Vector Limited
101 Carlton Gore Road
PO Box 99882, Newmarket
Auckland 1149,
New Zealand
www.vector.co.nz

Corporate Telephone
+64-9-978 7788

Corporate Facsimile
+64-9-978 7799

20 March 2015

John McLaren
Manager
Regulation Branch
Commerce Commission
Wellington

By email: submissions@comcom.govt.nz

Commission proposal to implement further amendments to input methodologies (IM) for electricity distributors subject to price-quality regulation

Introduction

1. Vector welcomes the opportunity to respond to the Commerce Commission's consultation paper: *How we propose to implement further amendments to input methodologies for electricity distributors subject to price quality regulation*.

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

   Kelvin Binning
   Senior Regulatory Analyst
   T: 09 213 1542
   E: Kelvin.Binning@vector.co.nz

The incremental rolling incentive scheme (IRIS)

3. Vector supports the principle of the opex IRIS: to ensure electricity distribution businesses (EDBs) have a consistent incentive to make cost savings no matter when in the regulatory period the saving opportunity arises.

4. This particular consultation deals with further amendments proposed for dealing with the situation of when an EDB transitions between default price-quality paths (DPP) and customised price-quality paths (CPP). Vector's comments in this submission primarily relate to the baseline adjustment term; the other proposed adjustment terms seem to work as intended.

The baseline adjustment term is an imperfect solution

5. Vector has significant concerns with the Commission's proposed approach for the baseline adjustment term. The proposed solution gives the Commission broad 'discretion' to estimate temporary savings for penultimate year opex.

6. The importance of accurately identifying temporary savings should not be underestimated. Given the Commission's baseline adjustment formula effectively multiplies the temporary saving five-fold (with an NPV adjustment) any inaccuracy with the Commission's estimate will have considerable consequences for EDBs and end-users. We agree with the submission of the Electricity Networks Association that the Commission's suggested approach (in paragraph 3.10 of the consultation paper) is not a suitable solution. We do not believe the approach gives sufficient certainty that significant errors will be avoided.

7. Vector has identified two possible alternative options that we believe would merit further consideration. These are discussed below.

Suspending the IRIS recoverable cost when an EDB requests a CPP

8. The first option is to set the IRIS carryover amounts from all the years of the DPP period that precedes the CPP period to zero. We believe this could work because in the most likely scenarios where an EDB would apply for a CPP the IRIS may provide perverse incentives anyway. These scenarios are:

   a) The EDB's DPP is not fit for purpose and it cannot safely operate its network within the DPP constraint.

   b) The EDB has been subject to a catastrophic/change event and the original forecasts for costs and volume have, as a result of the event, changed significantly from the time of the event.

9. In the first scenario, the EDB is likely to legitimately need to spend more than the Commission's opex forecast during the DPP and thus would expect to import a negative opex IRIS recoverable cost into its CPP. This is because, had the EDB met the Commission's forecasts, it would have probably spent less than necessary to deliver a safe and reliable service. Thus an IRIS that incentivises efficiencies prior to a CPP in such circumstances may not be incentivising the right behaviour.

10. In the second scenario, the EDB may have been operating its network either more efficiently than the Commission's forecast or reasonably close to forecast until the catastrophic or change event happened. Ideally the EDB

would receive the standard incentives in such circumstances. However, setting the IRIS carryover amounts to zero may be a better approach than the Commission's proposal, in which there is no real certainty about how the efficiency benefits will be shared between suppliers and consumers.

11. Also, in this scenario, the benefits of the IRIS are arguably diminished as historical actual opex does not become a predictable guide for future opex requirements. Rather, the catastrophic or change event would have a more important bearing on future opex requirements. Setting the IRIS carryover payments to zero may not have a significant negative impact in such circumstances.

12. This would also mitigate the IRIS consequences from overspending by the EDB from the time of the catastrophic or change event and the establishment of the CPP. Indeed it is almost certain that costs incurred in that time will be greater than that allowed by the DPP.

13. Thus the IRIS may result in a large negative opex IRIS recoverable cost for an EDB as it starts its CPP. This could substantially reduce the value of the CPP option to the EDB as a means of funding the necessary expenditure following a catastrophic or change event.

14. Given the above drivers for EDBs to request a CPP and the risks associated with the Commission's proposal, we believe it could be reasonable for the Commission to set the IRIS carryover payments to zero for the term of the CPP.

EDBs could determine the temporary and permanent components of expenditure changes

15. The second option is for the Commission to require EDBs to ascertain how much of their penultimate year expenditure changes were due to temporary factors and how much was due to permanent factors. EDBs could then provide this information to the Commission, supported by directors' certification and an independent auditor's opinion. We believe the safeguards of director certification and independent auditor opinion would provide sufficient assurance that the results reported are accurate.

16. However, we note that a detailed audit review of opex line items would be expensive and believe it would be appropriate to set a materiality threshold for opex line items below which certification and audit would not be required.

17. This approach would mitigate the likelihood of the Commission being the cause of error in forecasting temporary changes in penultimate year expenditure.

Other issues with the IRIS

Fluctuations in revenue from the recoverable cost

18. Vector is concerned about the strong fluctuations in the opex IRIS recoverable cost resulting from the second year adjustments. This problem equally applies to Transpower's second year adjustment term. The changes to revenue from the second year adjustments will likely result in revenue shock for Transpower and EDBs and price, and therefore bill, shock for customers. Furthermore, it is possible that retailers may withhold the benefit of any one year transfers from consumers given the second year adjustment reduction in costs will only be temporary.

19. Therefore, we encourage the Commission to modify its model so that second year adjustments are smoothed over the regulatory period and avoid such unnecessary shocks to suppliers and consumers.

Base year opex

20. We encourage the Commission to include a further IM amendment specifying that the base year will always be the penultimate year of the regulatory period. Departing from penultimate year actual opex for the next DPP price path reset will be an unforeseen event for EDBs. It would also likely require some effort on the part of the Commission to amend its models and require further industry scrutiny of the amendments. It is unclear what benefit this effort would deliver.

Conclusion

21. We continue to support the principle of the opex IRIS but are concerned that technical matters involved with the Commission's model may significantly diminish its predictability. We encourage the Commission to consider the feedback and ensure the IRIS operates in a predictable and stable manner and businesses have certainty about IRIS outcomes.

Yours sincerely,

Ian Ferguson
Regulatory Policy Manager