position is also relevant to the evaluation of an administrative settlement offer. Where a settlement offer is being assessed in the context of a prior intention to declare control, then the Commission will likely be able to draw on the analysis that has already been undertaken. Similarly, if an administrative settlement offer is received and considered before the Commission forms an intention to declare control (i.e., during a Stage 1 post-breach inquiry), then acceptance of a settlement might allow the Commission to reallocate significant resources from the post-breach inquiry to other workstreams.

129 Consequently, if the Commission's work has not yet undertaken a detailed building blocks analysis to identify the likely price path under control, then the Commission considers it may be appropriate in some circumstances—where investigation to that point indicates that there are no further issues warranting a more detailed analysis—for the counterfactual to relate to the prices necessary for the business not to breach the thresholds.

Net Benefits of Accepting and Implementing a Settlement

Net benefits of control

130 As discussed above (paragraphs 91-92), the potential benefits of control to consumers can arise from net gains in allocative, productive or dynamic efficiency, as well as transfers from the lines business to consumers (resulting from any excessive profits reduced by control). The direct costs of control include additional compliance and administrative costs from the imposition of control, and indirect costs may arise should control lead to inefficient behaviour. For instance, control could risk impacting productive or dynamic efficiency if there were not sufficient incentives to reduce costs should the business not be able to keep the benefits arising from efficiency gains for at least a period.

Reduced compliance and administrative costs from a settlement

131 While the same general types of benefits and costs are likely to be relevant to the implementation of an administrative settlement, in the Commission's view a settlement

differs markedly from control because it is initiated voluntarily on the part of the business concerned. Under an administrative settlement, the business itself takes responsibility for its performance and behaviour in a way that is consistent with the objectives of the targeted control regime, rather than the Commission being required to impose control on the business to ensure those objectives are met.

132 Because any settlement would be presented to the Commission on a voluntary basis, direct compliance and administrative costs are likely to be lower than under control, and the arrangement will be much less intrusive. Similarly, indirect costs are also likely to be lower, given the voluntary nature of the business's proposed actions. Therefore, a settlement may be preferable to control in a relatively light-handed regulatory regime such as the targeted control regime.

133 However, other factors to consider are whether the extent of the risk of non-compliance with the terms of the settlement, as well as whether business performance might be more difficult to monitor than under control and, if so, the possible impacts. If a business failed to fulfil the terms of the administrative settlement, the Commission would need to identify a further breach of the thresholds to be able to recommence the process in s 57H for making a decision on a declaration of control in relation to that business. Hence, the Commission considers it appropriate for settlements to be formalised through a deed. If the business concerned contravenes any of the provisions of that deed, then the Commission may in its discretion take the necessary steps to enforce the deed.

Efficiency implications

134 The Commission places significant weight on dynamic efficiency in comparison to the other dimensions of efficiency, given the importance of efficient investment to the long-term benefits of consumers, in light of the Purpose Statement. This is because, over time, under-investment increases the risk that a lines business may not be able to continue to provide services at a quality that reflects consumer demands. The importance of dynamic efficiency is similarly emphasised in the August 2006 GPS, which concerns the incentives of regulated businesses to invest in infrastructure. In particular, the GPS highlights the importance of regulatory stability, transparency and certainty for giving businesses the confidence to make long-lived investments (paragraph 56 above). On the other hand, the GPS also indicates that businesses ought to be held accountable for making investments where those investments have been provided for in regulated revenues and prices.

135 Where a business in breach of its existing price path threshold offers to comply with that threshold for the remainder of the regulatory period, and also to address any performance issues that led to the breach or any s 57E concerns which were identified by the Commission in its intention to declare control, it could be consistent with the Purpose Statement—and with an objective of regulatory stability and certainty—for the Commission not to control prices to a lower level. Such might be the case even if profits were to exceed the business's WACC range over the short term. This is because the price path threshold is intended to limit excessive profits, not to remove them entirely (paragraph 28 above).

136 As discussed above (paragraphs 29-31), businesses have an incentive to outperform the efficiency gains implied by their price path threshold because, throughout the five-year

regulatory period, businesses get to keep the additional profits which arise from any efficiency improvements that exceed those implied by their CPI-X price path. Allowing a distribution business to retain this higher level of returns also preserves the incentives for that business to make ongoing efficiency gains in subsequent periods.

137 As a result, consumers will benefit more because the level of efficiency gains available to be shared over subsequent regulatory periods—when the thresholds are reset—will be greater. Therefore, the long-term efficiency benefits to the consumers supplied by that business might outweigh any additional short-term benefits which could be realised by those consumers if controlled prices were lower than the existing price path threshold levels.

138 On the other hand, requiring profits to be shared more immediately than that implied by a business's X factor (i.e., before the end of the current regulatory period) may in some circumstances risk dampening future incentives for that business to invest and improve efficiency, thereby potentially reducing benefits to consumers in the longer term. This is because the business's profit expectations were based on the price path set at the outset of the period. Nevertheless, depending on the specific circumstances, the Commission might find that it would be consistent with the Purpose Statement to require profits to be shared sooner.

Indirect benefits from regulatory stability

139 The Commission notes that there are likely to be important signalling implications for the Part 4A regulatory regime from the various possible outcomes of an administrative settlement negotiation. Where a business commits to complying with its existing price path threshold for the remainder of the regulatory period, and any identified performance issues have been or will clearly be addressed, there may be significant indirect benefits from accepting and implementing a settlement as opposed to imposing control. This is because there may be positive impacts on both investment incentives and incentives to improve efficiency for the wider industry stemming from the regulatory certainty inherent in not varying from a medium-term (i.e., five-year) price path. Such indirect benefits to the industry as a whole may further outweigh any short-term benefits to the consumers of any single business from lower controlled prices.

Possible alternative outcomes

140 Nevertheless, what might be acceptable to the Commission as part of a settlement cannot be seen as a proxy for the terms on which control might subsequently be imposed, should a settlement not be able to be reached. In some circumstances, control will be justified, if outcomes consistent with the Purpose Statement cannot be achieved through other means. If there is no alternative but to impose control on a business, then it is possible that any excessive profits and/or efficiency gains over the current regulatory period would become shared with consumers earlier than the end of that period. However, incentives for future efficiency gains would still be preserved under control. Such incentives would be established once control is imposed as a result of setting the regulated price path for a reasonable number of years, thereby providing regulatory certainty in support of ongoing efficient capital and operating expenditure.

141 A different outcome might arise if the Commission's post-breach inquiry were to find evidence that the price path threshold is not of itself sufficiently high to maintain

appropriate investment incentives. As a result, the Commission might consider consulting on resetting the threshold upward (either on its own initiative, or as a consequence of evaluating a proposed settlement offer), even before the end of the current regulatory period.[56]

Views of Interested Parties

Basis for an intention to declare control

142 PwC's submission acknowledged its agreement with the Commission's Draft Decision Paper. However, PwC's submission primarily commented on the Commission's previously released Intention Paper. PwC submitted that the Commission's intention to declare control of Vector's electricity distribution services was, in its view, "out of line" with previous actions taken under the targeted control regime, and therefore created considerable regulatory uncertainty for all interested parties.

143 In particular, PwC suggested that, on the basis of guidance provided in the Commission's own Guidelines (paragraph 33 above), it would have been a "reasonable assumption" that "immaterial breaches" caused by factors outside a distribution business's control, and which are addressed by the business following the breach, should result in no further action by the Commission. PwC highlighted that the Guidelines indicate that in some circumstances—such as where the breach is due to a "technicality", or due to events not fully controllable by the business—the Commission may be satisfied that the breach does not warrant further investigation.[57]

144 PwC argued that Vector had fulfilled all of these criteria; yet, in PwC's view, the Commission published its intention to declare control in response to a single and immaterial breach of Vector's price path threshold. In addition, PwC submitted that the Commission's conclusions were drawn from information which had nothing to do with Vector's price path threshold breach, such as information concerning beneficial pricing to consumers who are also shareholders. In PwC's view, doing so was a significant difference from the approach taken by the Commission in the Unison intention to declare control.

145 The Commission emphasises that the Guidelines explain that, in such circumstances, it *may* be satisfied the breach does not warrant further investigation. This particularly might be the case where the information available is sufficient to determine that taking further action would not be consistent with the long-term interests of consumers.[58] In prioritising whether to select Vector for further investigation, in a manner consistent with s 57K of the Act, the Commission took into account that, despite the extent of Vector's breach of the initial price path threshold being relatively small, Vector is the largest electricity distribution business in New Zealand, with its performance affecting around one-third of all electricity consumers (paragraph 79 above). Vector had also breached the initial quality threshold.

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[56] For instance, in response to an administrative settlement offer from Transpower, the Commission has recently decided to reset Transpower's thresholds (Commerce Commission, supra n 18).

[57] Commerce Commission, supra n 9, paragraph 55.

[58] ibid, paragraph 56.

146 As is explained above (paragraphs 117-123), a breach of the thresholds simply provides the statutory authority for investigating whether the business's performance, in light of the Purpose Statement, warrants control. In Vector's case, the company had breached both the price path and quality thresholds as at 31 March 2004, and therefore the Commission had the statutory basis to first investigate whether any s 57E concerns were present at the time of the breach, and second to consider whether control might be an appropriate means to address those concerns. The Commission has investigated the circumstances of Vector's breaches of the initial thresholds.[59] However, the Commission emphasises that the key issue is therefore not whether the business is addressing the circumstances of the *breach*, as was submitted by PwC. Rather, the key issue is whether the business is addressing any identified *s 57E concerns*, and this may result in considering information in addition to that associated with the breach.

147 For Vector, this included information on the company's pricing policies. The Commission highlights that similar information regarding differential pricing policies to consumer owners was taken into account as part of the Commission's intention to declare control of Unison.[60] As such, the Commission does not agree with PwC that there was a significant difference between the Unison and Vector post-breach inquiries in respect of the information taken into account by the Commission.

148 Furthermore, the Commission published its intention to declare control of Vector after concluding that, based on the available evidence and analysis: (a) Vector was not appropriately addressing the identified s 57E concerns, despite having been given significant time to do so, and (b) control would result in long-term benefits to consumers (paragraphs 79-88). Hence, the Commission considers that its actions in relation to Vector have been consistent with its Guidelines, as well as with the guidance that has emerged from the case law on the implementation of the targeted control regime to date.

149 Nevertheless, the Commission acknowledges PwC's submission regarding the importance of regulatory certainty. While such certainty only develops over time, the Commission has previously indicated its intention to update its Guidelines as experience with implementing the regime is gained. The Commission also observes that many of the proposed changes to the regulatory provisions in the Commerce Act are intended to promote regulatory certainty over the longer term.[61] Irrespective of whether the Bill is enacted, the Commission proposes consulting further on various measures to promote certainty concerning the way in which it exercises its regulatory powers relating to electricity distribution businesses under the Commerce Act.[62]

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59 Commerce Commission, supra n 4, paragraph 155. Also refer paragraph 72 above.

60 Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Intention to Declare Control, Unison Networks Limited*, 9 September 2005, paragraph 274.

61 Refer footnote 14 above.

62 For instance, the Commission has already proposed measures such as *ex ante* investment reviews for the purpose of setting "customised thresholds" as one possible approach for promoting regulatory certainty and investment incentives, in the event that the regulatory provisions in the Commerce Amendment Bill are not implemented (e.g., Commerce Commission, *Regulation of Electricity Lines Businesses, Targeted Control Regime, Threshold Reset 2009, Discussion Paper*, 19 December 2007, paragraph 356).

Incentives provided by the thresholds

150 PwC's submission also argued that the intention to declare control of Vector was contrary to the principles underpinning the thresholds, whereby businesses have incentives to achieve efficiencies because they can retain some of those benefits in the short term. PwC submitted that the intention to declare control was based on an estimate of excess returns projected to be earned over the remainder of the regulatory period, despite Vector performing within the price path threshold set by the Commission for Vector during that period. Hence, in PwC's view, the Intention Paper focused on profits achieved within the threshold period but which resulted from behaviour consistent with complying with the thresholds. Furthermore, in its submission, PwC challenged the Commission to consider factors other than excess profits when considering what action to take following a threshold breach (such as efficiency, prices, quality and sharing benefits) given that, in PwC's view, calculations of excess profits are "problematic" and "subject to considerable debate and challenge".

151 The Commission highlights that the level of Vector's returns was not the primary basis for the intention to declare control and was not the only s 57E concern which the Commission identified. The key s 57E concern related to inefficiencies inherent in Vector's pricing structure (paragraph 86 above), and is being addressed through the Commission's settlement with Vector (paragraph 237). When the intention to declare control was published, control of Vector's electricity distribution services was seen as, among other things, potentially bringing benefits to consumers in respect of pricing, efficiency and service quality (paragraphs 94-100 above).

152 Nevertheless, as the Commission outlines above (paragraphs 135 and 139), where a business commits to complying with its existing price path threshold for the remainder of the regulatory period, and any identified performance issues are being addressed, there may be significant benefits from accepting and implementing a settlement as opposed to imposing control. Consequently, the Commission considers that its framework for evaluating administrative settlements appropriately takes account of PwC's views regarding the incentives provided by the thresholds, and that its decision not to declare control of Vector is consistent with this framework.

Summary

153 In sum, the Commission considers the following factors are relevant to assessing the net benefits to consumers from implementing an administrative settlement:

- net changes in dynamic/productive/allocative efficiency, including impacts on service quality;
- the potential for even greater benefits available to be shared with consumers when the thresholds are reset as a result of maintaining regulatory commitment to a medium-term price path, as long as the business concerned commits to addressing any performance issues that led to the breach and/or any s 57E concerns which were identified by the Commission in its intention to declare control;
- indirect benefits to the industry as a whole, where investment incentives are maintained through regulatory stability over the medium term;

- direct benefits from transfers to consumers, primarily resulting from the settlement reflecting a lower level of returns than would be the case if the Commission took no further action;
- any foregone short-term benefits to consumers stemming from a settlement that transfers a smaller proportion of excess returns to consumers than would control;
- direct and indirect benefits from the comparatively lower compliance costs and less intrusive nature of implementing a settlement versus imposing control; and
- any detriments to consumers associated with the risk of non-compliance by the business with the settlement terms.

EVALUATION OF VECTOR'S SETTLEMENT OFFER

154 This section details the terms of Vector's administrative settlement offer of 23 January 2007 (Offer) and the Commission's evaluation of those terms. It also includes the Commission's net benefits assessment of accepting the Offer, compared with imposing control, or alternatively, taking no further action.

Overview of Vector's Offer

Scope of the Offer

155 Vector's Offer is made in respect of the company's breaches of its price path and quality thresholds during the year ending 31 March 2004.[63] Vector does not seek to resolve its 2006 quality breach under the terms of the Offer or its threshold breaches in 2007 (which have occurred since the Offer was submitted to the Commission).

Customer group pricing

156 The key element of Vector's Offer is that it will undertake to make price adjustments to remove the significant over-charging of consumers across its regions and customer groups before 1 April 2009. Vector's Offer involves implementing price changes to achieve half the necessary rebalancing (in distribution revenue terms) for each customer group in each of the two years of the settlement period (i.e., the years beginning 1 April 2007 and 1 April 2008).[64] Although the Offer is made in respect of the period ending 31 March 2009, if any residual rebalancing is required to achieve the forecast target returns, Vector intends achieving these through a further round of price changes on 1 April 2009.[65]

Overall revenue

157 Under the Offer, Vector's proposed price adjustments are to occur within its existing price path threshold. Although the rebalancing is to be undertaken on a revenue neutral basis, in respect of distribution revenue, the revenue from the overall line charges faced by each customer group will also cover pass-through costs (of which the most significant are transmission charges) as well as changes in the CPI, consistent with Vector's CPI-0% price path threshold. Revenue changes also occur as a result of demand growth, given that the price path threshold acts on average *prices* rather than revenues.[66] (As a result, distribution businesses face both the upside benefits and downside risks of changes in demand).

158 The Commission notes that, unlike Unison—which increased its line charges by a significant percentage above the price path threshold—Vector's 2004 price path threshold breach occurred as a result of small variances between its actual and forecast pass-through costs (paragraph 66 above). Furthermore, Vector's required price adjustments and forecast target returns have been based on continuing to apply a 25 basis point (i.e., 0.25%) buffer to its forecasts of the CPI (paragraph 67 above) to ensure

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63 Vector, supra n 5, clause D.
64 ibid, clause 2.
65 ibid, clause 11.
66 ibid, pp 5 and 7.

ongoing compliance with the price path threshold over the settlement period (to the extent practicable given the need to set revenue targets based on forecasts of the CPI and forecasts of pass-through costs).

Efficiency gains and investment incentives

159 In the Offer, Vector acknowledges the price path threshold was set to encourage efficiency gains and to provide incentives for investment. Vector notes that its investment programme to date and its asset management plans have been predicated on the basis of its existing thresholds which apply from April 2004 to March 2009. Consequently, Vector's Offer states that the company will continue this investment programme, and accordingly the company commits to continuing to provide a secure, reliable and safe electricity supply in its Auckland, Northern and Wellington distribution networks.[67]

160 The Offer notes that, while complying with the price path threshold, Vector has been able to increase its capital and maintenance expenditures significantly. For instance, in the year prior to Vector's acquisition of UNL (paragraph 58 above), UNL's combined capital and maintenance expenditure on the Wellington and Northern networks was about $34 million. In the 12 months ending June 2006, Vector spent $107 million on those networks, and this is projected to increase further in subsequent years. Vector states that, under the terms of the Offer, its capital expenditure requirements for its electricity distribution business will not be compromised in seeking to deliver sound consumer reliability and security outcomes.[68]

161 Moreover, the Offer states that Vector will continue to seek efficiency gains in its electricity distribution business, with the expectation that the Commission will consider whether and how these efficiency gains should be shared with consumers at the threshold reset.[69]

Service quality

162 As noted above (paragraph 99), irrespective of Vector's past quality threshold breaches, the Commission considered it had sufficient grounds for forming an intention to declare control of Vector's electricity distribution services based on Vector's recent pricing behaviour alone. This was particularly the case given that Vector had not attempted to justify its pricing behaviour on the basis of improving service quality.

163 Vector's Offer acknowledges that the company will remain subject to its existing quality threshold. Vector expresses its commitment to operating and maintaining its electricity networks to achieve the reliability targets specified in its quality threshold. Vector does however note that, in any given year, Vector might not achieve these targets as a result of events beyond Vector's control, such as extreme weather events.[70]

164 Despite that not all of Vector's reliability performance in 2003/04 has been able to be explained through a desktop analysis of the impact of extreme events (paragraph 72 above), the Commission considers it is appropriate for the Offer to be made in respect

[67] ibid, clause 5.
[68] ibid, p 18.
[69] ibid, clauses 5 and 13.
[70] ibid, clause 12.

of both Vector's price path and quality threshold breaches in 2004 (paragraph 155 above). The Commission will still be able to consider Vector's quality performance further as part of its assessment of Vector's 2006 and 2007 quality threshold breaches, consistent with the approach applied for other distribution businesses.

Customer Group Pricing Proposals

Overall approach

165 As explained above (paragraph 156), Vector's Offer involves price changes on 1 April 2007 and 1 April 2008 to achieve revenue rebalances in two equal steps (on a forecast basis), in order that the returns for each customer group in each geographic region are less than or equal to Vector's target returns for the year ended 31 March 2009. Given that there are seven customer groups in each of the three network regions of Auckland, Northern and Wellington, there are 21 customer groups in total. The forecast target returns in percentage terms—which are on an attributed ODV base—include a 1.5% differential between residential and commercial/industrial customer groups (paragraphs 176-183 below), and the forecast revenues associated with these target returns are derived from Vector's Cost of Supply (COS) model (paragraphs 170-175 below).

166 Vector's COS model establishes the level of distribution revenues needed to equate with costs (including the target returns) for each of the 21 customer groups for the year ending 31 March 2009, based on forecast costs, demands, and so on, for that year (i.e., 2008/09). Vector has then worked backwards to determine the revenue changes for each customer group that would be needed on 1 April 2007 and 1 April 2008, in order to achieve the forecast revenues for 2008/09 derived from its COS model, in two equal stages. Hence, Vector's COS model has not been directly used to establish the target revenues in the Offer for 2007/08. Rather, 2007/08 was a transitional year during which Vector intended achieving half of the required rebalancing in revenue terms.[71]

Pricing principles

167 Vector's approach to developing its COS model and its overall pricing strategy has been to support improved cost-reflectivity in prices, so that customers face price signals that better reflect the costs of supply. This principle not only applies to the average price levels for each customer group, but to the individual tariff structure as well, where practicable. For example, Vector has introduced on-peak tariff structures for large industrial consumers in all three of its regional networks, in order to reward those consumers which reduce demands during morning and evening peaks. Vector has also started taking into account differing service quality levels through the introduction of "service charters" for different customer categories. These involve specifying service charter payments that provide consumers with compensation in the event that certain quality targets are not met.

168 Vector considers that its taking into account these factors in its pricing strategy aligns with relevant objectives in the October 2006 GPS on electricity governance,[72] namely that:

- energy and other resources are used efficiently;

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71 Vector, supra n 6, pp 11-12.
72 New Zealand Government, supra n 19.

- risks (including price risks) relating to security of supply are properly and efficiently managed;
- incentives for investment in generation, transmission, lines, energy efficiency, and demand-side management are maintained or enhanced and do not discriminate between public and private investment; and
- the full costs of producing and transporting each additional unit of electricity are signalled.

169 The Commission notes that another relevant objective in the October 2006 GPS is that "delivered electricity costs and prices are subject to sustained downward pressure". More generally, however, the Commission's preliminary view is that the following principles, which are consistent with the Purpose Statement, are applicable for the efficient pricing of those services (such as electricity distribution services) which have natural monopoly characteristics:

- the overall level of revenue should be such that firms are limited in their ability to extract excessive profits. However, revenue should also be sufficient to provide some reward to businesses for investment and operating efficiencies;
- the stand alone and incremental costs associated with supplying services to any combination of consumers will usually be expected to provide necessary, but not sufficient, bounds on subsidy-free and efficient levels of revenue;
- efficient prices depend not just on costs, but on consumer demand (including service quality) as well. For example, where one group of consumers is less price-responsive than another group of consumers of the same service, then—all other things being equal (including service quality levels)—one would expect the prices of the less price-responsive consumers to be higher. On the other hand, one would not expect consumers with largely similar cost, demand and quality characteristics to face markedly different prices; and
- to the extent that costs are marginal, the associated price components should reflect those marginal costs, where practicable.[73]

Cost of Supply (COS) model

170 The Commission observes that Vector's COS model has been progressively enhanced over time through a range of major and minor refinements, particularly in terms of disaggregation. For example, one of the more significant refinements was the move to 21 customer groups—for the purposes of tariff rebalancing—from the previous nine customer groups (i.e., Residential, Commercial and Industrial groups, in each of the three regional networks). Prior to April 2007, this "three by three" approach had been based on Vector's view at the time that the integrity of some of the data in earlier versions of its COS model was questionable at the 21 customer group level, particularly in respect of the coincident peak demand and kWh volume data provided by electricity retailers.

[73] For example: Commerce Commission, *Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Draft Decisions Paper*, 4 October 2007, paragraph 1227.

171 This increase in the number of customer groups may, among other factors, have contributed to some of the apparent reversals in rebalancing progress that occurred between 2005/06 and 2006/07 (paragraphs 82-84 above). However, the Commission highlights that, even at the nine customer group level, there were already significant differences in the returns being contributed by different groups, with the largest differences existing within Vector's original Auckland network. For instance, Vector had estimated that, for 2003/04, the returns contributed by its Auckland Residential customer group and its (combined) Auckland Industrial customer group were 2.3% and 33.5%, respectively.[74] Also, a number of the subsequent changes from 2004/05 to 2006/07 in derived returns at aggregate level (e.g., for the Wellington network as a whole) did not appear to have demonstrated substantive progress in the tariff rebalancing programme.

172 The COS model underpinning Vector's Offer allocates costs, and apportions asset value (based on ODV), to each of its 21 customer groups. Key cost categories in the COS model are: transmission charges, maintenance and operations (i.e., direct costs), administration (i.e., indirect costs), depreciation, tax and the interest tax shield,[75] as well as return on investment. Key cost drivers used to allocate these costs to each customer group include:

- coincident peak demand (e.g., transmission charges);[76]
- accumulated depreciation—based on the difference between optimised replacement cost (ORC) and ODV—thereby reflecting asset age (e.g., direct costs);
- ORC (e.g., depreciation); and
- number of connections—ICPs (e.g., indirect costs).[77]

173 The ODV (and ORC) values attributable to each customer group are found by using a combination of coincident peak demand and an "asset utilisation factor", given that capital costs are causally related to peak demands. Asset utilisation factors are determined for every asset in Vector's asset register, and represent Vector's estimates of

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74 Vector's calculations for 2003/04 were undertaken on a different ODV base from those presented in Table 1 above, given that Vector subsequently revalued its assets as at 31 March 2004 using the Commission's ODV Handbook of August 2004. Nevertheless, Vector's view was that this ODV revaluation, which was being undertaken at the time, would not materially affect the relativity in the return on ODV between customer groups.

75 The tax allocated to each customer group is a derived figure calculated from the other cost categories.

76 The coincident peak demand for each customer group is calculated by dividing the electricity volumes (i.e., kWh) consumed by each customer group, by the load factor estimated for that group.

77 Apart from its electricity distribution business, Vector is involved in other regulated activities (e.g., gas distribution) and non-regulated activities. Vector allocates its overall level of indirect costs to its electricity distribution business in accordance with the avoidable cost allocation methodology (ACAM) set out in the Electricity Information Disclosure Requirements 2004 (Requirements), and which have been grandfathered from the Electricity (Information Disclosure) Regulations. The Commission has indicated that it considers the current application of ACAM in the Requirements is not appropriate, and that it intends undertaking a substantial review of an appropriate common cost allocation method in the context of changes to the information disclosure regime for electricity lines businesses. However, given that Vector's Offer involves complying with its existing price path threshold for the remainder of the current regulatory period, there is no need to undertake a review of Vector's overall approach to allocating indirect costs to its electricity distribution business. On the other hand, had the Commission decided to declare control of Vector's electricity distribution services, it would likely have undertaken a detailed review of the level of indirect (and other) costs attributable to those services.

the proportion of that asset employed in supplying each customer group. These factors act to segregate assets from customer groups that either do not use those assets, or only use them in part. The coincident peak demand of each customer group is then used to weight the value of assets that have been allocated to that group in accordance with the relevant utilisation factors. (Further details on Vector's assumptions underpinning its COS model were released as part of the consultation package on the Draft Decision Paper).[78]

174 Vector notes that it is aware of work undertaken by the electricity distribution industry's Pricing Approaches Working Group (PAWG), and notes that PAWG's final paper is currently being reviewed by the Electricity Commission.[79] The Commission observes that the PAWG guidelines are relatively prescriptive in comparison to guidelines for electricity (or gas) distribution issued by regulators in Australia.[80] For the purposes of this administrative settlement, the Commission considers that the principles and assumptions underpinning Vector's COS model are reasonable, given Vector's circumstances at this point in time. In the Commission's view, that model is broadly consistent with the high-level principles proposed by the Commission (paragraph 169), derived by the industry itself, and set out in the October 2006 GPS, and implemented in a manner reflecting Vector's business-specific factors.

175 As the Commission noted in its final decisions on the Unison administrative settlement, wider consultation on distribution pricing methodologies (including guidelines on developing COS models) will be appropriate in the context of the Electricity Commission's work on developing consistent and common distribution pricing guidelines (or regulations, as necessary) for the electricity distribution industry.[81] In the meantime, the Commission does not intend mandating or prescribing a particular pricing methodology for Vector in the context of its administrative settlement (or for other electricity distribution businesses). Rather, the Commission is seeking to ensure that the voluntary proposals set out by Vector itself are consistent with high-level principles for efficient pricing, and are able to be tested and made transparent through consultation with interested parties.

Target return differentials

176 As noted above (paragraph 165), Vector's target returns on ODV, in percentage terms, involve a 1.5% differential between residential and commercial/industrial customer groups, which have target returns of 8.1% and 9.6% respectively. In Vector's COS model, these target returns have been determined on a post-tax nominal basis calculated

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78 Vector, supra n 6, pp 4-12.

79 Pricing Approaches Working Group, *Model Approaches to Distribution Pricing, Second Paper,* 2 February 2005. PAWG was funded by the Electricity Networks Association (ENA) and was established in response to a request from the Minister of Energy for the industry to establish model approaches to distribution pricing. The February 2005 report was submitted to the Electricity Commission following comments from distribution businesses, retailers and consumer representatives on an earlier draft (August 2004), given that the Electricity Commission is expected to develop principles and model approaches to distribution pricing (October 2006 GPS, paragraph 98). The Commission notes that PAWG's recommendations formed the starting point for the COS model which underpins Unison's administrative settlement with the Commission. However, Unison used a number of different cost drivers and allocators from those in PAWG's recommendations: Commerce Commission, supra n 45, paragraph 4.14.

80 For example: Meyrick and Associates, *Gas Distribution Pricing Principles,* Report Prepared for New Zealand Commerce Commission, 6 November 2007, sections 2.2 and 5.

81 Commerce Commission, supra n 17, paragraph 4.93.

in accordance with NZ GAAP requirements (in force at the time the current thresholds were set).

177 The Commission notes that, as was the case for the Unison administrative settlement, such targets are relevant solely for cost allocation purposes within the COS model, and are not directly comparable with Vector's weighted average cost of capital (WACC). For the purposes of tariff rebalancing, which Vector is undertaking on a revenue neutral basis (paragraph 157 above), the absolute magnitude of the target, and the basis for the calculation, is not as important as the application of consistent principles and a consistent approach to cost allocation across all customer groups.[82]

178 At the time the Intention Paper was published, Vector was proposing a target return differential between residential and industrial/commercial consumers of 2.6% (paragraph 96 above). At the time, the Commission noted that one possible justification for an apparently higher level of derived returns between customer groups might be if one group of consumers were to have a more inelastic demand than other groups. However, Vector's COS model did not appear to take into account differences in the elasticity of demand between customer groups. While, in the Commission's view, this was not an unreasonable approach to take, given the difficulty in practice of sourcing accurate data on price elasticities of demand, no alternative evidence was provided by Vector in support of its proposed differential of 2.6% in target returns.[83]

179 In the Offer, Vector justifies the relatively lower target return for residential consumers on the following grounds.

- *Commercial and industrial consumers have a higher level of service quality*. During a supply outage Vector prioritises its fault restorations so that industrial and commercial consumers are restored first, recognising that the literature on surveys of consumer willingness to pay for quality indicates industrial and commercial consumers are most adversely affected by outages. In addition, if the system operator requires Vector to shed load to manage transmission or generation constraints, residential loads are curtailed first.
- *Commercial and industrial consumers have a higher risk profile*. In Vector's view, commercial and industrial consumers tend to be serviced by a greater level of consumer-specific assets than residential consumers, and these may become "stranded" if the consumer exits, relocates or changes demand. Although some of these risks can be mitigated through multi-year contracts, Vector highlights that such contracts are relatively short when compared to the lifetimes of such assets.[84]

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82 For example: Commerce Commission, supra n 45, paragraph 4.21. Also, it is important to note that the target return calculation can be very sensitive to minor changes in variables that have a large base. For example, Vector's target returns in the Offer are higher by 0.5% than the targets in the original offer of October 2006 (paragraphs 103-104 above). The current targets are derived from an updated COS model which uses actuals instead of forecasts, where these have since become available. Vector has informed the Commission that, although actual revenue and ODV were within 1% of their forecasts for 2006, the impact on the target return in the COS model (in percentage terms) was compounded by the numerator and denominator of the target return calculation moving in opposite directions. Despite the targets being higher, in both the original offer and the current Offer the targets were set by Vector to ensure compliance with its existing price path threshold given a 25 basis point buffer (paragraph 144 above).

83 Commerce Commission, supra n 4, paragraphs 190-192.

84 Vector, supra n 5, pp 17-18. The Commission notes that Unison, in its administrative settlement, assumed the same target returns for all its customer groups in its COS model. However, Unison explained that this

180 In the Intention Paper the Commission noted that, because the financing costs of Vector's business are incurred at the whole-of-business level, there would appear to be no rationale for a different cost of capital to be associated with different customer groups.[85] However, the Commission observes that, in respect of Vector's current justification for a higher target return to address the risk of asset stranding, the higher return effectively acts as a proxy for greater cashflows that would arise from accelerated depreciation of assets which might become stranded, rather than reflecting any systematic factor affecting the cost of capital.

181 Apart from the above reasons relating to asset stranding and service quality, Vector also notes that, from a practical perspective, cost of service models necessarily have to simplify some aspects of reality.[86] For example, some assets only exist to provide additional security and redundancy for commercial and industrial consumers, even though those assets are often shared by residential consumers. Hence, Vector considers that introducing a returns differential between residential consumers and other consumers attempts to ensure that costs are not over-allocated to residential consumers.

182 The Commission acknowledges Vector's view that cost of supply models need to simplify some aspects of reality.[87] For instance, some customer groups with low demand that are classified as industrial/commercial consumers may have similar demand and service quality characteristics as residential consumers. However, determining a different target return for each of the seven customer groups might over-complicate the COS pricing model. The issues associated with appropriately allocating different costs, demand characteristics and service quality levels to various customer groups is a complex task, and different assumptions on cost allocators will inevitably result in different derived returns. In light of this complexity, the Commission considers that narrowing the return differential from 2.6% to 1.5% is reasonable, particularly given the possible variation in derived returns that would likely result from applying different COS model assumptions.

183 As with its preliminary view on Vector's overall COS model, the Commission considers that Vector's proposal to use different target returns is reasonable for the purposes of this settlement, given Vector's circumstances at this point in time. However, the Commission highlights that this is another issue which would be appropriate to consult on further in the context of the Electricity Commission's work on developing consistent and common electricity distribution pricing guidelines (paragraphs 174-175 above).

184 In sum, the Commission considers that the steps which Vector is proposing—and has almost entirely implemented already (paragraphs 198-200 below)—will, by April 2009, remove the large disparities which have been prevalent in Vector's line charges, and which were clearly inconsistent with efficient pricing principles. While there is always room for debate on the appropriate cost allocators to apply in any COS model, it is apparent that in developing its model Vector has been mindful that legitimate factors for differentiating prices on an efficient basis include cost, demand and service quality (paragraphs 167, and 170-173 above).

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approach was for pragmatic purposes, and it expressed a similar view to Vector concerning the likely impact of asset stranding: Commerce Commission, supra n 17, paragraph 4.95.

85 Commerce Commission, supra n 4, paragraph 162.

86 Vector, supra n 5, p 17.

87 ibid, p 17.

Proposed revenue and price adjustments

185 Based on its COS model, its target returns, and its decision to implement the revenue changes in two equal stages, Vector estimated the revenue changes and associated price adjustments needed for each customer group to contribute its target return by 31 March 2009. Table 2 below shows the forecast revenue changes and average price changes (in $/ICP) for each customer group for the 2007/08 and 2008/09 years under the Offer. Table 3 also presents the estimated returns, including the "interim milestone" returns in the transitional year of 2007/08. Because the price changes have been intended to implement 50% of the change in revenue terms, the interim milestone returns are not necessarily halfway points between the 2006/07 and 2008/09 returns, given year-to-year variations in costs and so on.[88]

Table 2: Estimated Average Price Adjustments by Customer Group[89]

Customer Group	2007/2008				2008/2009			
	Average Distribution Charge Change ($/ICP)	Average Distribution Charge Change (%)	Average Line Charge Change ($/ICP)	Average Line Charge Change (%)	Average Distribution Charge Change ($/ICP)	Average Distribution Charge Change (%)	Average Line Charge Change ($/ICP)	Average Line Charge Change (%)
Auckland								
Unmetered	64	3.3	107	6.0	62	3.3	154	8.0
Residential	60	11.2	71	15.0	58	11.2	83	15.0
Small Commercial	-188	-8.0	-128	-6.0	-183	-8.0	-67	-3.0
Medium Commercial	435	5.9	819	12.0	427	5.9	801	10.0
Large Commercial	-2,343	-17.1	-1,926	-14.0	-2,298	-17.1	-1,620	-14.0
Small Industrial	-5,608	-12.8	-4,355	-10.0	-5,496	-12.8	-3,353	-9.0
Large Industrial	19,367	13.0	21,724	15.0	19,075	13.0	25,603	16.0
Wellington								
Unmetered	-18	-0.1	1,271	8.0	-17	-0.1	657	4.0
Residential	-18	-2.9	-5	-1.0	-18	-2.9	4	1.0
Small Commercial	-544	-23.5	-556	-25.0	-539	-23.5	-457	-27.0
Medium Commercial	-2,560	-12.5	-1,312	-7.0	-2,524	-15.5	-1,748	-10.0
Large Commercial	-7,744	-20.3	-5,805	-16.0	-7,616	-20.3	-6,170	-20.0
Small Industrial	-9,222	-13.2	-7,111	-11.0	-9,222	-13.2	-6,611	-11.0
Large Industrial	-5,069	-2.5	-4,552	-2.0	-5,069	-2.5	1,517	1.0
Northern								
Unmetered	3,034	28.0	2,959	28.0	2,993	28.0	3,517	26.0
Residential	49	8.5	64	12.0	48	8.5	74	13.0
Small Commercial	-46	-3.9	-11	-1.0	-45	-3.9	10	1.0
Medium Commercial	-109	-1.1	424	5.0	-107	-1.1	355	4.0
Large Commercial	-7,079	-33.6	-6,252	-30.0	-6,987	-33.6	-5,961	-42.0
Small Industrial	-6,107	-14.1	-4,886	-12.0	-6,009	-14.1	-4,169	-11.0
Large Industrial	11,869	5.6	15,957	8.0	11,869	5.6	21,174	10.0

88 ibid, p 6.

89 Derived from Tables 4-6 of Vector's Offer (ibid, pp 8-9), using ICP values also provided by Vector (supra n 6, Tables 9-11 and Tables 13-15). Average Line Charge Changes include the effects of the CPI, pass-through costs and growth in addition to the Average Distribution Charge Changes (paragraph 157 above).

Table 3: Vector's Forecast Returns on ODV by Customer Group[90]

Customer Group	2006/07 (forecast)	2007/08 (interim milestone)	2008/09 (target)
Auckland			
Unmetered	9.1%	9.3%	9.6%
Domestic	5.0%	6.9%	8.1%
Small Commercial	13.0%	11.3%	9.6%
Medium Commercial	8.1%	8.9%	9.6%
Large Commercial	18.3%	13.8%	9.6%
Small Industrial	15.5%	12.5%	9.6%
Large Industrial	7.1%	8.0%	9.6%
Wellington			
Unmetered	9.0%	9.7%	9.6%
Domestic	9.3%	9.1%	8.1%
Small Commercial	30.0%	19.6%	9.6%
Medium Commercial	16.4%	13.1%	9.6%
Large Commercial	23.1%	16.5%	9.6%
Small Industrial	17.4%	13.6%	9.6%
Large Industrial	10.5%	10.4%	9.6%
Northern			
Unmetered	3.5%	6.4%	9.6%
Domestic	5.2%	6.6%	8.1%
Small Commercial	11.7%	10.3%	9.6%
Medium Commercial	10.2%	9.8%	9.6%
Large Commercial	45.0%	25.9%	9.6%
Small Industrial	20.1%	13.6%	9.6%
Large Industrial	7.6%	8.6%	9.6%

186 The Offer provides for Vector to elect not to implement any required price *increase* for any individual consumer or customer class for any reasons, including if that price increase would be likely to cause disconnections or undue hardship for the consumer(s). In such a situation, Vector maintains not to recover the associated revenue reduction from other consumers. The Offer makes it clear that this provision does not affect Vector's obligation to reduce prices where such reductions are required as part of the rebalancing process.[91] Among other things, this proposal recognises that Vector has a number of industrial and commercial customers on individual contracts with fixed prices, and it may not be possible to increase prices to those consumers during the settlement period.[92]

187 The Offer also provides for these forecast return targets to be revised, prior to price changes being made each year, as a result of updating the COS model with audited financial results, and also for revised CPI and pass-through cost forecasts.[93] For example, such an updating of the COS model with actual results occurred prior to the price changes made on 1 April 2007 (paragraph 104 above).

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90 Derived from Tables 1-3 of Vector's Offer (Vector, supra n 5, p 6).
91 ibid, clause 4.
92 ibid, p 14.
93 ibid, clauses 2 and 10.

188 The Offer outlines the process by which Vector would seek the Commission's agreement to make any revision to the parameters behind the necessary price adjustments. If Vector considers that revisions are needed, it will:

- advise the Commission in writing of the need for the proposed revision;
- provide the Commission with reasons and evidence for the proposed revisions;
- advise the Commission how the proposed revisions will affect the rebalancing process and future price changes; and
- only implement the proposed revision if the Commission has agreed that the revision is required.[94]

189 Also, as noted above (paragraph 156 above), if any residual rebalancing is still required to achieve the forecast target returns, Vector will achieve these through a further price change on 1 April 2009 in a manner forecast to complete the rebalancing process by 31 March 2010.[95]

190 The Commission considers that the proposed price adjustments contained in the Offer would remove the current pricing imbalances by 1 April 2009, subject to any minor residual rebalancing still required as a result of differences between forecasts and actuals. Also, the Commission agrees with Vector's proposal to achieve the rebalancing through equal stages over two years. A number of the current imbalances are substantial, and therefore it is sensible not to attempt to implement the necessary adjustments all in one year. However, with the exception of any residual rebalancing that might still be required, the Commission does not favour allowing Vector more than two years to achieve its rebalancing programme. This is because Vector already had two years (over 2005 and 2006) to address the inefficiencies in its distribution prices,[96] and because the Commission considers it is appropriate for the issue to be resolved before the thresholds are reset.

Monitoring Compliance with the Settlement

Proposed compliance provisions

191 Under the terms of its Offer, Vector commits to providing evidence and information to the Commission detailing the implementation of the required price adjustments. Such evidence will be supported by auditor's certificates. In particular, Vector commits to providing two auditors' certificates during each year of the Offer.

192 First, Vector would submit to the Commission an auditor's certificate by 31 May of each year, confirming that Vector made the required price adjustments on 1 April of that year for each customer group as set out in its settlement.[97]

193 Second, Vector will provide a second auditor's certificate by 30 November each year confirming that:

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94 ibid, clause 9.
95 ibid, clause 11.
96 Vector's Offer records that its revenue rebalancing process began in May 2005 (ibid, clause C and p 13).
97 ibid, clause 6.

- Vector's COS model has been updated to incorporate actual financial results for the previous year and updated forecasts as appropriate;
- Vector calculated proposed price changes for the following year using the updated COS model; and
- the proposed price changes for each customer group are forecast to achieve the revenue rebalances as set out in the settlement.[98]

194 In addition to these certificates, Vector would also provide the Commission with a representative sample of prices and price changes from each customer group by 30 November each year, to demonstrate that the price changes are consistent with the revenue rebalances set out in the settlement.[99] Also, in the event that some residual rebalancing is still required by April 2009 (paragraph 189 above), Vector would remain subject to its commitment to provide an auditor's certificate by 30 November 2010 stating the effect of the residual rebalancing.[100]

195 The Commission considers that the proposed auditing and information provision processes proposed in the Offer are sufficient for it to adequately monitor Vector's compliance with the terms of the settlement. As noted above, any proposed changes to the price adjustments resulting from the actual financial results would be subject to the Commission's agreement.

196 In addition, the terms of the settlement have been formalised in a Settlement Deed signed by Vector and the Commission. The Deed contains provisions for monitoring compliance with the settlement terms, and the Commission in its discretion may seek to enforce the Deed.

197 The Commission also intends continuing to perform annual reviews of Vector's Asset Management Plans disclosed under the Electricity Information Disclosure Requirements. While Vector's investment incentives would be preserved through the settlement, such monitoring would also assist in making Vector accountable in respect of its commitment under the settlement to provide a secure, reliable and safe electricity supply in its three distribution network areas by investing at the necessary level (paragraph 159 above).

Implementation of Vector's Offer to date

198 While consultation on Vector's Offer and the Commission's Draft Decision Paper was ongoing, Vector proceeded with implementing its price changes on 1 April 2007 and 1 April 2008 in a manner consistent with the Offer. In addition, Vector submitted to the Commission an audit report from Deloitte (dated 31 May 2007) reporting on Vector's compliance with its rebalancing targets as specified in the Offer.

199 Deloitte's audit report highlighted two minor differences in the actual price adjustments made by Vector on 1 April 2007 from those set out in the Offer. Vector advised Deloitte that these differences are caused by:

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[98] ibid, clause 7.
[99] ibid, clause 8.
[100] ibid, clause 11.

- the use of *lower* tariffs for residential consumers on a 3-phase residential plan in Auckland and Wellington, in order to comply with the requirements of the Electricity (Low Fixed Charge Tariff Options for Domestic Consumers) Regulations 2004; and
- the level of transmission charges, which were *reduced* slightly in finalising the COS model (having an impact of around 0.16% of the relevant revenues).

200 In the Commission's view, both these changes were consistent with the terms of Vector's Offer (paragraph 186 above). The Commission considers that Vector's move to implement the Offer, without having received a final agreement from the Commission, has demonstrated the company's strong commitment to the Offer.

Net Benefits Assessment

Assessment scenarios

201 In its Intention Paper, the Commission applied the analytical framework and approach outlined in its Guidelines and expressed its preliminary view that control of Vector's electricity distribution services would result in significant net benefits to consumers (paragraph 94 above). As discussed above (paragraphs 126-127), once an intention to declare control has been published, a settlement offer represents a (factual) scenario to be compared against both a (counterfactual) scenario of taking no further action (i.e., "no control"), and an additional (counterfactual) scenario of control. In either case, the Commission is mindful not to incur unnecessary administrative and compliance costs by undertaking analysis that might not be particularly material to the decision (paragraph 128 above).

202 The likely key outcomes of the three scenarios of no control, imposing control, or accepting and implementing Vector's Offer, are summarised in Table 4. The relative net benefits of the administrative settlement compared to no control and to control are discussed further below (in paragraphs 203-205, and paragraphs 206-215, respectively).

Table 4: Comparison of Likely Outcomes under Scenarios of No Control, Control and Vector's Proposed Administrative Settlement

	No Control	**Control**	**Administrative Settlement**
Tariff rebalancing	Likelihood of limited or at least delayed progress	Tariff rebalancing programme to be completed by April 2009	Tariff rebalancing programme to be completed by April 2009
Overall price level	Subject to Vector's existing price path threshold	Likely to be below Vector's existing price path threshold, but final authorisation not likely before April 2009	Subject to Vector's existing price path threshold, with thresholds subsequently reset

	No Control	Control	Administrative Settlement
Investment incentives	Stemming from Vector's existing price path threshold	Potentially detrimental impact on Vector's investment incentives from changing the price path *during* the regulatory period	Vector has committed to making investments needed to provide secure, reliable and safe electricity supply
Wider regulatory impact	Taking no action in response to Vector's pricing inefficiencies would set a poor precedent	Potentially detrimental impact on wider investment incentives	Potentially greater regulatory certainty
Incremental regulatory and compliance costs	None	Significant	Minor

Net benefits of the settlement versus no control

203 Vector's modified pricing behaviour, in response to the Commission's intention to declare control, has already resulted in benefits to Vector's electricity consumers. Vector has already implemented price changes in April 2007 and April 2008 in order to mitigate its pricing inefficiencies. Given that most of the benefits have already been realised, the potential level of remaining benefits that can still be realised (under either a settlement or control) prior to the thresholds being reset is less than was the case at the time of Vector's initial breach.

204 However, consistent with its decision not to declare control of Unison, the Commission considers that the most appropriate "no control" scenario for the purposes of deciding whether to declare control is one which reflects the most likely behaviour of the lines business in the absence of a credible threat of control.[101] Although Vector has maintained that its tariff rebalancing programme began in 2005 (paragraphs 77-78 and 190 above), prior to the Intention Paper being published, little progress had been made in removing the inefficiencies in Vector's pricing. The situation had even deteriorated for many customer groups by July 2006 (paragraphs 82-84 and 171 above). Substantive progress on Vector's tariff rebalancing programme does not appear to have eventuated until after the Commission published its intention to declare control. Hence, it is evident that the benefits to consumers of continuing to implement that programme under the proposed settlement exceed those of a "no control" scenario (i.e., one in which Vector is not influenced by a credible threat of control).

[101] Commerce Commission, supra n 17, paragraph 4.46.

205 Apart from having direct benefits to many of Vector's customer groups in the form of lower prices (e.g., refer Table 5 below), the Commission considers that implementing Vector's tariff rebalancing programme under the settlement will improve allocative and dynamic efficiency. Many of the customer groups that have faced over-charging are commercial and industrial consumers in the productive sector which have to compete nationally and/or internationally in markets for tradable goods (paragraph 98 above). Application of Vector's COS model—which is intended to align prices more closely to underlying costs, demand and service quality (paragraph 184 above)—will reduce the likelihood that major consumer investment and consumption decisions are distorted (e.g., which form of energy supply to use, which type of technology to adopt, and where to locate a new business or plant). Given that Vector is the supplier of around one-third of New Zealand's electricity distribution services, the magnitude of the likely efficiency benefits are likely to be substantial.

Table 5: Estimated Annual Average Savings from Vector's Rebalancing Programme

Customer Group	**Annual Line Charge Savings from Removing Over-Charging ($/ICP)**[102]
Auckland Small Commercial	$128
Auckland Large Commercial	$1,926
Auckland Small Industrial	$4,355
Wellington Small Commercial	$556
Wellington Medium Commercial	$1,312
Wellington Large Commercial	$5,806
Wellington Small Industrial	$7,111
Northern Large Commercial	$6,252
Northern Small Industrial	$4,886

Net benefits of the settlement versus control

206 The Commission considers that, with respect to Vector's tariff rebalancing programme, the benefits under control are likely to be largely the same as under the proposed settlement. However, the key additional benefit to consumers that could potentially be realised through control of Vector's distribution services would be to limit Vector's returns to a greater extent than would be the case under the settlement, which involves Vector complying with its existing price path threshold (paragraph 157 above). Although the Commission had not undertaken a full building blocks assessment of Vector's current and forecast revenues, the Intention Paper estimated that further average distribution charge reductions of up to 2%-11% per annum could be achieved under control, in the two years leading up to the reset of the thresholds (paragraph 96 above).

207 Vector has committed to comply with its price path threshold for the remainder of the regulatory period. As outlined in its decision not to declare control of Unison, the Commission considers that, where such a commitment exists, it is consistent with the

[102] 2007/08 year only. Additional savings occur in 2008/09 as shown in Table 2 above.

Purpose Statement, and with an objective of regulatory stability and certainty, for the Commission *not* to control prices to a lower level than the price path threshold. Such is the case even if a lines business's returns would exceed its likely WACC range over the short term (i.e., until 31 March 2009).[103] Experience from other jurisdictions demonstrates that the incentive power of a CPI-X regulatory price path is strongly dependent on the length of the regulatory period over which the path is set, and a regulatory commitment not to change that path during the regulatory period.

208 As reiterated above (paragraphs 135-138), the price path threshold is only intended to *limit* excessive profits. The Commission considers there are likely to be significant indirect benefits from accepting and implementing a settlement, such as Vector's Offer, which involves commitment to an existing price path threshold. There are likely to be positive impacts on investment and efficiency incentives for Vector (and also the wider industry) from continuing to signal the Commission's regulatory commitment to a medium-term price path, thereby contributing to regulatory certainty and stability (paragraph 139 above). Such longer term indirect benefits may further outweigh any short-term benefits to Vector's consumers from lower prices until the end of the regulatory period.

209 In particular, the Commission acknowledges Vector's position that its investment programme and asset management plans have been predicated on the basis of its existing thresholds which were set for the five-year regulatory period from April 2004 to March 2009. The Commission also highlights that, under the proposed settlement, Vector commits to investing to provide a secure, reliable and safe electricity supply in its Auckland, Northern and Wellington distribution networks (paragraph 159 above).

210 Furthermore, in committing to comply with its existing price path threshold, Vector also acknowledges that it will continue to have incentives to outperform the efficiency gains implied by that threshold (paragraph 161 above). Allowing Vector to continue retaining any additional efficiency gains made during the settlement period is likely to increase the level of benefits available to be shared with its consumers when the thresholds are reset, and preserves the company's incentives for ongoing efficiency gains in subsequent regulatory periods.

211 The Commission acknowledges that Vector's Offer does not directly address the evidence concerning the company's excess profits identified at the time of the Intention Paper (paragraphs 86 and 96 above). Had Vector not committed to address the key s 57E concern regarding the inefficiencies inherent its electricity pricing strategy and tariff structures, then control of Vector's distribution services might still have been warranted. If control had been imposed, then Vector's excess profits and/or efficiency gains over the current regulatory period would potentially have been able to be shared with its consumers earlier than the end of the current period. Moreover, incentives for future efficiency gains would still have been preserved under control (paragraph 140 above). Such incentives are able to be established once control is imposed as a result of setting the controlled price path for a reasonable number of years, thereby providing regulatory certainty in support of ongoing efficient capital and operating expenditure.

212 On balance, the Commission considers that the longer term benefits arising from maintaining Vector's five-year price path that was set at the outset of the regulatory

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[103] ibid, paragraph 4.53.

period are likely to outweigh any incremental short-term benefits to consumers—from now until the threshold reset—that might be foregone because controlled prices could be set lower than current price path threshold levels.

213 The Commission considers that the justification for taking this position in respect of Vector is likely to be even stronger than it was in the case of Unison, because:

- unlike Unison—which increased its line charges by a significant percentage above the price path threshold—Vector's 2004 price path threshold breach occurred as a result of small variances between its actual and forecast pass-through costs (paragraph 66 above);
- Vector's past and planned tariff changes under the price path threshold would continue to be based on applying a 25 basis point buffer to its forecasts of the CPI—to date this has meant that Vector has recovered more than $8 million less than the revenue permitted under the threshold (paragraph 67 above); and
- Vector's investment decisions affect around one-third of New Zealand's market for electricity distribution services.

214 In respect of the relative costs of a settlement compared to control, the Commission notes that Vector's Offer was submitted (and has been implemented) voluntarily. Therefore, direct compliance and regulatory costs are likely to be significantly lower than under control, thereby achieving outcomes consistent with the Purpose Statement at a lower cost. In particular, were the Commission to develop its own COS model for Vector, this would be a costly and time-consuming exercise. As the Commission's experience with finalising the authorisation for Vector's controlled gas distribution services bears out, implementing full price control is a time-consuming and costly exercise. Realistically, a final authorisation of controlled prices for Vector's electricity distribution services could not be imposed before the time when the thresholds are due to be reset in any event. At that time, as Vector acknowledges (paragraph 161 above), the Commission will be able to consider to what extent any efficiency gains or excess profits ought to be further shared with consumers.

215 Monitoring compliance with any settlement is, however, important for the effectiveness of the arrangement and for the desired benefits for consumers to be achieved. The Commission considers that Vector's proposed auditing and information provision processes are sufficient for compliance with the terms of the settlement to be monitored effectively and at a relatively low cost. Moreover, Vector has already demonstrated its commitment to the proposed settlement by implementing the first and second stage of the necessary price adjustments and by providing the Commission with an audit report on the first stage of those adjustments (paragraphs 198-200 above). In addition, the settlement terms have been formalised in a Settlement Deed which the Commission can, in its discretion, enforce in the manner and form that it considers appropriate (paragraphs 195-196 above).

Views of Interested Parties

Tariff rebalancing

216 As noted above (paragraph 142 above), PwC's submission acknowledged its agreement with the Commission's Draft Decision Paper. In particular, PwC submitted that it is

consistent with the intention of the thresholds to accept Vector's commitment to set prices within its overall price path threshold for the remainder of the regulatory period.

217 PwC's submission also stated that the Commission's Draft Decision Paper and Vector's Offer emerged after what appears to be considerable investigation into the costs of service for each of Vector's tariff groups. However, PwC noted that it is not party to the details pertaining to Vector's pricing strategy and models, and cannot therefore comment on the specific aspects of Vector's circumstances. Instead, PwC commented on a number of points of principle, observing that cost of service models such as those applied in Vector's Offer are only one tool that may be used by network businesses when setting prices. In particular, PwC argued that the initial Intention Paper reflected a simplistic understanding of pricing for network services, and PwC expressed its concern that the Commission formed its views on the performance of Vector on such a basis.

218 MEUG submitted that, in support of the Offer, Vector had provided no quantitative analysis to justify the proposed 1.5% differential in the ROI component between residential and industrial commercial consumers. MEUG argued that there are arguments against having such a differential and in time those will need to be fully considered.

219 In its submission, MRP conceded that the Commission had grounds for reviewing Vector's tariffs on a disaggregated basis, given that Vector had disclosed it was earning excess returns in Wellington and the North Shore, and from certain customer groups (i.e., up to 54%). However, MRP also expressed some scepticism about the validity of these figures, given that the presence of common costs means there is a wide range of prices for which there is not necessarily excess returns or cross-subsidies. MRP argued that to validly reach a conclusion about pricing requires determining price elasticities of demand, as well as incremental and common costs.[104]

220 As noted above (paragraph 169), the Commission agrees with the relevance of the factors cited by MRP to the issue of efficient pricing, but observes that quantitative assessments of such factors can be problematic—a point also relevant to MEUG's submission. Nevertheless, this difficulty does not mean that broad principles cannot be developed which can allow conclusions to be drawn about inefficient pricing behaviour, particularly where extremes in price components are evident. For instance, one would not expect consumers with largely similar cost, demand and quality characteristics to face markedly different prices, or to have prices derived in a markedly different manner. Where apparent differences occur, the Commission considers that the onus should be on the distribution business concerned to set out and explain its reasons. In Vector's case,

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[104] MRP also specifically drew the Commission's attention to the impact of the regulations concerning low fixed charge requirements. MRP highlighted that Ramsey pricing principles suggest that common costs should be allocated more towards consumers with relative inelastic demands. However, if those consumers are residential, then the low fixed charge regulations will mean that the costs will principally be passed on as variable charges, rather than fixed charges, further exacerbating the allocative inefficiency of the low fixed charge tariff requirements. In response, the Commission observes that, for a price inelastic consumer, changing the proportion of fixed to variable charges will in fact have comparatively minimal difference on the consumer's total bill, and therefore on the amount of common costs to which that consumer contributes. While the Commission agrees that constraints on the split of fixed and variable charges have the potential to introduce allocative inefficiencies, such inefficiencies will actually be much greater for price responsive consumers, not price inelastic consumers.

the company's own analysis highlighted such problems, and its COS model was developed to address them (paragraph 167 above).

221 The Commission acknowledges PwC's view, similar to Vector's own (paragraph 182 above), that COS models necessarily simplify some aspects of reality. Consequently, as noted above (paragraphs 174-175), rather than prescribing a particular pricing methodology for Vector, the Commission has sought to ensure that the voluntary proposals set out by Vector itself are consistent with high-level principles for efficient pricing, and have been able to be tested and made transparent through consultation with interested parties, such as those represented by PwC.

222 For the purposes of this administrative settlement, the Commission considers that the principles and assumptions underpinning Vector's COS model are reasonable, given Vector's circumstances at this point in time. However, there will be wider consultation on this issue in the context of the Electricity Commission's work on developing consistent and common distribution pricing guidelines for the electricity distribution industry. As noted above (paragraph 183), one of the issues which could be considered further as part of that process is the issue highlighted by MEUG, namely the appropriate differentials in target returns between various consumer classes.

Net benefits assessment

223 Referring to the Commission's Intention Paper, MRP submitted that the Commission should be careful in claiming that there will be a direct financial benefit to those consumers who face lower prices under control, as off-setting this will be increases in charges to other customers. While MRP indicated that it agrees wealth transfers between producers and consumers are relevant in assessing the merits of price control, MPR argued that wealth transfers amongst consumer groups are effectively a zero sum game. Moreover, MRP stated that it was notable the Commission had not quantified the benefits of imposing control on a disaggregated basis as opposed to an aggregate basis. MRP questioned whether the Commission would find any meaningful benefits from such an analysis. Consequently, MRP urged the Commission to undertake a quantitative cost benefit analysis of the benefits of intervening at the customer group/regional tariff level before doing so again in the future (whether in implementing price control or negotiating an administrative settlement).

224 In a similar vein, MEUG's submission stated that a quantitative analysis should have been undertaken by the Commission to assist understanding the trade-offs to be considered. In addition, MEUG noted that the qualitative assessment in the Draft Decision Paper did not consider the benefit that the control option would have in terms of improving the behaviour of other distribution businesses. MEUG argued that there would be very strong incentives on other businesses not to breach their thresholds if Vector were controlled.

225 The Commission acknowledges MRP's views concerning the net benefits of intervening in respect of relative price levels, but highlights that the nature of the costs involved under this administrative settlement are quite different from those which might be incurred under control. As the Commission highlights above (paragraph 214), were the Commission to develop its own COS model for Vector, this would be a costly and time-consuming exercise. In the Commission's view, potentially the most cost-effective approach for improving the efficiency of distribution pricing is through establishing

guidelines for the industry as a whole (paragraph 175 above). Apart from providing an acceptable common standard, there could also be benefits in respect of promoting retail competition—both objectives underpinning the original policy to develop model approaches to distribution pricing. However, in the meantime, until such guidelines are put in place, the Commission considers that accepting Vector's voluntary settlement is a cost-effective way to address line charges which were clearly inconsistent with efficient pricing principles (paragraph 184 above).

226 In response to MEUG's submission, the Commission reiterates that, while the thresholds are intended to provide incentives consistent with the Purpose Statement, they are a screening mechanism and not an instrument of control. There may be legitimate reasons for breaching the thresholds, and the Commission considers that it would be inappropriate if incentives not to breach were so strong that, in some circumstances, they might act as a disincentive to efficiency. Moreover, as noted above (paragraph 128 above), the Commission is mindful not to incur unnecessary administrative and compliance costs by undertaking analysis that might not be particularly material to the decision at hand. Had the Commission decided to control Vector's electricity distribution services, a final authorisation could not have been imposed before the thresholds are due to be reset (paragraph 214 above). As Vector acknowledges (paragraph 161 above), the Commission will, in any event, be able to consider to what extent any efficiency gains or excess profits ought to be further shared with consumers at that time.

Process issues

227 In its submission, MRP expressed disappointment at the length of time the Commission took to reach its draft decision not to declare control of Vector. In particular, MRP argued that consultation on the Draft Decision Paper could only have a limited purpose given that Vector had already started implementing its Offer, and that, in general, consultation should occur before any potential settlement is implemented.

228 The Commission notes that Vector began implementing its Offer voluntarily, and independently of the Commission's timeframe for consultation. While it might have been possible for the consultation period to have been undertaken over a shorter timeframe, the Commission observes that it is able to prioritise its decision-making processes under the targeted control regime, taking into account the Purpose Statement. At the stage the Draft Decision Paper was issued, the Commission's preliminary view was that implementing Vector's Offer would finally begin to address the key s 57E concern that had already been identified some time previously by the Commission. Given that Vector had already begun addressing the s 57E concerns, final resolution of its post-breach inquiry could therefore be assigned a somewhat lower priority. In any event, although the Offer began to be implemented by Vector while the consultation process was ongoing, this did not limit the Commission's ability to have eventually reached different conclusions or to have taken a different course of action in response to issues raised during that process.

Summary

229 Vector's Offer is specifically intended to address the key s 57E concern identified in the Commission's intention to declare control, namely the inefficiencies inherent in the company's electricity pricing strategy and tariff structures (paragraph 9 above). In

addition, under Vector's Offer, the company commits to complying with its existing price path threshold for the remainder of the regulatory period.

230 In general, the Commission considers that a price path threshold—when complemented by a quality threshold—is by its very nature consistent with the outcomes sought in s 57E(a)-(c) of Part 4A (paragraphs 28-32 above). More specifically, in Vector's case, complying with its existing thresholds going forward, as part of the proposed settlement, will continue to: (a) limit Vector's ability to extract excessive profits; (b) provide strong incentives for Vector to improve efficiency and to provide services at a quality that reflects consumer demands; and (c) ensure Vector shares the benefits of efficiency gains with consumers.

231 With respect to s 57E(c), while some efficiency gains will be shared with Vector's consumers during the regulatory period—because the X factor in its price path threshold reflects expected average efficiency gains—further opportunity for sharing efficiency gains will come at the end of that period (paragraphs 136-138 above). This is important, because allowing Vector to retain the benefits of its additional efficiency gains made during the regulatory period, and therefore preserving the company's incentives to make ongoing efficiency gains, increases the level of benefits available to be shared with its consumers from the end of the current regulatory period, when the thresholds are reset.

232 In sum, having taken into account the submissions from interested parties, the Commission considers that the following net benefits to consumers, consistent with the Purpose Statement, will be realised from accepting and implementing Vector's Offer:

- Vector's tariff rebalancing programme will provide allocative and dynamic efficiency benefits in a less intrusive and costly manner than would be possible under control;
- Vector's compliance with its existing thresholds, and its commitment to addressing the pricing inefficiencies identified in the Commission's intention to declare control, will promote behaviour consistent with s 57E(a)-(c) of the Purpose Statement at a lower administrative and compliance cost than control;
- Vector's incentives to invest in order to maintain network performance will be preserved over the settlement period, as is evidenced by the company's commitment to providing a secure, reliable and safe electricity supply in its Auckland, Northern and Wellington distribution networks;
- any forgone short-term benefits to Vector's consumers, from potentially lower prices under control, will likely be more than offset over time by the positive impacts on investment incentives for Vector (and the wider industry), which stem from the regulatory certainty provided by the Commission reinforcing its commitment to setting medium-term price paths;
- allowing Vector to retain any additional efficiency gains it makes over the settlement period will increase the level of benefits available to be shared with its consumers when the thresholds are reset; and
- with any settlement there is a possibility of non-compliance, but the Commission considers it will be straightforward to monitor the implementation of the settlement, and if Vector were to contravene any of the provisions of the

Settlement Deed, the Commission may in its discretion enforce the Deed in the manner and form that it considers appropriate.

DECISION NOT TO DECLARE CONTROL

Decision Not to Declare Control of Vector

233 In its intention to declare control, the Commission outlined its view at the time that control of Vector's electricity distribution services would be consistent with the Purpose Statement. Having now evaluated Vector's Offer and taken into account the views of interested parties (as is set out in the previous section), the Commission's view is that control is not necessary to address the s 57E concerns identified in the Intention Paper (paragraph 86 above), because these concerns will be appropriately addressed through acceptance and implementation of the Offer.

Preventing over-charging of various customer groups

234 The Intention Paper indicated that control would prevent the over-charging of many customer groups, which has been for the benefit of some shareholding consumers (i.e., particularly Auckland residential consumers), and limit the ability of Vector to earn excess revenue (paragraph 94 above).

235 Since the Commission's intention to declare control was published in August 2006, Vector has largely implemented its tariff rebalancing programme. Vector has implemented the first two stages of price reductions to those customer groups that were being significantly overcharged—for instance, consumers in the Large Commercial group in Vector's Northern network were contributing returns of more than 54% (paragraph 87 above). Under the terms of the settlement, the tariff rebalancing programme will effectively be completed by March 2009, with any minor residual rebalancing undertaken in a final stage from 1 April 2009 to 31 March 2010.

236 While control would likely further limit Vector's ability to extract excessive profits, Vector's voluntary compliance with its existing price path threshold as part of the settlement will, in the Commission's view, promote the same objective at lower administrative and compliance costs (paragraphs 157 and 214 above). Furthermore, Vector's incentives to invest to maintain network performance will be preserved over the settlement period (paragraph 159 above).

237 On balance, the Commission considers that, given Vector has committed to address the key s 57E concern regarding the inefficiencies in its pricing, any additional but forgone short-term benefits to its consumers—from potentially lower prices under control—are likely to be more than offset by positive impacts on investment and efficiency incentives for the company (and the wider industry), as a result of Vector retaining its existing price path threshold (paragraphs 212-213 above). In the Commission's view, reinforcing the regulatory commitment to such a medium-term price path will significantly contribute to regulatory certainty and stability (paragraphs 207-209 above). In addition, Vector will be able to retain any additional efficiency gains it makes during the settlement period, thereby increasing the level of benefits available to be shared with its consumers when the thresholds are reset (paragraph 210 above).

Improving efficiencies

238 The Intention Paper indicated that control would improve efficiencies by aligning charges more with the underlying costs of providing that service, thereby sharing efficiency gains with consumers (paragraph 94 above).

239 Vector's tariff rebalancing programme, as set out in the Offer, espouses cost-reflective pricing principles. In the Commission's view, implementing the rebalancing programme through the settlement will likely provide allocative and dynamic efficiency benefits in a less intrusive and costly manner than would be the case under control (paragraphs 205 and 214 above).

System reliability

240 The Intention Paper also indicated that control could ensure that the prices charged were commensurate with the quality of service that reflects consumer demands (paragraph 94 above). However, the Intention Paper stated that, irrespective of Vector's past quality threshold breaches, the Commission had sufficient grounds for forming an intention to declare control of Vector's electricity distribution services based on Vector's pricing behaviour alone. Vector had not attempted to justify its pricing behaviour on the basis of improving service quality (paragraph 162 above).

241 Vector's Offer acknowledges that the company will remain subject to its existing quality threshold, and makes a commitment to operating and maintaining its electricity networks to achieve the reliability targets specified in that threshold. Aside from the settlement, which only relates to Vector's threshold breaches in 2004, the Commission will still be able to consider Vector's quality performance further as part of its assessment of Vector's breaches of the quality threshold in 2006 and 2007 (paragraphs 163-164 above).

Commission's decision

242 In conclusion therefore, the Commission considers that the likely outcomes associated with implementing the administrative settlement outlined in Vector's Offer are consistent with the Purpose Statement. Furthermore, over the relatively short settlement period from now until the threshold reset, acceptance and implementation of the settlement would be at least as advantageous to the long-term interests of consumers as would control. As a result, at this stage, a declaration of control in respect of Vector's electricity distribution services is not necessary to ensure that the objectives of the targeted control regime are promoted, provided the settlement is implemented. Therefore, the Commission has decided not to make a declaration of control in respect of the distribution services supplied by Vector.

Next Steps

243 Vector's Offer has now been formalised through a Settlement Deed that incorporates the terms of that offer. Consequently, the Commission is able to close its post-breach inquiry into Vector's breaches of the initial price path and quality thresholds in 2004. In accordance with s 57H(d)(ii) of the Act, the Commission will shortly publish an overview of its reasons for not making a control declaration in the *Gazette*.