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Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
Commerce Commission
44 The Terrace, Wellington 6140

By email: im.review@comcom.govt.nz

Dear Keston**,**

Vector submission on the draft amended input methodologies determinations

1. This is Vector's submission on the Commerce Commission's (Commission) Input Methodologies Technical Consultation Update Paper (Technical Consultation), published on 13 October 2016. The Technical Consultation provides a further update on drafting amendments to IMs for businesses regulated under Part 4 of the Commerce Act (the Act). Vector has commented on the updated changes for the IMs as they relate to electricity distribution businesses (EDBs) and gas distribution businesses (GDBs).

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

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3. Our comments on specific draft IM determination clauses are set out in **Appendix A** appended to this letter. No part of this submission is confidential.

Procedural issues

4. Vector is concerned about the substantive policy changes embedded in the Commission's Technical Consultation. Where the Commission has departed from its IM Draft Decisions in the Technical Consultation a better approach would have been to consult directly on the changed view instead of embedding the new view in the IM legal drafting.

Weighted average cost of capital – cost of debt

Debt risk premium

5. The Commission has acknowledged the risk of mismatches between historical debt risk premiums entered into by suppliers and the allowance for the debt risk premium (DRP) in the current on-the-day methodology for estimating weighted average cost of capital (WACC).

6. Frontier Economics, on behalf of Transpower, noted the full impact of the mismatch from applying a rate-on-the-day approach for estimating WACC across all supplier investment is much greater than that acknowledged by the Commission's analysis of the issue.

7. Nonetheless, Vector supports the Commission's proposed change from the on-the-day approach for estimating the DRP. While the Commission has not addressed the full investment risk from mismatches in the on-the-day estimate of WACC, it has acknowledged debt margins cannot be hedged by regulated suppliers under an on-the-day approach. Accordingly, Vector welcomes the Commission taking steps to reduce the impact of the mismatch risk from the on-the-day approach for estimating WACC. We make specific comments on how to improve the historical averaging of the DRP in the table below.

Debt issuance costs

8. Vector is concerned the Commission will be radically changing its compensation approach for debt issuance costs from that proposed in the Draft Decision. The discussion about debt issuance costs has been around the appropriate basis point allowance for compensation. The decision to change compensation to an operating expenditure item is a radical departure and warranted specific engagement on the change.

9. Vector is also concerned about the absence of detail for how debt issuance costs will be accommodated in operating expenditures. The Commission has recognised such costs are legitimate expenses requiring compensation. To this end, we are concerned about the fact there is no specification as to how the Commission will accommodate debt issuance expenditures for suppliers. We have reservations about an approach that risks providing less compensation than necessary for executing debt financing as contemplated by the WACC IM.

10. Given the WACC IM presumes a level of gearing and equity issuance by suppliers for financing their regulated businesses, we also believe there needs to be recognition of equity issuance costs within the WACC IM. This would ensure where suppliers finance their business in the manner contemplated by the WACC IM, they will receive compensation for the issuance costs expected to be incurred with equity financing.

Inflation forecasting

11. The Commission's proposed changes for inflation forecasting are at odds with all the evidence in the IM review on forecasting. The Commission's proposal to rely exclusively on the Reserve Bank of New Zealand's (RBNZ) monetary policy statement inflation forecast

disregards all evidence about the reliability and performance of this forecast to reasonably accurately estimate headline inflation.

12. Of particular concern is the Commission codifying within the IMs an inflation forecast trajectory for periods not within the monetary policy statement to trend to the RBNZ inflation "target". This IM is at odds with the performance of headline inflation over an extended period of time. We encourage the Commission to reconsider the evidence on inflation forecasting.

13. Given the Commission's recognition of the inflation risk to debt holders from achieving a nominal return where actual inflation is lower than the Commission's inflation forecast, we find the proposed drafting of the inflation clauses to magnify the likelihood of this inflation risk.

Revenue cap mechanisms

Revenue cap wash-up cap

14. Vector continues to oppose the need for a revenue cap wash-up cap. We do not believe EDBs should have to bear the risk of unrecovered revenues as a result of this type of cap.

15. Vector notes the Commission has specified in the IMs the cap on revenues permitted in the revenue wash-up cap at 20 percent of *net allowable revenue*. This cap is asymmetrical meaning it only applies where EDBs have over-forecasted expected volumes and therefore under-recovered revenues by more than 20 percent of *net allowable revenue*. Any under-recovered revenue above the cap will be excluded from the "wash-up".

16. While a 20 percent tolerance appears generous, this percentage tolerance excludes a significant portion of the forecasting risk EDBs face. The revenue cap wash-up cap excludes pass-through and recoverable costs from the cap (which can be in the hundreds of millions of dollars). In effect, the forecasting tolerance provided by the cap is much less than 20 percent of the supplier's forecast. We recommend the Commission redraft the -20 percent on *allowable revenue* reflecting the gross-forecasting risk supplier's face.

Cap on average increase in prices

17. Vector noted the need for both a cap and collar on draw-downs and the cap on increase in average prices was an excessive approach to mitigate the risk from price shock. We support only one lever for addressing this risk. Vector recommended the "cap and collar" as the better lever for managing the risk of price shock as it provided less onerous obligations for tariff restructuring. The concern around tariff restructuring is magnified by the Electricity Authority's (the Authority) on foot review of distribution pricing.

18. We also have concerns about the application of the cap on increases in average prices. To this end we have concerns about the vague language of "function of demand" used in the IMs. We encourage the Commission to provide more clarity around this terminology and engage with stakeholders on the topic.

19. We see there is significant risk of a narrowly specified cap having the unintended consequence of creating a large liability accumulating in a supplier's wash-up account. A real example of such a scenario occurring is the Authority's transmission pricing methodology (TPM) review which, if implemented, could increase Vector's recoverable costs by $78 million dollars at any point in time during the price-path and stay at the new higher value. In this case, a narrowly specified average price increase cap would result in with much of the increased annual costs from TPM accumulating in the wash-up account and potentially never be recovered.

Change event re-opener for quality legislation changes

20. As discussed in the Electricity Networks Association's letter to the Commission, the new *Health and Safety at Work Act 2015* imposes a positive risk management duty for EDBs to perform work isolated or de-energised. This legislative change will make it more difficult for EDBs to meet service quality targets for SAIDI and SAIFI derived from historical performance (before the new legislation came into force). To this end, Vector recommends the IMs should include the flexibility of ensuring quality targets are able to be amended for externally imposed changes directly impacting supplier ability to meet specified targets in default/customised price paths.

21. The Commission has suggested section 53ZB of the Act precludes the new DPP reopener for quality as proposed by the IM review from being relied upon until the next DPP on 1 April 2020. Accordingly, the Commission is proposing to retain the quality-only CPP until the new DPP re-opener can come into effect. Vector considers this to be a sub-optimal solution.

22. A quality-only CPP would limit the opportunity for affected EDBs to have their service quality targets revised. This is due to the fact there is a limit on CPP applications the Commission may accept within the designated CPP application "windows". Given the new *Health and Safety at Work Act* effects all non-exempt EDBs equally, there is a strong likelihood that some EDBs will have their quality targets reset while others will have to wait until they can make a CPP application.

23. Accordingly, Vector recommends the Commission should use the power under section 52Q of the Act to amend the current "in-flight" DPP to ensure the quality standard and quality

incentive scheme reflect the new operating environment of limited live-line work to minimise the conflict with the new *Health and Safety at Work Act*.

Yours sincerely
For and on behalf of Vector Ltd

Richard Sharp
Head of Regulatory and Pricing

APPENDIX A:

Vector's comments on the draft amendments to the IM determinations

TABLE 1. COMMENTS ON THE EDB AND GDB IM DETERMINATIONS

EDB and GDB	
Clause reference	**Comment**
General provisions	
Application of new IMs for ID, DPP and CPP 1.1.2(4)	While Vector does not support the removal of ACAM as a cost allocation method, we do support the proposal in 1.1.2(4)(b) for the changes for Part 2, subpart 1 to commence from disclosure year 2019.
Next closest alternative removed 1.1.2(4) and GDB IM 4.5.6(1), EDB IM 4.5.7(2), 5.6.7(5), 5.6.8(4)-(5)	Vector supports the removal of the next closest alternative.
Removal of ACAM from cost allocation 2.1.1-2.1.6	Vector does not support the removal of ACAM from the information disclosure cost allocation IMs. Vector does not see any credible evidence of a problem with the cost allocation IMs to warrant such a significant change. Vector also does not see any reason for the use of OVABAA to be limited to the allocation that would occur if ACAM was a permissible cost allocation method. Nonetheless, Vector encourages the Commission to make further changes to the requirements for OVABAA to encourage active use of it as a cost allocation method.
Asset valuation	
Value of commissioned assets – cost of financing 2.2.11(2)(b) and (3)(b)	Vector continues to recommend the Commission remove clause 2.2.11(3)(b) requiring borrowing costs to include borrowing costs specifically for the purpose of capex projects or programmes. As mentioned in our first submission on the drafting changes, Vector does not raise debt at a project or programme level. We believe our debt raising practices will be similar to other suppliers. Therefore, the requirements of 2.2.11(3)(b) create an unachievable compliance obligation for suppliers.
Value of commissioned assets – cost of financing 2.2.11(3)	We continue to recommend the Commission reconsider its requirement for cost of financing to be exclusive of capital contributions. We continue to recommend the Commission adhere to GAAP as divergences to GAAP create costly systems changes.
Finance leases EDB IMs 1.1.4(2), 2.2.11(1) and 5.3.11(1)	The change to finance leases gives effect to the original concern raised by PwC in relation to recoverable costs.

Asset acquired from regulated supplier 2.2.11(1)	No comment.
Cost of capital	
Debt issuance costs EDB IMs 2.4.1(4)-(5), 2.4.9(3)-(4), 4.4.1(4)-(5) and 4.4.2(6)	Vector has serious reservations about such a significant change of removing debt issuance costs from the weighted average cost of capital IM. We also do not believe the Commission has sufficiently specified how these costs will be recovered as part of operating expenditures. We recommend the Commission provide greater assurance and specification that supplier debt issuance costs will be reasonably accounted for in any recalibrated operating expenditure allowance. This should include a specific consultation on the methodology for the inclusion of debt issuance costs in opex allowances.
Debt premium approach	As discussed above, Vector agrees with the Commission's concern about supplier debt margin mismatches to the allowance provided with an on-the-day approach for estimating the DRP. Accordingly, Vector supports a historical average for estimating the DRP. We provide our comments on estimating the DRP below.
Debt premium estimation proposed 2.4.4	Vector recommends the Commission determines an averaging period over 12 months for each of the five years included in the historical average for the DRP, rather than using five annual three month averaging windows. We are concerned the Commission's method will not capture all movements in debt risk premium over the period from measuring the same three months over the five years.
TCSD clarification EDB IMs 2.4.9(3)	No comment.
TCSD 2.4.9	As per our comments on debt issuance costs, Vector's preference is for issuance costs to still be recognised as part of the WACC IM and as part of the TCSD.
Specification of price	
Capex wash-up for CPPs	No comment.
Urgent project allowance	No comment
Reconsideration of price-path	
Catastrophic event re-opener materiality threshold EDB IMs 4.5.1(d)(iv)	There should also be guidance as to how the threshold will be assessed where costs are incurred over multiple disclosure years.
Change event – materiality threshold	Vector notes the ENA's letter to the Commission noting the impact of the new *Health and Safety at Work Act 2015*. The changes to health

4.5.2(e)	and safety are a legislative change that will have an immediate impact on suppliers meeting the quality targets. To this end Vector supports support the inclusion of an additional clause in 4.5.2 for a change event reflecting new legislative or regulatory requirements that impact a supplier's ability to meet prescribed quality targets without having to trigger the one percent revenue threshold.
Change event 'IM becomes unworkable'	Vector recommends this new provision should also consider the impact of legislative or regulation changes to DPP/CPP that make requirements of the determination unworkable such as the changes to the Health and Safety at Work Act 2015.
Contingent projects 5.6.7(7)	No comment
Unforeseen projects EDB IMs 5.6.7(8)	No comment
Other	
Removal of redundant clauses	No comment
Forecast CPI definition	
Forecast CPI for DPP revaluation 4.2.3(3)(4) and 5.3.10(5) and 5.4.13(1)	Vector has serious reservations about the proposal for deriving CPI revaluation relying exclusively on the Reserve Bank of New Zealand's (RBNZ) monetary policy statement (MPS). As discussed extensively in submissions in the Commission's IM review – there is irrefutable evidence that the RBNZ's forecasts have had systematic errors over an extended period of time. The RBNZ itself has acknowledged that its inflations forecasts are merely forecasts and should not be considered to be without forecast error.[1] Vector recommends the Commission continue to consider other sources of inflation forecasting to increase the robustness of its estimate of inflation. Vector strongly discourages the Commission from implementing clause 4.2.3(4)(c). This clause allows the Commission to presume inflation will trend to two percent (the mid-range of the RBNZ) target for periods outside of the MPS. We believe it is not the place of the IMs to "lock in" this forecast approach especially when the assumption of mid-point trending has not materialised in recent history.
Forecast CPI 3.1.1(8)	Vector has similar concerns with the Commission's new definition of forecast CPI as above with forecast CPI for DPP revaluation.
Forecast CPI for IRIS transitional provisions 3.1.15(6)	Vector does not see any reason why the inflation forecast for later periods is different for the IRIS than for forecast CPI and forecast CPI for DPP revaluations.

[1] Dr John McDermott, 'How the Bank formulates and assesses its monetary policy decision', Speech to Manawatu Chamber of Commerce in Palmerston North, 13 July 2016

Table 2. Comments on the EDB IM determination

EDB	
Issue and clause reference	**Comment**
Asset valuation	
Remaining asset life 1.1.4 and 2.2.8(4)(a)	Vector continues to recommend removing RAB indexation as a better method to compensate against the risk of partial capital recovery.
Reduced life asset 2.2.8(5)(d) and 2.2.8(1)(c) and (d)	Vector appreciates the basis for the change. Again the consequential changes highlight the complexities of the Commission's approach for dealing with the risk of partial capital recovery. We agree with the Commission's interpretation that an asset that has been assessed by an engineer of having a reduced life may also have its life again adjusted by an adjustment factor determined by the Commission.
Standard physical asset lives Schedule A	Vector recommends the Commission adopt all recommendations by the ENA on Schedule A. The ENA's recommendations included changing the lives of: wood poles to 40 years, Circuit/Transformer/Feeder/ Bus Section/Coupler and Protection & Controls – Digital to 15 years and DC supplies, Batteries and Invertors to 15 years. These suggestions are consistent with the Electrical Engineers Association Asset Health Indicator Guide. Vector also supports splitting group category of DC supplies, Batteries and Invertors out with Batteries and Invertors each having a life of 10 years consistent with business expectation of asset life.
Taxation	
Weighted average remaining useful life 2.3.5(1), 2.3.5(4), 5.3.17(1) and 5.3.17(4)	No comment
Specification of Price	
Definition of prices 3.1.1(9)	No comment
Pass-through balance residual value 3.1.3(12)	Vector recommends the IMs specify within the recoverable costs a specific recoverable cost *accommodating the transition* from a weighted average price cap to pure gross revenue cap where any non-zero outstanding balance from the "pass-through balance" for pass-through and recoverable costs from the current regulatory period can be recovered in the next DPP.

Revenue wash-up cap 3.1.3 (13)(c)-(g)	We still retain our opposition for the revenue wash-up cap. We also believe the asymmetric 20 percent cap is misleading as EDBs will be required to forecast revenues at a gross level including pass-through and recoverable costs. The 20 percent cap actually translates to a much lower percentage cap for Vector. We recommend the IMs apply a 20 percent cap on total allowable revenue (including pass-through and recoverable costs). This will accurately capture the forecasting risk EDBs are exposed to.
Cap on increase in average prices 3.1.1(2) and 3.1.1(5)	The Commission has proposed to limit the extent of recovery of any under-recovered revenue in any one year based on 'forecast allowable revenue as a function of demand'. The IMs defer the specifics of this definition to the section 52P Determination. Vector has some concern about the terminology of "function of demand" – Vector recommends the Commission provide greater clarity around this term rather than deferring the meaning to the section 52P determination. We encourage the Commission to engage with industry on the appropriate definition for "function of demand" to ensure a credible definition that is durable. We caution the Commission from specifying a narrow average price increase. Vector recommends the average price increases should not result in the cap binding unnecessarily. Implementation of the Authority's TPM review is an example of where a narrowly specified cap could result in liabilities accumulating in the wash-up account, given the proposed changes to TPM would result in a $78M per annum increase in charges. This sudden, significant and permanent increase in recoverable costs may never be recovered under a narrowly specified cap.
Removal of cap and collar on draw-downs (removal of 3.1.3(13)(h))	Vector noted the need for both a cap and collar on draw-downs and the cap on increase in average prices was an excessive approach to mitigate the risk from price shock. We support only one lever for addressing this risk. Vector recommended the "cap and collar" as the better lever for managing the risk of price shock as it provided less onerous obligations for tariff restructuring. We also believe the lever would better address risks such as that being considered for TPM by the Electricity Authority.
Cap on voluntary undercharging 3.1.3(13)(a)	No comment
Mandatory draw down in favour of customers 3.1.3(13)(h)	No comment
Reconsideration of price-quality path	
Quality-standard variation re-opener 4.5.5(4)	Vector supports the additional considerations for the Commission when considering a quality standard re-opener.
Quality standard variation re-opener	Vector agrees with the new information required for a quality standard re-opener which requires the supplier to specify the

requirements	alternative SAIDI and SAIFI targets, limits, caps and collars as well as the boundary value for unplanned outages (for both SAIDI and SAIFI).

Table 3. Comments on the GDB IM determination

GDB	
Issue and clause reference	**Comment**
Taxation	
Definition of temporary differences 1.1.4(2)	No comment
Weighted average remaining useful life 2.3.5(1), 2.3.5(4), 5.3.17(1) and 5.3.17(4)	No comment
Specification of price	
Accounting for pass-through and recoverable costs 3.1.1(1)-(3)	Vector supports the Commission's decision not to apply the pass-through balance for GDBs on the basis of the expected costs not being of a magnitude to warrant the mechanisms of the pass-through balance.
Price cap for the first year of the regulatory period 3.1.1(2)	No comment
Discounts 3.1.1(4)-(5)	No comment
Recoverable costs 3.1.3(1)(g) [removed]	No comment
Reconsideration of price path	
CPRG reopener 4.5.5	Vector continues to recommend the Commission include a DPP reopener for constant price revenue growth forecasts that are much more exaggerated than materialised demand.