Submission to the Commerce Commission on Incentives for Suppliers to Control Expenditure During a Regulatory Period

21 October 2013

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INTRODUCTION

1. Vector welcomes the opportunity to submit in response to the Commerce Commission's Process and Issues Paper "Incentives for Suppliers to Control Expenditure During a Regulatory Period" (Incentives Paper), dated 20 September 2013.

2. Please find attached a companion report "Efficiency impacts of operation of Part 4 – Stylised Example Mark II", dated 21 October 2013. The stylised example is a follow-up to the earlier report "Efficiency impacts of Starting Price Adjustments – Stylised Example", dated 19 December 2011. The Mark II Stylised Example has been updated to reflect that the Base Year cannot be year 5 of the Regulatory Period, and to illustrate how the Commission can readily raise and smooth out incentives through options for setting the Base Year, adoption of IRIS, and adoption of a staggered pricing methodology.

3. Please also find attached a report from Castalia "Comments on Regulatory Incentives Process and Issues Paper", dated 21 October 2013.

4. The reports previously commissioned by Vector from Castalia and CEG on the impacts of economic regulation on incentives[1] also provide evidence from regulators, economic literature etc that the way regulators operate economic regulation can have substantial impacts on efficiency incentives, both positive and negative.

5. No part of Vector's submission, or the attached reports, are confidential and we are happy for them to be publicly released.

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

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[1] For example:

- Castalia, Evidence on the Impacts of Regulatory Incentives to Improve Efficiency, Report to Vector, April 2012.
- CEG, Empirical studies on the impacts of economic regulation, Report to Vector, July 2012.

VECTOR SUPPORTS ENHANCING EFFICIENCY INCENTIVES

7. Vector welcomes the commencement, by the Commission, of work on providing better incentives to improve efficiency as part of the operation of Part 4 of the Commerce Act 1986. Vector considers this to be a positive initiative that can create win-wins for consumers and regulated suppliers; enabling better profitability, lower (than otherwise) prices and improved service quality. For the purpose of this submission incentives to improve efficiency is treated as synonymous with incentives to innovate and improve efficiency.

8. The Incentives Paper highlights a number of issues with the current operation of Part 4 of the Commerce Act. Vector agrees with the Commission's assessment. We note it broadly aligns with the assessment provided in Vector's stylised example and with international experience of operation of economic regulation.

9. The current Part 4 has been operating for a relatively short period of time. There will be opportunities to evolve the operation of Part 4, including in relation to efficiency incentives, and to leverage off the experience and operation of economic regulation in other jurisdictions. Vector believes the Commission has time to make significant improvements to the operation of Part 4 for the next electricity and gas resets, but also that further evolution and development will be desirable beyond that.

10. In view of the Incentives Paper, Vector would emphasise that incentives to improve efficiency are not just about cost or controlling expenditure, but also about service quality. The Incentives Paper is silent on service quality. The present operation of Part 4 of the Commerce Act offers no incentives or reward for improving service quality.

11. Vector's world-leading smartphone app[2] is a good example of the type of innovation that can provide superior service for consumers. The app enables real-time updates on the status of the Vector networks and complements our other customer communications channels such as our website and social media. Customers can bookmark important locations, such as work, home and school or multiple worksites, and the app does the rest, delivering the information they need to minimise disruptions from power outages.

12. This smartphone app initiative was relatively low cost. Other innovations that could improve service quality require more significant expenditures. For these initiatives to be viable, regulated suppliers need to be able to maintain or increase their overall returns as a result of increasing service quality. The current regulatory framework provides the opposite outcome by creating the opportunity for regulated suppliers to improve profitability by degrading service quality.

[2] http://vector.co.nz/outages

WHERE TO FROM HERE?

13. The Commission has stated "incentive mechanisms only provide benefits to consumers when they have been signaled to suppliers up front".[3] We agree. The sooner incentive mechanisms are introduced the sooner they can start providing benefits to consumers.

14. Some options would be easier to implement, particularly before the next electricity reset, such as an IRIS and a staggered sharing mechanism. We refer the Commission to the report Vector commissioned from Castalia "Commerce Act Part 4 Funding Review: The Role of Incentive Mechanisms" (19 July 2013) for further consideration of what could be achievable for the next electricity reset.

15. In considering changes to the current Part 4 and Input Methodologies Vector would like to emphasize the following:

    a. Vector agrees with the Commission that it would be desirable to raise efficiency incentives and to smooth out their variability, including avoidance of circumstances where regulated suppliers' retention of efficiency gains is less than 0% (e.g. temporary cost reductions in the Base Year) and more than 100%.

    b. There is no single "silver bullet". Vector believes a package of complementary incentive mechanisms would be desirable, for example: IRIS, staggered pricing mechanism and an S-factor.

    c. The Commission should consider the impact of the Base Year on incentives and whether this has implications for how the Base Year is set. The optimal (worst) time to start reducing costs is after (at the beginning of) the Base Year:

        i. If the efficiency initiative requires one-off opex the optimal time to undertake the expenditure would be during the Base Year (with the efficiency gains realised in subsequent years).

        ii. If the efficiency initiative requires capex the optimal time to undertake the expenditure is at the end of the Base Year.

16. Vector also considers that for any incentive mechanism to be fully effective suppliers and consumers need to have certainty in relation to the rules, requirements and processes that would be applied to the operation of the mechanism. This would suggest it is desirable, to the extent it is permissible, to include the incentive mechanisms within Input Methodologies, just as the IRIS is.

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[3] Paragraph 156, Commerce Commission, Revised Draft Reset of the 2010-15 Default Price-Quality Paths, 21 August 2012.