SUBMISSION TO THE COMMERCE COMMISSION ON THE DEFAULT PRICE QUALITY PATHS FOR GAS PIPELINE BUSINESSES DRAFT REASONS PAPER

CREATING A NEW ENERGY FUTURE

CONTENTS

EXECUTIVE SUMMARY

This submission is Vector's response to the Commerce Commission's (the Commission) *Default Price-Quality Paths for Gas Pipeline Businesses (GPBs) from 1 October 2017 to 30 September 2022 Draft Reasons Paper* (2017 GPB DPP Draft Reasons Paper). Below is a high level summary of our submission.

Topic	Vector view

Expenditure forecasts	• Vector **does not support** the Commission's approach for determining the exclusions of non-network expenditures for Vector.
	• Vector **does not support** the Commission's policy for the treatment of economies of scale and dis-economies of scale following the First Gas Ltd (FGL) transactions – i.e. the policy of "adding back" scale benefits and "subtracting" scale diseconomies. The policy of "adding back" scale benefits:
	    ○ Departs from the policy of setting forward looking expenditures;
	    ○ Contradicts the Commission's position in the 2010 IM reasons paper which recommended the sharing of efficiency benefits at the time of setting a new default price path (DPP) or customised price path (CPP);
	    ○ Creates perverse incentives for CPP applications; and
	    ○ Delivers an unhelpful precedent for the treatment of mergers/acquisitions for other sectors regulated under Part 4.
	• Vector **recommends** the Commission apply a forward-looking policy for the treatment of economies of scale and diseconomies from the FGL transactions.

Forecasting	• Vector **recommends** the Commission ensure its constant price revenue growth forecasts are achievable, and not sensitive to prevailing weather conditions during the DPP period. • Vector **remains concerned** about the Commission's forecasts of inflation being systematically biased to over-forecast inflation. The Commission's inflation forecasts are anticipating inflation to exceed two percent despite inflation not reaching this level for the majority of the decade. • Vector **recommends** the Commission continue to consider cross-checks to its inflation forecast or supplement its single

	source for inflation with other sources of inflation to mitigate the financial risks from persisting biases in the inflation forecast.
Quality standard	• Vector **supports** the continuance of response time to emergency (RTE) as the quality measure for GPBs. • Vector **supports** the proposal not to apply the new major events quality standard to gas distribution businesses (GDBs).

INTRODUCTION

1. This is Vector's submission on the Commission's 2017 GPB DPP Draft Reasons Paper, released on 10 February 2017. No part of this submission is confidential.

2. Vector's contact person for this submission is:

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3. Vector owns and operates a GPB subject to DPP regulation under Part 4 of the *Commerce Act 1986* (the Act). Vector is interested with ensuring the Commission's final decision for the DPP is consistent with the Part 4 framework for price-quality regulation, including the application of input methodologies (IMs).

4. Vector also asked the Competition Economics Group (CEG) to review the Commission's policy for the treatment of economies of scale following the FGL transactions for the forthcoming DPP reset. Attached with this submission is CEG's report titled *Treatment of Changes to Economies of Scale due to Transactions*.

SETTING EXPENDITURES

5. Vector supports the endeavour of the Commission to improve the quality of the regulatory regime in assessing supplier expenditures. The Commission's approach is to consider asset management plan (AMP) forecasts against a "historic baseline" of expenditures – using three years of gas pipeline business (GPB) information disclosure filings. The Commission also used materiality bounds for assessing expenditures above historic disclosures (10 percent for capital expenditure and five percent for operating expenditure).

6. The Commission is right to suggest the proposed approach for assessing expenditures for the forthcoming DPP reset reflects incremental improvements given the greater availability of historical information. The improvement is largely supported by historical gas information disclosure (GID) filings which the Commission is using to supplement supplier AMP forecasts. This most certainly provides useful context for suppliers continuing to provide the same services across regulatory periods without any significant disruption to their business.

7. However, in the context of FGL transactions, where previously independent gas transmission businesses (GTBs) (one previously owned by Vector) have been consolidated and Vector's non-Auckland GDB has been sold, the application of this

approach becomes compromised to the suppliers subject to the transactions. A "historical context" on forward-looking expenditures for such suppliers in some respects illuminates very little about the efficient requirements for the supplier.

Commission's approach to setting non-network expenditures

8. The Commission's exclusion of Vector's non-network expenditures for the forthcoming reset is an area where we do not support the Commission and its engineering expert's approach.

9. Critically, Vector was not given any context that the Commission's extraordinary questions forwarded on 9 November 2016 would be materially fundamental to the setting of expenditure allowances.

10. In this respect, the Commission's engineering expert Strata has come to conclusions based on a non-apparent interpretation of the Commission's questions and found our responses unsatisfactory. This is not a desirable process or approach. Indeed, at the very least, the Commission should have provided an opportunity for clarification or redefined its question to Vector to ensure Vector had an opportunity to address the Commission's concern.

11. Strata suggested Vector's explanation for non-network expenditure forecast increases as "not valid" as "forecasts should be compared to actual expenditures." This is a very different question to that put to Vector. Vector was asked by the Commission to justify the explanation in our AMP for *"the increase to the forecast for non-network expenditure."* Vector responded to this question by identifying why the forecast had changed from Vector's previously published AMP.

12. The actual expenditure from which Strata is supposedly basing the actual non-network costs for Vector's Auckland GDB appears to be based on its own judgement of "actual" category expenditure. Historical GID for Vector does not provide a disaggregated view between Vector's Auckland and non-Auckland networks for expenditure categories. Historical non-network expenditure was also not requested by the Commission when it used its information gathering power under section 53ZD of the Act. Accordingly, any historical "back-casting" to actual expenditures appears to be based on judgements of the split of non-network expenditures between Vector and FGL's GDBs rather than audited filings. The approach seems at odd with the Commission's usual requirement for evidence when drawing conclusions.

13. Nonetheless, the statement from Strata that "forecasts should be compared to historical expenditures" is not a reasonable policy for the Commission to pursue when analysing costs for businesses having undergone radical transformations following

mergers or divestments. Continuing to assume an industry design that does not exist provides very little insight into the efficient needs of regulated businesses operating in the sector. For example, it would be unreasonable to assume Chorus as being part of the integrated Telecom when setting access prices for its regulated services.

Identifying economies of scale or diseconomies of scale from the FGL transactions

14. The FGL transactions have resulted in Vector losing two significant revenue streams that previously bore costs related to functions essential to the operation of the Vector's businesses – *including* risk management, health and safety and information technology functions. At the same time FGL's ownership of the MDL and Vector GTB will be the first time both transmission systems will be operated under a common owner plus also owning both Vector's non-Auckland GDB and GasNet's Bay of Plenty GDB.

15. The Commission's review of FGL's GTB consolidated AMP forecast for the former MDL and Vector transmission systems observed the forecast to be significantly higher than the actual historic expenditures of the GTBs but lower than the previous AMP forecasts published by MDL and Vector GTB independently. Despite this observation, the Commission concluded it did "not see any clear efficiency gain from the merger being included in the forecast expenditure."[1] Accordingly, the Commission appears to consider there to be no economies of scale benefit arising from the FGL transactions.

16. In contrast, as discussed above, in reviewing Vector's Auckland GDB AMP, the Commission has identified losses in scale to Vector's GDB. This loss in scale was not identified by comparing AMP forecasts from prior to the FGL transaction to the 2016 AMP published post FGL transactions but by contrasting the 2016 AMP forecast against estimates of historical expenditures for the Auckland GDB.

17. In practice, the Commission has not treated the effects of scale symmetrically in its review of expenditures. Vector is being held to a different standard to FGL for the identification of scale benefit or detriment as a result of the FGL transactions.

Non-network expenditures – the treatment of common costs

18. The inclusion of an efficient allowance for common costs when determining appropriate costs for regulated services is well settled as an important consideration for determining efficient prices for regulated services. Indeed under section

[1] Commerce Commission, *Default Price-Quality Paths for Gas Pipeline Businesses from 1 October 2017 to 30 September 2022: Draft Reasons Paper*, 10 February 2017 p. 112

52T(1)(a)(iii) of the *Commerce Act 1986* the Commission is explicitly required to have an Input Methodology (IM) governing the allocation of common costs (including between activities, businesses, consumer classes and geographic areas).

19. For telecommunications services regulated under the *Telecommunications Act 2001* the Commission is required to set access prices for designated services including an allowance for forward-looking common costs.[2] Accordingly, the recently settled total service long run incremental costs prices set for Chorus' unbundled copper local loop and unbundled bit-stream access included an estimate of common costs (including non-direct costs) for the service in the access prices.

20. The approach applied to date by the Commission across different regulated sectors is to allow for common costs (including non-direct costs) when setting prices for regulated services. Further, the approach to date, has been for an estimate of the efficient forward looking costs for delivering the regulated service. This approach is consistent with the principles of incentive regulation where regulated suppliers are set allowances based on a reasonable estimate of the supplier's common costs. The approach also meets the long-term benefit of end-users as the supplier is expected to be able to operate their regulated service within the common cost allowance.

The Commission's policy for recognising economies of scale and diseconomies of scale for the new DPP

21. The Commission indicated that it will treat any business scale gained or lost as a result of the FGL transactions symmetrically. The DPP draft decision has:

    1) **Added back** any economies of scale gain to the expenditure forecast and

    2) **Subtracted** any economies of scale loss from the expenditure forecast.[3]

22. As noted above, the Commission does not appear to have identified any scale benefit to FGL and appears not to have "added" any economies of scale benefit back to its accepted forecast. Nonetheless, the Commission has identified scale losses to Vector's GDB business.

23. In this case, were the Commission to recognise the scale losses to Vector's GDB at the time of the ensuing reset in 2022, the total effect of the FGL transaction will be a loss to consumers.

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[2] Clause 1, Schedule 1 (designated services and specified services*) Telecommunications Act 2001*

[3] *Ibid* n1 p.51

24. Were the Commission to adopt a consistent approach to the identification of economies of scale and diseconomies of scale resulting from the FGL transactions, it is likely to observe both economies of scale from the consolidation of previously independent businesses and diseconomies of scale.

25. Nonetheless, Vector submits the above policy of "adding back" economies scale and "subtracting" economies of scale is misconceived as it:

    1) Is counter to the principle behind incentive regulation and setting forward looking costs;

    2) Violates the principles for treatment of mergers articulated in the 2010 IMs Reasons Paper and therefore compromises the Commission's adherence to section 52T(1)(a)(iii) of the Act;

    3) Creates perverse incentives for customised price path applications; and

    4) Results in fragmentation on the treatment of economies of scale for Part 4 regulated sectors (unworkable for EDB merger/acquisition activity).

26. Each of these reasons are discussed below.

Recalibration of the DPP should be consistent with incentive regulation

27. The Commission's treatment of economies of scale derogates from the Commission's role of forecasting efficient (forward looking) expenditures for the suppliers subject to the DPP. Incentive regulation encourages the sharing of efficiency improvements in the supply of the regulated service with customers when prices are reset at the end of each regulatory period. However, a necessary part of incentive regulation is for the starting prices to be reasonably adequate for the supplier to effectively manage the regulated service to the prescribed level of quality.

28. At the heart of the Commission's policy for treating economies of scale from the FGL transactions is to continue to apply a "backwards" looking approach to setting expenditures where the former structure of the industry (i.e. two separate transmission owners and a single owner of GDBs in Auckland and outside of Auckland) exists for the duration of the new full DPP.

29. The Commission's proposed treatment of the diseconomies of scale to Vector's Auckland GDB requires Vector to endure having its allowances set below what is reasonable for a business of its scale for the forthcoming regulatory period.

30. An approach more consistent with incentive regulation would have been for the Commission to set forward looking prices in the new DPP including setting the economies of scale benefit resulting from the FGL transactions.

Treatment of economies of scale resulting from First Gas Ltd (FGL) transactions is inconsistent with the IMs

31. Vector is concerned about the Commission's policy for the treatment of economies of scale and diseconomies of scale resulting from the FGL transactions is a marked departure from the Commission's approach set out in the *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper* 2010 (2010 IM Reasons Paper). In the 2010 IM Reasons Paper, the Commission articulated its view on how synergy savings should being realised as a result of mergers and acquisitions of involving other regulated suppliers. The Commission noted:

> *Following a merger or acquisition part-way through a regulatory period, under the IMs suppliers are not required to reallocate their costs and reflect any changes in shared costs in their prices (e.g by re-opening the price-path). For transparency, however, suppliers must report their actual costs as part of information disclosure. The effect of this is that suppliers may retain any benefits from efficiencies resulting from the transaction, since they may "double count" costs and hence recover the shared costs more than once from consumers of regulated services. The ability to retain these gains provides the incentive to achieve these efficiencies, consistent with s 52A(1)(c). At the end of the regulatory period the Commission resets the price path through starting price adjustments under a DPP or CPP.*[4]

32. Accordingly, the Commission clearly specified any benefit resulting from an acquisition would occur for the remaining duration of an "in-flight" DPP or CPP. At the end of the DPP or CPP the Commission would reset prices through a starting price adjustment to ensure any "double" count of costs would be shared with consumers. The IMs reasons paper clearly specifies a forward looking estimate of efficiencies for the resetting of a DPP or CPP. Indeed the application of this policy has also been the expectation of consumers for the forthcoming reset.[5]

33. However, for the forthcoming 2017-2022 GPB DPP the Commission appears to continue "double counting" costs through its "adding back" scale and "subtracting" diseconomies for FGL and Vector. Rather than returning economies of scale (dis) benefits from the FGL transactions which have been retained by suppliers for the last

[4] Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, December 2010, p.80 paragraph 3.3.28

[5] Major Gas Users Group, *Submission on Default Price-Quality Paths for Gas Pipeline Services from 1 October 2017*, 30 March 2016

1.5 years to consumers as part of the starting price adjustment, the 2017 GPB DPP Draft Reasons Paper intends to withhold the (dis) benefit and cost for another full five year regulatory period.

34. In effect, the proposed approach in the 2017 Draft GPB DPP Reasons Paper continues the "double counting" for the merger of GTBs beyond what was contemplated by the 2010 IM Reasons Paper.

35. Accordingly, the Commission's new policy of "adding back" scale and "subtracting" lost scale appears to be departing from its settled policy position for the treatment of shared costs as a result of a merger. This may also be inconsistent with the role IMs to provide certainty as envisaged by the Act.[6]

Impact of economies of scale and diseconomies of scale treatment for customised price path (CPP) applications

36. The Commission's policy for treating the economies of scale and diseconomies of scale for the new DPP also creates perverse incentives for CPP applications. By purposely disregarding the synergy benefit of the consolidation of the GTBs the Commission has created an incentive for FGL not to seek out a CPP – even in circumstances where it may consider a need for a CPP.

37. A CPP would require the Commission to explicitly re-examine the "adding back" benefit in advance of the DPP reset in October 2022. Therefore, any driver for a CPP application by FGL would have to be considered in the context of the "net" impact of forfeiting synergy benefit granted from the policy of "adding back" with the business case driver for a CPP – such as disallowed capital expenditure for specific projects.

38. To eliminate the incentive for FGL not to apply for a CPP, the Commission may consider a CPP application for FGL's transmission service without inquiring into the "adding back" benefit from the GTB consolidation. In this case customers are denied for an even greater period of time the economies of scale benefits from the FGL transactions.

39. This is not a fanciful issue given the Commission has anticipated FGL requiring a CPP for its GTB in the forthcoming DPP period. Indeed the Commission has even provided for an application allowance in FGL operating expenditures.

[6] Section 52T(1)(a)(iii) of the *Commerce Act 1986* specifies that matters covered by Input Methodologies include **allocation of common costs**, including between activities, businesses, consumer classes and geographic areas.

The Commission's proposed treatment of economies of scale for the FGL transactions creates fragmentation across Part 4 sectors

40. A significant shortcoming of the Commission's proposed policy for the treatment of economies of scale from the FGL transactions is that it would be very difficult to apply to other price-quality regulated sectors under Part 4 of the Act. The proposed policy of "adding back" and "subtracting" the economies of scale benefit (as being proposed for the GPB DPP) is unlikely to work for price-quality regulated electricity distribution businesses (EDBs).

41. Given the number of EDBs in New Zealand, this is the more likely sector for further mergers and acquisition activity for price-quality regulated sectors. Accordingly, Vector encourages the Commission to undertake an approach that is able to be applied consistently across regulated price-quality sectors.

42. In the case of EDBs the Commission has introduced an incremental rolling incentive scheme (IRIS) for expenditures into the EDB IMs. Therefore, were the Commission to apply the same policy to two merging EDBs then customers are potentially denied the synergy benefit for not only the ensuing DPP or CPP period (where the Commission does not examine the synergy benefit) but also into the following regulatory period where positive IRIS credits are continued to be recovered from customers (i.e. customers are denied synergy benefits for more than the five year regulatory period).

43. The effect of applying the proposed treatment for economies of scale and diseconomies of scale from the FGL transactions to potential merger or acquisition between regulated EDBs is to significantly delay the synergy benefits for customers.

Vector's recommendation for the Commission's policy for treatment of economies of scale or diseconomies of scale

44. For the above reasons, Vector **recommends** the Commission adopt a policy of considering economies of scale and diseconomies of scale as they arise on a forward looking basis when setting a DPP or CPP. This policy would be consistent with the 2010 IMs reasons paper and also reflects the prevailing guidance in the IMs when the FGL transactions were settled.

2016 GID does not provide a valid data point for assessing non-network expenditure

45. We also have significant reservations about the utility 2016 GDB information disclosures will provide in further illuminating current and future non-network expenditures requirements for FGL and Vector's GDB. While Vector and FGL have both submitted information disclosures for the 2016 disclosure year – the substance

of these disclosures is based on the settlement of the transaction transferring ownership of the Vector transmission pipeline and non-Auckland GDB in April 2016 (10 months into the disclosure year). Therefore, Vector's non-network expenditures for a significant period of the disclosure year will have been influenced by the fact that such expenditures were being shared across the businesses ultimately subject to the transaction.

FORECASTING

Constant price revenue growth

46. Vector acknowledges the inherent challenges for estimating volume growth encompassing both connections and gas conveyed across the different customer segments for determining constant price revenue growth forecasts (CPRG). As the Commission's CPRG model highlights variable volumes for gas can vary considerably.

47. The Commission's modelling shows the decline in billed kilowatt hours (kWh) for residential customers between the 2013 and 2014 disclosure years to be over 17 million kWh. Indeed residential customers are the largest customer segment for Vector's GDB accounting for more than half of the business. This change in demand is most likely weather driven.

48. Vector's 2015 AMP also shows the gas delivered by Vector's Auckland GDB to have steadily declined for the three years following the 2012 disclosure year. In this respect Vector's 2016 AMP also shows modest growth in peak demand across Vector's major gas stations. Auckland central, is Vector's largest gas station with over 71K connections, is estimating coincident peak demand growth of only 1.1 percent over the 10 years with a lot of the growth occurring in the tail end of the forecast. The coincident peak demand for the Auckland gas station is meaningful given it is a meshed system which allows it to better deal with local peak constraints.

49. Vector's own modelling is forecasting year on year declines for per customer consumption of gas across our major customer segments. At the same time our most recent forecasts for gas conveyed is only anticipating modest growth of under one percent year-on-year for the foreseeable period. Accordingly, the Commission's CPRG model's anticipated sustained growth for the period of 1.5% is higher than Vector's expectation. We **recommend** the Commission ensure its growth forecasts are achievable, and to the extent possible, capable of being realised despite the prevailing weather during the period.

Inflation forecasting

50. Vector has serious reservations about the inflation forecasts being considered for the DPP. The Commission's consumer price index (CPI) model is forecasting inflation exceeding or equalling two percent for four out of the five years of the regulatory period for purpose of estimating revaluation income and starting prices.

51. The Commission has acknowledged its inflation forecast for the setting the initial DPP (2013-2018) over-forecasted inflation for the regulatory period.[7] Therefore, it is disconcerting the Commission is forecasting inflation for the forthcoming DPP at or higher than two percent despite inflation failing to exceed this level for the majority of the decade. Indeed the only time inflation has exceeded two percent in this decade occurred coincident with an increase to the goods and services tax (GST) rate. Accordingly, Vector considers there to be material risk with the Commission's inflation forecast for the forthcoming DPP will over-estimate inflation again for another five year period.

52. Rather than the Commission's forecast of inflation being broadly "symmetric" across regulatory periods as the Commission stated in the IM final decision reasons paper[8] – we are likely to experience greater financial risk due to a persisting bias in the Commission's inflation forecast across regulatory periods.

53. The Commission's IM final decision suggested suppliers are able to manage the financial risk of the Commission's inflation forecast errors by issuing inflation-indexed debt.[9] Vector finds the Commission's suggestion challenging and not practically helpful. This is largely due to the fact that the market for inflation indexed debt in New Zealand is highly illiquid. Moreover, such debt is generally only issued by entities with a higher credit rating than that assumed by the benchmark entity in the Commission's weighted average cost of capital (WACC) IM.

54. Vector **recommends** the Commission consider the reasonableness of its inflation forecasts given the extended history of low actual inflation since the start of the decade.

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[7] *Ibid* n1 p.8

[8] Commerce Commission, *Input Methodologies Review Decisions Topic 1: Form of Control and RAB Indexation for EDBs, GPBs and Transpower*, 20 December 2016, p.62

[9] *Ibid* n8

SERVICE QUALITY STANDARDS

55. Vector supports the Commission's retention of response time to emergency (RTE) as the quality standard for regulated GPBs. The measure of RTE provides the appropriate discipline on suppliers to meet consumer concern for safety on reticulated gas pipelines.

56. We support the implementation of Powerco's recommendation for reporting of information on instances where suppliers have failed to meet the 180 minute RTE limit from 30 working days to 45 working days. The additional time will assist the supplier in providing more comprehensive information about the incident and ensure reporting to the Commission coincides with findings from internal investigations into the incident.

57. Vector also supports the Commission confining the new major interruption quality standard to GTBs. Given the absence of customer concern and limited history of major events on GDBs (no recent significant event on Vector's GDB) there is little benefit to customers from the additional quality measure and is likely to result in additional costs given the change in the consequences for quality non-compliance resulting from a major interruption.