Cross-submission to the Commerce Commission on Incentives for Suppliers to Control Expenditure During a Regulatory Period

1 November 2013

INTRODUCTION

1. Vector welcomes the opportunity to cross-submit in relation 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. No part of Vector's submission, or the attached reports, are confidential and we are happy for them to be publicly released.

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OBSERVATIONS IN RELATION TO OTHER SUBMISSIONS

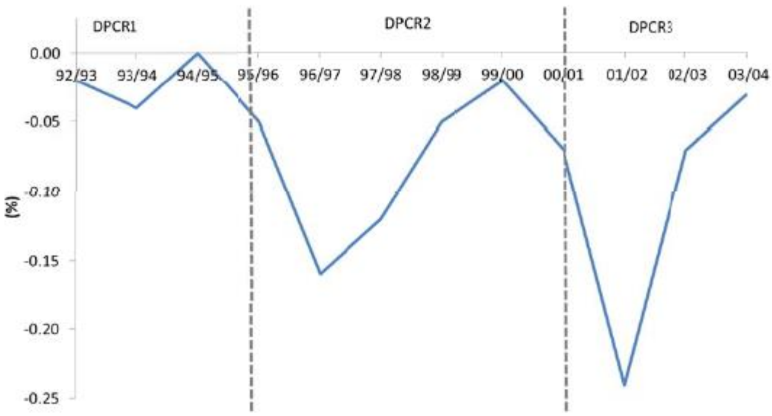
4. The submissions made to the Commerce Commission were supportive of the Commerce Commission promoting greater efficiency incentives, albeit with caveats. They also reinforce Vector's view that incentives need to be stronger where substantial investment is required (e.g. Unison: smart grid and mergers and acquisitions) and a package of efficiency mechanisms should be developed rather than relying on an IRIS.

5. While the submissions were limited to electricity and gas network businesses, we note that other parties such as Contact Energy have made submissions to the Commission previously supporting promotion of greater efficiency incentives, IRIS etc.

Caveats made in submissions

6. Vector has the following observations in relation to certain caveats made in submissions about efficiency incentives:

7. **Various factors impact on decision making:** Eastland Network and MDL are correct that there are various factors that impact on a regulated suppliers' decisions, including timing of investment and expenditure. This does not invalidate the Commission's analysis/retention factor assessment. It is observable from international experience that regulatory incentives do impact on regulated suppliers decisions. UK distributors, for example, moved opex predominantly to the regulatory base year to obtain higher expenditure allowance in the following regulatory period:



Growth in Real Unit Operating Expenditure (UK Distribution)

8. All the Eastland Network and MDL comments highlight is that, while regulated suppliers may have incentives to divert expenditure into the Base Year/make efficiency gains after the Base Year, it would never be the case that all expenditure would be transferred to the Base Year etc.

9. **Regulatory certainty:** PricewaterhouseCoopers raise valid concerns about regulatory uncertainty and that "Incentives may be undone at each reset because the value of any carry over incentive (for consumers or suppliers) can be offset by other changes to the reset method." This is a matter the Commission should give careful consideration to how best to resolve.

10. **Forecasting error:** Unison (and others) emphasise the importance of improving forecasting accuracy.

11. While Vector agrees this is important, some mechanisms the Commission could adopt would reduce the need for the Commission to undertake forecasting e.g. mechanisms such as OfWat's Sliding Scale Capex Incentive Scheme which incentivises/rewards regulated suppliers accurate capex forecasts.

12. Furthermore, Vector is of the view that the Commission should recognise that, regardless of how sophisticated its forecasting methodologies are, the information available for forecasting will inevitably be imperfect, given uncertainty about the future. This means forecasting will inevitably be prone to error and inaccuracy.

13. One consequence of this is that regulated suppliers are rewarded for some cost reductions which may not be efficiency gains, but the Commission should have tolerance of this. Castalia's comments in this respect are worth reiterating:

> **Regulatory incentives should minimise the risk of false negatives**
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> Incentive-based regulation sets prices based on forward-looking price paths. This process invariably raises a challenge for regulators: how can the regulator be confident that future cost reductions (or increases) will be driven by efficiency (or inefficiency), rather than by other drivers (such as altering service quality, cyclical volatility in costs, or just pure luck)? The reality, particularly given the low cost characteristics of the DPP, is that the regulator will not have the information needed to disentangle true efficiency gains from other cost drivers. An IRIS has the effect of increasing this challenge by imposing the benefit or cost of actual performance on regulated suppliers for a longer period of time.
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> The regulatory framework can either minimise type I errors (false positives) or minimise type II errors (false negatives) …
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> Incentive errors arise because regulators do not, and cannot, have perfect information. Even if the regulator dedicates substantial resources to trying to gain better information, gaps will remain. This means errors are inevitable … incentive based regulation should have an explicit tolerance for type I errors (and avoidance of type II errors). This is because type I errors maintains positive incentives on regulated suppliers to improve performance. A regulatory regime with type I errors tends to motivate regulated suppliers to improve performance because their returns are connected to their performance ...

14. This is reinforced by Vector's view that it is better for the Commerce Commission to err on the side of prices that are "too high" rather than "too low". The adverse consequences of prices that are too low can be expected to be worse for consumers, than prices that are too high, if they have a detrimental impact on investment and maintenance, resulting in poorer service quality and reliability.[1]

[1] This is a point that Vector has made in various submissions. See, for example, Vector "Submission to the Commerce Commission on Revised Draft Reset of the 2010-15 Default Price-Quality Paths for Electricity Distribution Businesses", dated 1 October 2012.