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10 February 2012

Cross-submission on Additional Input Methodologies Process and Issues Paper

1. Vector welcomes the opportunity to provide this cross-submission, responding to submissions received on the Commerce Commission's (Commission) Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper (Process and Issues Paper). No part of this submission is confidential.

2. In this cross-submission Vector responds to certain statements made by Unison Networks Ltd, Maui Development Ltd (MDL) and Jeff Balchin of PriceWaterhouseCoopers on behalf of Powerco.

3. Vector's contact person for this cross-submission is:

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Claw-back

4. Unison has made a series of points in relation to claw-back as it applies to electricity distribution businesses (EDBs), which we respond to in turn below.

Inclusion of claw-back criteria and methodology in the SPA IM

5. Unison considers the criteria for and implementation method of claw-back should form part of the SPA IM.

6. Vector agrees.

Policy arguments in relation to claw-back

7. Unison considers that where there are significant over- and under-recoveries, there are strong policy grounds to support the application of claw-back. Further, there should be a presumption in favour of claw-back to account for the transition to the new regulatory regime since 2010.

8. Vector submits that there are strong policy grounds for not applying claw-back at the initial reset for EDBs. As Economic Insights has advised, it is preferable to implement the starting price adjustment methodology on a purely forward looking basis, in part because it "has least potential to distort EDB decision-making".[1]

9. Further, as Vector has previously submitted:[2]

   a) Claw-back, in the case of perceived over-recovery of revenues, is likely to lead to under-investment for the remaining years of the regulatory period as that supplier will now be making a sub-WACC return over those years; and

   b) While in theory the perceived over-recovery and claw-back should cancel each other out, in reality EDBs will have made their capital investments in years 2010/11 and 2011/12 without being aware that claw-back would be applied. As a result, the EDB will have limited opportunities to reduce these costs to offset the claw-back that is to be applied in later years. The result would most likely be under-investment by the EDB in the later years of the regulatory period.

Impact of claw-back on efficiency incentives

10. Unison made the following points in relation to concerns about negative impacts of claw-back on efficiency incentives:

    a) The scale of the transfer could be reduced for those earning excessive profits;

    b) For suppliers earning less than WACC, the Commission could evaluate their cost efficiency and cost performance;

    c) Unison questions why suppliers would have reduced incentives to improve efficiency in future given limited claw-back discretion in the Commerce Act;

    d) Efficiency impacts would be mitigated by IRIS and/or a staggered approach to reducing prices; and

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[1] Economic Insights, *Review of the Commerce Commission's Analytical Framework for Starting Price Adjustments*, 20 April 2011, page 10.

[2] Vector Ltd., *Submission to the Commerce Commission on 2010-15 DPP Starting Price Adjustment and Other Amendments Update Paper*, 16 May 2011, pages 44-47.

e) Investment incentives would be damaged by suppliers earning less than WACC since the start of the regulatory period.

11. In response (and in the same a-e order as the points above), Vector submits that:

a) A reduction in the scale of the transfer would only mitigate the difficulties associated with claw-back, not remove them altogether.

b) A Commission evaluation of cost efficiency or cost performance of regulated suppliers in order to, in effect, set prices would not be appropriate or necessary in the DPP context.

c) The impact of a claw-back on efficiency gains would be far reaching. This is because a decision to apply claw-back would indicate the Commission was not concerned with promotion of efficiency gains. Even if claw-back is imposed sparingly in the future, the message that claw-back would send will not promote efficiency gains.

d) Vector does not agree that efficiency impacts would be mitigated by an IRIS or a staggered starting price adjustment. These mechanisms are designed to generally promote efficiency incentives within a regulatory period, not to offset negative efficiency impacts of decisions to transfer efficiency gains to consumers in a very short timeframe as would occur under a claw-back arrangement. The IRIS and stagger would need to be significantly more generous to overcome the negative impacts of a claw-back.

e) Vector submits that the impact on investment incentives of not applying claw-back is likely to be less severe than Unison implies. While investment incentives may have been damaged by under-recovery since the start of the regulatory period, that impact cannot now be undone. By the same logic as Unison applies, applying claw-back would damage investment incentives for suppliers facing a negative starting price adjustment as they will under-recover in the remaining years of the regulatory period.

SPA IM should not focus only on initial resets

12. MDL has submitted that the Commission should focus only on the SPA for the 2013 initial resets and only consider the approach to future resets after some experience is gained with the regulatory regime.

13. Vector does not agree with MDL. Suppliers of electricity distribution and gas pipeline services invest in assets with long useful lives and need confidence of the ability to earn a commercial return over the lifetime of those investments.

14. As Castalia point out:

> "Defining how profitability assessments will be carried out allows suppliers to know the substance of the regulatory regime before their prices are adjusted. The starting price adjustment input methodologies should enable suppliers to assess the likely impacts of profitability assessments on their business."[3]

15. If regulated suppliers have no certainty with regard to how prices may be adjusted at future resets for electricity and gas, they will have less confidence in their business environment and will be less likely to invest. For certainty to be provided, regulated suppliers need assurances that the SPA methodology used for the initial resets will also be applied to future resets, with any changes being clearly justified and consulted on. This is best achieved by setting a general SPA IM that covers future resets, which is still able to be amended where necessary following the process in Part 4 of the Commerce Act. This is consistent with the policy objective underpinning input methodologies: that certainty is provided by setting the rules and processes that apply to regulation upfront (rather than on a case by case or piecemeal basis).

The staggered SPA

16. Vector agrees with Mr Balchin that "a 'staggering' mechanism would be an improvement to the DPP regime and would be low cost to implement, but would not fully remedy the incentive issues that have been identified."[4] Mr Balchin correctly points out that the incentives to improve efficiency under a stagger diminish over the regulatory period, which is a point that Vector's submissions on the stagger have illustrated.

17. This point is why Vector has recommended that the Commission implement a staggered SPA in addition to implementing an Incremental Rolling Incentive Scheme (IRIS). Our submissions have stressed that a staggered SPA and IRIS are complements and not substitutes. Either mechanism could be introduced without the other, but for the Commission to ensure regulated suppliers have incentives to invest, innovate and improve efficiency it would be best to implement both a stagger and an IRIS.

Clarification of previous submission

18. Finally, and for the avoidance of doubt, we also wish to make it clear that Vector's position on the application of the ID IMs to DPP regulation (as set out in Vector's submission dated 27 January 2012) is without prejudice to

[3] Castalia, *Additional Input Methodologies for Default Price-Quality Paths: Report to the Commerce Commission on behalf of Powerco*, January 2012, page ii.
[4] Letter from Jeff Balchin, PWC, to Richard Fletcher, Powerco, *Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper*, 26 January 2012, page 18.

Vector's position in its extant merits review appeals that materially better input methodologies should be adopted.

Yours sincerely,

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