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12 October 2012

John McLaren
Chief Advisor
Regulation Branch
Commerce Commission
WELLINGTON

Dear John,

Cross-submission: Revised Draft Reset for EDB DPPs

1. Vector welcomes the opportunity to make a cross-submission to the Commerce Commission (Commission) on its Revised Draft Reset of the 2010-15 Default Price-Quality Paths (the Revised Draft Reset), 21 August 2012.

2. Please find attached a report from Castalia, Comments on Submissions on Revised Draft Reset of Electricity Distribution Prices, 12 October 2012. The Castalia Report:

   a. Responds to concerns raised about use of econometrics for forecasting opex; and

   b. Provides advice on construction of a sector-specific index for inflation.

3. No part of Vector's submission, or the Castalia Report, is confidential and we are happy for them to be publicly released.

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

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Common themes in the submissions

5. The submissions generally reinforce, and support, the concerns Vector raised in its submission; including:

   a. EDBs will not necessarily expect to recover the Commission's WACC for 2012-15, notwithstanding the Commission's view that they will.

   b. There is considerable scope for improvement in the way the Commission determines current and projected profitability.

c.	CPPs should not, and cannot, be relied on to address asymmetric risk.	There are numerous submissions on this point, but PricewaterhouseCoopers provides a useful illustration of the risk created by the fact that a CPP will traverse more than one DPP: > … the remedies available under a CPP are limited by the delay in the CPP decision making process. Accordingly, in practice, CPPs which are triggered as a consequence of a DPP decision will fall across two DPP regulatory periods. We believe that it will be difficult for non-exempt EDBs to make a decision to apply for a CPP which does span across two DPP periods, where they do not know how the next DPP will be reset.
d.	The Commission should introduce efficiency mechanisms such as IRIS, stagger and/or s 54Q mechanisms.	For example, Contact Energy, the only gentailer to submit on the Revised Draft Reset, stated that "Contact supports implementation of an incremental rolling incentive scheme for default price-quality paths". Powerco's view is that either mechanism would be an improvement over the status quo". Powerco suggests that "On balance however Powerco favours the IRIS mechanism". This reflects a misunderstanding of IRIS and the stagger mechanism. They are complements (IRIS smoothes incentives over the regulatory period, while a stagger raises them overall), not substitutes.

Asymmetric risk and the use of CPPs to offset this risk

6. On the matter of asymmetric risk and whether CPPs should be relied on to address this risk, Vector believes the Commission should consider the approach it has taken to determinations under the Telecommunications 2001.

7. Vector believes the philosophy that the Commission has previously taken to regulation under the Telecommunications Act is sound and entirely appropriate for its operation of economic regulation under Part 4 of the Commerce Act; for example:

> A low price may produce some static efficiency improvements and benefits for end-users in the short-run, but may have an adverse impact on the incentives for investment and innovation in infrastructure in the longer term.[1]
>
> The Commission has also recognised the risks associated with regulatory intervention … These risks can arise from … the Commission making decisions on the basis of imperfect information, including uncertainty about the level and structure of efficient access prices … [2]
>
> given the tension between dynamic and static forms of efficiency, the Commission is of the view that it is appropriate to place relatively more weight on dynamic efficiency considerations. In

[1] Paragraph 153, Commerce Commission, Determination on the TelstraClear Application for Determination for Designated Access Services, 5 November 2002.

[2] Paragraph 154, Commerce Commission, Determination on the TelstraClear Application for Determination for Designated Access Services, 5 November 2002.

> other words, if it were the case that setting prices too low would significantly jeopardize incentives for investment in access networks, the trade-off between higher prices and more investment on the one side and lower prices and short-term consumer gains on the other would be resolved by the Commission in favour of the former.[3]
>
> The Commission accepts in principle that the risk to dynamic efficiency of a low access price is asymmetric and that the balance of risk favours setting a price that errs on the high side. [4]
>
> In summary, the Commission concludes that the median point of the benchmark range is the appropriate starting point for the pricing decision and that an adjustment should be made to reflect the asymmetric nature of the risk to dynamic efficiency of a low price. [5]

8. These comments are particularly salient as Vector considers that there are strong parallels between the DPP/CPP regime under Part 4 of the Commerce Act and the initial pricing principle/final pricing principle arrangements for designated services under the Telecommunications Act.

9. The initial pricing principle (setting price based on benchmarking against prices in comparable countries) offers a low cost way of establishing a price for the regulated service, in an analogous way to the intention of the DPP.

10. If the Access Provider does not consider the initial price determination meets its particular circumstances it can seek a final price determination based on the final pricing principle. This would require cost modelling e.g. the final pricing principle for interconnection services is TSLRIC. The final pricing determination could be lower or higher than the price under the initial pricing determination.

11. The conclusion we draw from the Commission's previous position in relation to the Telecommunications Act is that the Commission should provide an allowance for regulatory error/err in favour of investment incentives and should not use CPPs as an error correction mechanism.

Specific areas of comment

12. There are four specific matters raised in other submissions that Vector responds to:

    a. Concerns about the econometric approach the Commission has adopted for forecasting opex;

    b. Contact Energy's claim that the Commission's approach "creates a material bias in favour of the EDBs" and enables EDBs "to earn what seems a relatively high regulated return";

    c. Arguments that claw-back should be applied from 1 April 2010;

    d. Differing views on the discount rate that should be adopted for claw-back; and

    e. Inclusion of claw-back in the RAB.

Econometric approach adopted for forecasting opex

13. A number of submitters have raised concerns about the Commission's econometric approach for forecasting opex.

[3] Paragraph 155, Commerce Commission, Determination on the TelstraClear Application for Determination for Designated Access Services, 5 November 2002.

[4] Paragraph 168, Commerce Commission, Determination on the TelstraClear Application for Determination for Designated Access Services, 5 November 2002.

[5] Paragraph 153, Commerce Commission, Determination on the TelstraClear Application for Determination for Designated Access Services, 5 November 2002.

14. For example, Powerco points out that the Commission's econometric forecasting has been "... completed [with] very limited testing to ascertain if there are other significant explanatory variables. It is unlikely that simple metrics such as network length and ICP numbers sufficiently explain an EDB's opex growth".

15. The concerns highlight that the Commission should not assume that EDBs will necessarily expect to earn a normal return under the reset and this should be addressed by some form of a "safety margin".

16. Vector, Castalia and CEG's submissions included recommendations that the Commission should adopt to improve the reliability and robustness of its econometric forecasting for opex. Adopting these recommendations would help allay the concerns raised in submissions, and as the attached Castalia report shows, would provide a better basis for predicting future opex.

Contact's claims of a material bias in favour of EDBs

17. Contact states that it "considers that the approach taken by the Commission (in part due to the requirements of Part 4 of the Commerce Act ... creates a material bias in favour of the EDBs and consequently higher prices than would prevail in a competitive market".

18. It is unclear why Contact is seeking to relitigate this issue now. The WACC has been set in accordance with the input methodology determination made in December 2010. The appropriateness of the use of the 75th percentile is not a relevant issue to the price reset decision.

19. The Commission has made it clear "... the social costs associated with underestimation of the cost of capital in a regulatory setting involving constraining prices to end users ... are likely to outweigh the short-term costs of overestimation (i.e. if the cost of capital is set too low, the incentives for suppliers to undertake efficient investments will be reduced, which would be inconsistent with the long-term benefit of consumers)".[6]

20. Vector would add that: (i) the WACC is only one component of EDB costs; (ii) the Commission has not provided an upward "bias" (or safety margin) on any other components of EDB costs; and (iii) the submissions the Commission has received in this, and in previous consultation rounds, highlight that there are a number of issues with the Commission's calculation of current and projected profitability which mean EDBs will not necessarily expect the reset to enable them to earn a normal return for 1 April 2012-15. For example, the switch to adopting econometrics to forecast opex and revenue, and the econometric approach and assumptions adopted, clearly have substantial impacts on the Commission's projection of costs and revenues for each EDB.

Adoption of claw-back from 1 April 2010

21. Centralines, MEUG and Unison support claw-back to April 2010.

22. MEUG is the only party to overtly advocate claw-back to April 2010 for over-recovery.

23. MEUG sets up a straw-man to argue against the Commission's position by implying that the Commission has only provided two reasons against claw-back,[7]

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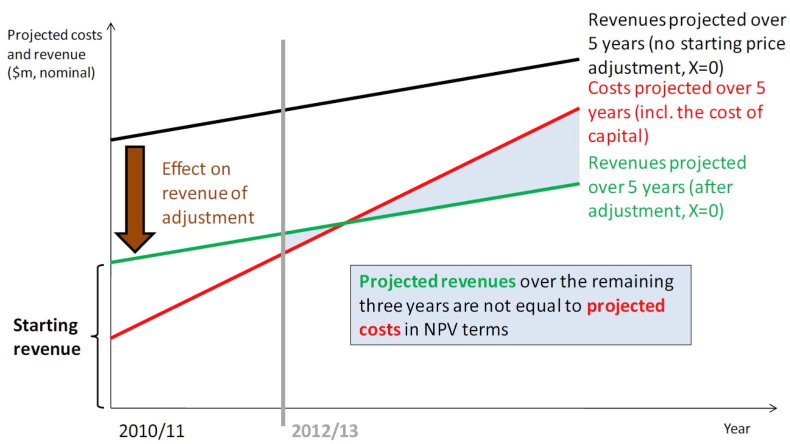
[6] Paragraph H1.32, Commerce Commission, Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper, December 2010.

[7] The two reasons being that: (i) "1 April 2012 was the earliest date prices could have changed"; and (ii) "that a majority of submitters in earlier consultation rounds supported claw-back for one year or less".

and only refuting those arguments. There are sound reasons against claw-back to 2010 which the Commission and others have provided. Vector would query whether any of MEUG's members would consider it satisfactory to: (i) have their revenue retrospectively reduced, without advance warning that this would be done; or (ii) have regulation which meant they expected to earn below normal returns.[8]

24. Unison criticised the Commission's statements in the Revised Draft Decision that it rejected claw-back to 2010 because "1 April 2012 provides the relevant date, in our opinion, from which suppliers should have the opportunity to earn a normal return." Unison appears to be asserting that the Commission has made a decision without proper justification, with Unison stating that they are "dis-heartened that the Commission considers that this is proper justification". In this particular instance, the basis for the Commission's "opinion", which was provided in previous papers but not fully referenced in the Revised Draft Reset, is sound.[9]

25. In response to MEUG and Unison's claims, Vector notes, by way of example, that the Commission has explained how adoption of claw-back for the full regulatory period would mean that EDBs with downward price adjustments would not earn a normal return from when the mid-period reset was introduced to the end of the regulatory period (as reflected in the following diagram).



Source: Figures 12 - 14, Commerce Commission, Update Paper: Starting Price Adjustments & Other Amendments, April 2011.

26. Vector agrees with the Commission that the approach reflected in the above figure which requires application of claw-back, would be undesirable because "A supplier would ... not be forecast to earn a normal return over the final year years of the period ..."[10]

27. Vector notes that the arguments Centralines and Unison make as to why claw-back should apply to 2010 are specific to under-recovery. We recognise that the arguments for and against claw-back may differ in relation to under or over-recovery. Vector would stress though that it would not be desirable to apply claw-back to ensure EDBs expected to earn normal returns for 2010-12 if it resulted in some EDBs expecting to earn below normal returns, on a forward-looking basis,

[8] For example, refer to Commerce Commission, Update Paper: Starting Price Adjustments & Other Amendments, April 2011.

[9] Ibid.

[10] Paragraph 4.11, Commerce Commission, Update Paper: Starting Price Adjustments & Other Amendments, April 2011.

for 2012-15. The Commission provided a sound analysis to demonstrate this point in its Update Paper: Starting Price Adjustments & Other Amendments, April 2011.

Discount rate that should be adopted for claw-back

28. Vector's submission argued that the Commission should apply the risk-free rate or, failing that, the cost of debt determined for the period 1 April 2012-13. Consistent with this view, Contact argues "the maximum discount rate used for calculating the NPV of claw-back adjustments should be the cost of debt".

29. For the avoidance of doubt, it should be noted that Vector's view was specific to over-recovery of revenue and recognises there may be legitimate arguments for differing discount rates for under and over-recovery.

30. Unison argues that the Commission should apply the DPP WACC as the discount rate. Vector does not agree with this view or Unison's arguments in favour of the DPP WACC.

31. Unison claims that "it would be unlawful for the Commission to use anything other than the 75th percentile of WACC for the 2010-15 DPP regulatory period for the cost of capital applying to claw-back as the IMs do not allow for anything else."

32. While Unison is correct that clause 4.1.9 of the IMs for EDBs provides that "Where the **Commission** takes into account the cost of capital in making a **DPP determination**, the **Commission** will use the **75th percentile estimate of WACC**", this clause is entirely irrelevant to Unison's argument because the Commission is determining the discount rate to be applied for claw-back, not the cost of capital. There is nothing in the IMs for EDBs, or in the provisions of the Commerce Act relating to claw-back, to suggest the discount rate for claw-back has to be set at the cost of capital.

33. Unison claims that "The Commission does not explain why the claw-back amount is a "fixed payment", or how it is "more akin to a loan between suppliers and consumers"." Vector considers this to be so clear as to be self-evident. Where there is over-recovery (under-recovery) and the Commission has determined this shall be returned to the consumer (EDB), the EDB (consumer) is effectively borrowing, albeit unintentionally, money from the consumer (EDB) from when the over-recovery (under-recovery) occurred to when it was paid back. Fundamentally, these are the characteristics of a loan.

34. While Unison is correct to say there will be some "uncertainty" about the level of claw-back, at present, this is because the level of under or over-recovery is not yet known. This in no way precludes the claw-back being represented by a "fixed payment" in return. The Commission's proposal to apply claw-back in 2014 when quantities for the 2013 year are known, will allow an accurate fixed payment to be determined.

35. Just because the Commission is depicting claw-back of under or over-recovery as "more akin to a loan between suppliers and consumers" does not mean that "The Commission is effectively implying that an EDB would borrow against the regulatory promise that revenues will materialise in 2014/15 to pay out an equivalent dividend to shareholders in 2012/13." The Commission has not said it was identical to a loan, rather that it was "more akin to a loan". The fact that the over or under-recovery was not voluntarily agreed to by consumers and EDBs does not mean that it does not have characteristics of a loan.

36. If the Commission applied the DPP WACC as the discount rate for claw-back, consumers would be penalised for under-recovery because they would, in effect, be borrowing money from EDBs at an interest rate in excess of the cost they

would incur from borrowing the same amount from a bank over the April 2012-period. Vector does not believe this would be in the long-term interest of consumers.

37. The reality is that a *de facto* loan to consumers is low risk to EDBs (EDBs are natural monopolies so can readily recover any allowed revenues from consumers) and the opportunity cost to the EDB (effectively the cost of debt) from having to rely on claw-back rather than full-recovery of costs from 1 April 2012 is substantially lower than WACC. As Contact Energy notes "It is arguable that having been calculated, there is no risk to the recovery of the claw-back and the risk-free rate of return should be used as the discount rate."

Precedent under the Telecommunications Act

38. The allocation of the net cost of the Telecommunications Service Obligation (TSO) under the Telecommunications Act 2001 provides relevant precedent for the setting of the discount rate; including that the discount rate does not need to be the same as WACC.

39. Under the Telecommunications Act liable persons were originally required to contribute to the net cost of the TSO services provided by Telecom.

40. There was always a gap between the when Telecom incurred the costs of the TSO and when the Commission determined and allocated the net cost. For example, the Commission determined the net cost of the TSO for 2001/02 on 17 December 2003.

41. The Commission compensated Telecom for the delay in payment (between the end of Telecom's financial year and payment from liable persons was received) by adding the "loss of use of money" to the net cost of the TSO. The Commission set the "loss of use of money" as the 90 day bank bill rate as at the date of the final determination, in accordance with section 92(g) of the 2001 version of the Telecommunications Act.

42. The Telecommunications Act has subsequently been revised such that liable persons pay the crown a contribution to the Telecommunications Development Levy. Consistent with the previous provisions, section 89(2)(b) of the (July 2011 version) Telecommunications Act requires that "the liable person must pay the Crown interest on the unpaid amount at the 90-day bank bill rate (as at 21 working days after the date on which the determination is publicly notified)".

Inclusion of claw-back in the RAB

43. CentraLines have proposed that claw-back be included in the Regulatory Asset Base (RAB).

44. Doing this would mean: (i) WACC becomes the discount rate by default (see discussion above); and (ii) claw-back would be smeared over the "asset life" of the claw-back. (Centralines is silent on what asset life/depreciation treatment it proposes for claw-back.)

45. Vector does not believe this would be permissible under the Commerce Act. Claw-back is defined in the Act under section 52D. While the Commission has a degree of discretion over claw-back (whether to apply it, whether to claw-back under/over-recovery in part or in full, whether to treat under/over-recovery asymmetrically, what period to apply the claw-back over, what discount rate to use etc), it is nevertheless limited by the definition in section 52D to applying claw-back by way of prices. The section 52D definition does not include provision to treat claw-back as an asset (or presumably a liability in the case of over-recovery).

46. Regardless, Vector does not believe including claw-back in the RAB would be in the long-term interest of end-users:

    a. It would exacerbate the concerns Vector has raised about using WACC as the discount rate, as it would mean that WACC would be applied as the discount rate over a longer period of time e.g. consumers in Centralines area (and other network areas where under-recovery occurred) would, in effect, be borrowing off Centralines and have to pay Centralines' WACC for the period that claw-back remained in the RAB. Centralines would make a risk-free margin between the WACC and its cost of debt.

    b. It would create inter-generational equity issues amongst consumers as there would be a bigger gap between when consumers over/under-paid and when the over/under recovery is recouped.

47. The Commerce Act provides sufficient basis for claw-back to be smeared over a number of years without the need to use the RAB.

Kind regards

Bruce Girdwood
Regulatory Affairs Manager