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| Company Name | Vector |
| For Year Ended | 31 March 2017 |

# Schedule 14 Mandatory Explanatory Notes

1. This schedule requires EDBs to provide explanatory notes to information provided in accordance with clauses 2.3.1, 2.4.21, 2.4.22, and subclauses 2.5.1(1)(f), and 2.5.2(1)(e).

2. This schedule is mandatory—EDBs must provide the explanatory comment specified below, in accordance with clause 2.7.1. Information provided in boxes 1 to 12 of this schedule is part of the audited disclosure information, and so is subject to the assurance requirements specified in section 2.8.

3. Schedule 15 (Voluntary Explanatory Notes to Schedules) provides for EDBs to give additional explanation of disclosed information should they elect to do so.

*Return on Investment (Schedule 2)*

4. In the box below, comment on return on investment as disclosed in Schedule 2. This comment must include information on reclassified items in accordance with subclause 2.7.1(2).

**Box 1: Explanatory comment on return on investment**

The RY17 ROI for Vector's Electricity Distribution Business (EDB) is 7.01%. This is lower than the 67th percentile vanilla WACC of 7.19% and the ex-ante RY17 ROI of 7.34% generated using the Commission's DPP estimates for that year. The key factor depressing the returns in RY17 are lower lines revenue and higher "losses from asset disposals" relative to the DPP forecast.

EDBs should have an ex-ante expectation of earning the 67$^{th}$ percentile vanilla WACC over a regulatory period. Persistent and asymmetric forecast errors (CPI and growth) are significantly undermining this expectation. Assumptions made by the Commerce Commission in setting our regulated revenues also continue to prove challenging. In particular, errors in the Commerce Commission's electricity growth forecasts have contributed to Vector under-recovering by more than $60 million over the past 5 years. Furthermore, the regulator's persistent over forecasting of revaluation rates has resulted in Vector missing out on additional revenue of more than $130 million over the same period.

There has been no re-classification of items in the disclosure year.

*Regulatory Profit (Schedule 3)*

5. In the box below, comment on regulatory profit for the disclosure year as disclosed in Schedule 3. This comment must include-

5.1 a description of material items included in other regulated income (other than gains / (losses) on asset disposals), as disclosed in 3(i) of Schedule 3

5.2 information on reclassified items in accordance with subclause 2.7.1(2).

| **Box 2: Explanatory comment on regulatory profit** |
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| There has been no re-classification of items in the disclosure year. |

*Merger and acquisition expenses (3(iv) of Schedule 3)*

6. If the EDB incurred merger and acquisitions expenditure during the disclosure year, provide the following information in the box below-

6.1 information on reclassified items in accordance with subclause 2.7.1(2)

6.2 any other commentary on the benefits of the merger and acquisition expenditure to the EDB.

| **Box 3: Explanatory comment on merger and acquisition expenditure** |
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| No merger and acquisition expenditure has been incurred during the disclosure year.<br><br>There has been no re-classification of items in the disclosure year. |

*Value of the Regulatory Asset Base (Schedule 4)*

7. In the box below, comment on the value of the regulatory asset base (rolled forward) in Schedule 4. This comment must include information on reclassified items in accordance with subclause 2.7.1(2).

**Box 4: Explanatory comment on the value of the regulatory asset based (rolled forward)**

There has been no re-classification of items in the disclosure year.

The value of the regulatory asset base has been determined by rolling forward the initial regulatory asset base with allowance made for additions, disposals, depreciation and revaluation in accordance with the Electricity Distribution Services Input Methodologies Determination 2012.

The non-network assets adjustment that results from asset reallocation ($2.1m) is predominantly due to the divestment of the gas transmission and Non-Auckland gas distribution businesses.

<u>Roll forward of works under construction</u>

The assets acquired from a related party have been consolidated into our disclosures within Schedule 4(iv): Roll forward of Works under Construction as the assets are recognised as “Assets commissioned” but, because of their related party nature, not as “Capital expenditure”. Based on the current operation of the formulas in schedule 4(iv), this results in a reduction in works under construction which is not an accurate representation of the nature of the transactions. In its issues register response to this anomaly when raised by Powernet in 2016, the Commission recommended adding an additional row to resolve this issue and providing a description of the nature of the transaction. We have adopted this approach in our disclosures.

*Regulatory tax allowance: disclosure of permanent differences (5a(i) of Schedule 5a)*

8. In the box below, provide descriptions and workings of the material items recorded in the following asterisked categories of 5a(i) of Schedule 5a-

   8.1 Income not included in regulatory profit / (loss) before tax but taxable;

   8.2 Expenditure or loss in regulatory profit / (loss) before tax but not deductible;

   8.3 Income included in regulatory profit / (loss) before tax but not taxable;

   8.4 Expenditure or loss deductible but not in regulatory profit / (loss) before tax.

**Box 5: Regulatory tax allowance: permanent differences**

RAB loss on disposal of assets after excluding amount in deferred tax is $6.5m. This relates to non-deductible unamortised initial differences of RAB assets disposed and the revaluation component in RAB disposal.

*Regulatory tax allowance: disclosure of temporary differences (5a(vi) of Schedule 5a)*

9. In the box below, provide descriptions and workings of material items recorded in the asterisked category 'Tax effect of other temporary differences' in 5a(vi) of Schedule 5a.

| **Box 6: Tax effect of other temporary differences (current disclosure year)** |
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| Movement in provisions and accruals -$0.8m. |

*Related party transactions: disclosure of related party transactions (Schedule 5b)*

10. In the box below, provide descriptions of related party transactions beyond those disclosed on Schedule 5b including identification and descriptions as to the nature of directly attributable costs disclosed under subclause 2.3.6(1)(b).

**Box 7: Related party transactions**

A detailed description of related party transactions has been disclosed in Schedule 5b.

Vector's electricity business purchased telecommunications services from a Vector Limited subsidiary, Vector Communications. These services have historically been provided by Vector Communications on a rolling annual basis. During RY17 Vector restructured its telecommunications arrangements by entering into an indefeasible right of use (IRU) with Vector Communications. The purpose of the IRU was to secure for Vector's electricity business long term access to telecommunications services, which are becoming increasingly critical as new technologies such as distributed generation, storage and electric vehicles become pervasive on its network. The IRU is classified as an asset arising from a finance lease and has a value of $88.7m. This transaction has been certified as "arms-length" by directors on the basis of an independent valuation undertaken by a suitably experienced valuer.

There have been no related party transactions within the disclosure year that require disclosure under clause 2.3.6 (1) (b).

*Cost allocation (Schedule 5d)*

11. In the box below, comment on cost allocation as disclosed in Schedule 5d. This comment must include information on reclassified items in accordance with subclause 2.7.1(2).

**Box 8: Cost allocation**

There has been no re-classification of items in the disclosure year.

ABAA (accounting-based allocation approach) has been applied to allocate not directly attributable costs in the disclosure year in accordance with the IM determination.

*Asset allocation (Schedule 5e)*

12. In the box below, comment on asset allocation as disclosed in Schedule 5e. This comment must include information on reclassified items in accordance with subclause 2.7.1(2).

**Box 9: Commentary on asset allocation**

There has been no re-classification of items in the disclosure year.

Vector satisfies the thresholds in the IM determination to enable the application of ACAM to allocate not directly attributable fixed assets.

*Capital Expenditure for the Disclosure Year (Schedule 6a)*

13. In the box below, comment on expenditure on assets for the disclosure year, as disclosed in Schedule 6a. This comment must include-

    13.1 a description of the materiality threshold applied to identify material projects and programmes described in Schedule 6a;

    13.2 information on reclassified items in accordance with subclause 2.7.1(2),

**Box 10: Explanation of capital expenditure for the disclosure year**

The materiality threshold applied to identify material projects is the level of audit materiality applied by Vector's regulatory auditors ($11.8m).

There were no material projects or programmes during the period.

There were no reclassifications in the year.

*Operational Expenditure for the Disclosure Year (Schedule 6b)*

14. In the box below, comment on operational expenditure for the disclosure year, as disclosed in Schedule 6b. This comment must include-

    14.1 Commentary on assets replaced or renewed with asset replacement and renewal operational expenditure, as reported in 6b(i) of Schedule 6b;

    14.2 Information on reclassified items in accordance with subclause 2.7.1(2);

14.3 Commentary on any material atypical expenditure included in operational expenditure disclosed in Schedule 6b, a including the value of the expenditure the purpose of the expenditure, and the operational expenditure categories the expenditure relates to.

**Box 11: Explanation of operational expenditure for the disclosure year**

Vector has not replaced any assets under operational expenditure in the disclosure year (excludes replacement of components of assets that do extend the life of the asset). All asset replacement and renewal of asset expenditure has been classified as capital expenditure.

There was no atypical expenditure during the period which exceeded our materiality threshold, as described above.

There has been no re-classification of items in the disclosure year.

*Variance between forecast and actual expenditure (Schedule 7)*

15. In the box below, comment on variance in actual to forecast expenditure for the disclosure year, as reported in Schedule 7. This comment must include information on reclassified items in accordance with subclause 2.7.1(2).

**Box 12: Explanatory comment on variance in actual to forecast expenditure**

Capital Expenditure:

Overall actual expenditure was 5% or $10m higher than forecast with key drivers being:

Consumer connections expenditure increased by 39% or $16m driven by increased connections and subdivision activity.

System growth expenditure reduced by (33%) or ($15m) as some reinforcement projects were deferred into RY18 including Warkworth South, Newmarket Land Purchase, Hobsonville Point Zone Substation and the Auckland Hospital Capacity Reinforcement project.

Asset replacement and renewal expenditure increased by 11% or $8m due to additional costs in relation to Penrose, and additional pole replacements partially offset by the delayed timing of the switchgear replacement programme.

Asset relocation, reliability, safety and environment and non network activities were broadly in line with forecast.

Operating Expenditure:

Overall actual expenditure was $3m lower than forecast with key drivers being:

There were higher vegetation management costs due to an increased focus on the worst performing feeders.

Routine and corrective maintenance expenditure is broadly in line with the forecast.

Spend in relation to asset replacement and renewal activity was less than forecast. This has been impacted by Field Service Provider (FSP) resourcing and planning challenges, FSPs losing resources due to the growing cost of living in Auckland and difficulties in attracting the right people. In addition, we were also impacted by three major weather events at the start of this year that diverted crews onto repair and restoration activity.

Lower system operations and network support costs are due largely to the reversal of a provision made in the prior period.

As a result of the sale of the Gas Transmission and non-Auckland Gas Distribution businesses to First Gas Limited, there has been a higher allocation of corporate costs to electricity due to diseconomies of scale which is only partially offset by savings achieved from the sales.

*Information relating to revenues and quantities for the disclosure year*

16. In the box below provide-

16.1 a comparison of the target revenue disclosed before the start of the disclosure year, in accordance with clause 2.4.1 and subclause 2.4.3(3) to total billed line charge revenue for the disclosure year, as disclosed in Schedule 8; and

16.2 explanatory comment on reasons for any material differences between target revenue and total billed line charge revenue.

| **Box 13: Explanatory comment relating to revenue for the disclosure year** |
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| Vector's target revenue for the year ended on 31 March 2017, as included in our pricing methodology disclosure pursuant to clause 2.4.1(1) and 2.4.3(3) of the Electricity Distribution Information Disclosure Determination 2012, was $618m.<br><br>Total billed line charge revenue for the disclosure year ended on 31 March 2017 was $616m, as disclosed in schedule 8 of this disclosure. The variance between target revenue and total billed line charge is $2m or (0.32%). The small variance is mainly due to slightly lower than forecasted volumes due to warmer than expected weather in the winter period. |

*Network Reliability for the Disclosure Year (Schedule 10)*

| **Box 14: Commentary on network reliability for the disclosure year** |
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| Vector has completed Schedule 10 and disclosed information consistent with the normalisation requirements contained within the Electricity Distribution Information Disclosure Determination 2012. It should be noted that the disclosed SAIDI and SAIFI values are therefore not aligned with those presented in Vector's 2017 Compliance Statement (which is based on the Electricity Default Price-Quality Path Determination 2015). This is in line with guidance from the Commerce Commission's Issues Register item #447.<br><br>The details on Vector's network reliability, including actions and initiatives to improve reliability performance, can be found in Vector's 2017 Price-Quality Annual Compliance Statement: https://www.vector.co.nz/about-us/regulatory/disclosures-electricity/price-quality-path<br><br>When reviewing the metrics presented in Schedule 10, the following point should also be noted. Vector has elected to report normalised SAIFI and SAIDI values for each sub-network based on normalised assessment datasets for each sub-network, with boundary values calculated using the reference dataset for the sub-networks. This is one of two options the Commission provides for EDBs to report on sub-network reliability (ref: External Issues |

Register response #231). Vector has chosen this option on the basis that this methodology provides more meaningful analysis of the actual performance of each sub-network.

17. In the box below, comment on network reliability for the disclosure year, as disclosed in Schedule 10.

*Insurance cover*

18. In the box below, provide details of any insurance cover for the assets used to provide electricity distribution services, including-

    18.1 The EDB's approaches and practices in regard to the insurance of assets used to provide electricity distribution services, including the level of insurance;

    18.2 In respect of any self insurance, the level of reserves, details of how reserves are managed and invested, and details of any reinsurance.

**Box 15: Explanation of insurance cover**

Vector Limited takes insurance cover for a large number of group assets. These policies cover material damage, business interruption and contract works insurance.

Insurance costs are allocated to the EDB using the proportion these assets represent relative to Vector's overall insured assets.

In respect of the insurance cover the information reflects "insurance years" running from 1 September to 31 August each year and premium costs are allocated to the appropriate regulatory years to derive the premium values.

*Amendments to previously disclosed information*

19. In the box below, provide information about amendments to previously disclosed information disclosed in accordance with clause 2.12.1 in the last 7 years, including:

    19.1 a description of each error; and

    19.2 for each error, reference to the web address where the disclosure made in accordance with clause 2.12.1 is publicly disclosed.

**Box 16: Disclosure of amendment to previously disclosed information**

N/A

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| Company Name | Vector |
| For Year Ended | 31 March 2017 |

# Schedule 15 Voluntary Explanatory Notes

1. This schedule enables EDBs to provide, should they wish to-

   1.1 additional explanatory comment to reports prepared in accordance with clauses 2.3.1, 2.4.21, 2.4.22, 2.5.1 and 2.5.2;

   1.2 information on any substantial changes to information disclosed in relation to a prior disclosure year, as a result of final wash-ups.

2. Information in this schedule is not part of the audited disclosure information, and so is not subject to the assurance requirements specified in section 2.8.

3. Provide additional explanatory comment in the box below.

**Box 1: Voluntary explanatory comment on disclosed information**

On 20 April 2016 Vector sold its Gas Transmission business and non-Auckland gas distribution business to First Gas. For the RY17 disclosures, the cost and asset allocations reflected in these disclosures have been prepared entirely on a post-sale basis (i.e. we have not calculated a separate set of cost allocators for the 13 business days at the beginning of the period when Vector still owned the Gas Transmission and non-Auckland gas distribution business).

**Box 2: Voluntary explanatory comment on disclosed information**

From the 2016 financial year (also income tax year), Vector Group changed its tax depreciation methodology to straight line method. The regulatory tax depreciation follows the tax rules; accordingly, the RY17 regulatory tax depreciation is calculated using the straight line method.

**Box 3: Voluntary explanatory comment on disclosed information**

The significant difference between RAB and Tax assets commissioned largely relates to an acquisition of assets from Vector Communications Ltd (VCL). For RAB purposes, this asset is recorded at market value, whereas for regulatory tax, it is the adjusted tax value of the asset transferred from VCL to Vector Limited by following the tax rules.

**Box 4: Voluntary explanatory comment on disclosed information**

In August 2016, the Court of Appeal found in Vector's favour in respect of a dispute with the Inland Revenue Department (IRD). The dispute centred on whether Vector's receipt of $53m from Transpower for the granting of various access rights was taxable. To manage its risk during the dispute, Vector, in its income tax returns treated the proceeds as taxable, and in accordance with section EI 7 (Income Tax Act 2007) spread the amount equally over a 6 year period from 2011. Vector filed with the IRD a Notice of Proposed Adjustment for each of the years.

For each of the regulatory years 2012 to 2016, the regulatory tax treatment followed the income tax treatment, whereby 1/6 of the proceeds (i.e $8.9m, tax effect $2.5m) was treated as a taxable permanent difference (row 10 of schedule 5a).

Following judgement (High Court and Court of Appeal) that the receipt was not taxable the IRD has reversed prior years assessments during the 2017 financial year.

The amount reversed is not included in Vector's current year regulatory profit. The Electricity Distribution Services Input Methodologies Determination 2012 (IM) is silent on the treatment of prior period adjustments. None of the permanent differences provisions (clause 2.3.3 of the IM) apply. In Vector's view the historical treatment was not a material error. No restatement or reversal of prior year tunnel proceeds has been made on schedule 5a in the current regulatory year. If the tunnel proceeds were not treated as taxable income in the relevant reported periods, the ROI reported by Vector in each of the regulatory years RY12 to RY16 would increase by 10 basis points.