



Submission on

Input methodologies review:

**Updated draft decision on cost allocation for electricity
distribution and gas pipeline businesses**

13 October 2016

Table of Contents

1. Introduction	1
2. Summary of Powerco's views	2
3. Draft decision and recent process	3
4. Certainty and confidence in the regulatory regime	3
5. Implications for Powerco's investments.....	4
6. ACAM delivers materially reasonable outcomes	4
7. OVABAA is too expensive and complicated to rely on	4
8. Costs created by the new allocation approach	6
9. Ring fencing.....	6
10. Transition and CPP implications.....	7
11. Appendix A – the OVABAA decision tree	8

1. Introduction

1. This is Powerco Limited's (Powerco) submission on the Commerce Commission's (Commission) consultation paper, *Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses*, dated 22 September 2016.
2. Powerco supports the submission of the Electricity Networks Association (ENA) on this matter.
3. This submission considers:
 - 3.1 The process followed in developing the updated draft decision
 - 3.2 The potential impact of the draft decision on certainty and confidence
 - 3.3 The potential implications of changing the cost allocation Input Methodology (IM) for Powerco's investments
 - 3.4 That the avoidable cost allocation methodology (ACAM) should be retained in the IMs
 - 3.5 That the optional variation to the accounting based allocation approach (OVABAA) is too complex and costly to be relied on to deliver the outcomes required by the Act
 - 3.6 Ring-fencing implications of the consultation process
 - 3.7 The costs created by removing the ACAM option
 - 3.8 Transition implications, including for customised price-quality paths (CPPs).

2. Summary of Powerco's views

4. The following table summarises Powerco's views on the Commission's proposals and provides recommendations for consideration.

ACAM	Powerco view	Recommendation
The Commission has proposed removing ACAM from the IMs as a stand-alone option.	ACAM does not deliver materially different outcomes in terms of prices and does not disadvantage consumers of regulated services when compared to accounting based allocations but ACAM (subject to appropriate materiality thresholds) is administratively less costly to apply. This proposal has been made late in the process and without clear evidence that a problem exists now or is likely to exist in the near future.	ACAM should not be removed from the IMs at this time but consideration could be given to lowering the materiality threshold below which ACAM may be applied. More compelling information is required to justify removing ACAM from the IMs.
OVABAA	Powerco view	Recommendation
The Commission considers OVABAA is sufficient to ensure the cost allocation IM does not unduly deter investment in unregulated services.	OVABAA is more complex and costly to apply when compared to ACAM for little discernible benefit	If ACAM is removed, OVABAA should be reviewed and the processes for its application made transparent to ensure it is cost-effective and practicable.
Transitional provisions	Powerco view	Recommendation
The updated cost allocation IM (without ACAM) will apply for disclosures from 1 April 2018, but not to price resets (including any CPP in effect) before 1 April 2020.	Powerco supports the Commission's consideration of transitional arrangements and early notification of when any changes to the cost allocation IM would take effect.	We note that changes would only affect customised price-quality paths that take effect in or after 2020.
Ring-fencing	Powerco view	Recommendation
The Commission states this updated draft decision was not made in relation to concerns about emerging technology investments.	While we believe that adjusting the cost allocation IM is unnecessary, it is more reasonable and consistent with the Part 4 regime than ring-fencing business activities.	The Commission should maintain its draft decision to not apply ring-fencing to EDB investments in emerging technologies.

3. Draft decision and recent process

5. In June 2016 the Commission consulted on draft decisions regarding almost all IMs, as part of its statutory IM review. This draft decision included a proposal to adjust the ACAM materiality thresholds but maintained the view (which the Commission has consistently expressed since the IMs were determined in 2010) that ACAM outcomes were not materially different from those that would result from using the accounting based allocation approach (ABAA).¹
6. On 22 September, having considered submissions on the draft decision, the Commission released an updated draft decision on the cost allocation IM. The updated draft decision was to remove ACAM from the IMs as an option that EDBs and GPBs can apply. As we understand it, ACAM will remain in the IMs as a limit on allocations that can be applied under OVABAA.

4. Certainty and confidence in the regulatory regime

7. The Commission has released its updated draft decision very late in the process and without any new or compelling evidence that ACAM causes problems for consumers and / or results in materially inefficient outcomes. The earlier rounds of the IM review process did not identify that ACAM was a problem or that the Commission intended to make major changes in this area.
8. Powerco supports the Commission socialising its emerging views by way of an updated draft decision, particularly in circumstances such this when (in our view) the evidence for change is not compelling and further input to the process is beneficial.
9. The Commission places reliance on submissions of Contact Energy and ERANZ in response to the draft decision but in our view neither of these submissions presented new evidence sufficient to justify moving away from the status quo or altering the original draft decision. They:
 - 9.1 point to the potential impact of applying ACAM in dollar terms but the values they describe are at the higher end of what is possible and we are not aware of ACAM being used at the levels indicated,
 - 9.2 suggested that ACAM materiality thresholds should be so low that ACAM is only applied where the unregulated activity is insignificant for the EDB and for the unregulated market, and
 - 9.3 argued that ACAM could seriously distort competitive market outcomes.
10. This information is not new as the maximum dollar value amounts can easily be calculated from data provided through information disclosures. The other points are consistent with previous submissions from Contact and ERANZ on the emerging technologies workshop paper.
11. Other matters referred to by the Commission as influencing its decision, for example the 2013 Merits Appeal judgment, were also known at the time of the draft decision so on the face of it cannot be seen as grounds to change the draft decision.

¹ *Input methodologies review draft decisions, Topic paper 3: The future impact of emerging technology in the energy sector*, para 116.

12. Powerco places value on a key attribute of our regulatory regime being that decisions are not changed without compelling evidence to justify the change. In this case this threshold does not appear to have been met.

5. Implications for Powerco's investments.

13. Powerco currently provides a small number of unregulated services, many of which directly benefit our consumers (e.g. Base power, building leases for our service providers which ultimately flows through to lower service delivery costs). In other cases our unregulated services provide benefits to the wider economy (e.g. UFB roll-out). While the ability to apply ACAM is not a deciding factor in any decision to supply unregulated services, the ability to allocate costs on a simple and easy to maintain basis is a consideration. For example, Powerco has an arrangement with communications companies where fibre can be placed on some of our poles to assist with the Ultra-Fast Broadband deployment within our network footprint. Had we known we would incur increased administration and system development costs because ACAM would not be an available option we may have been less likely to reach the current agreement we have with the fibre provider regarding the UFB deployment.
14. If we had chosen to not permit the placement of fibre on our poles, the effect on regulated consumers would have been materially the same but costs to the fibre provider would have been higher and New Zealand as a whole would have been worse off.

6. ACAM delivers materially reasonable outcomes

15. We recommend retaining the current ACAM option in the IMs (although we are comfortable with a review of the materiality thresholds to ensure they are appropriate).
16. Powerco's view is that ACAM causes no negative outcomes for consumers of regulated or unregulated services, but removing it will increase costs and unduly deter investments in unregulated services (as we explain in the next section of this submission, OVABAA is too expensive an option to rely on).
17. The Commission does not seem to have changed its view that the price outcomes under ACAM are materially the same as those that can be applied under ABAA. Nor is there any evidence that ACAM is impeding competition in unregulated services (and the Commission has stated this is not a driver of the changed draft decision in any case). As such, we see no reason to change the IMs at this stage.

7. OVABAA is too expensive and complicated to rely on

18. The Act requires the Commission to set a cost allocation IM that does not unduly deter investments by EDBs in unregulated businesses.² The Commission states that this will be achieved even after ACAM is removed as the OVABAA option will still be available. The Commission's view is consistent with the 2010 IM Reasons Paper, where OVABAA was described as the option that delivered the 'not unduly deter' objective.
19. In reality many EDBs have used ACAM to allocate costs in a way that ensures the viability of unregulated businesses and this is how the 'not unduly deter' objective has been met in practice. Because the ACAM option is available, EDBs have not had to use

² S 52T(3).

OVABAA. As OVABAA is a more complex method, EDBs are less likely to seek to use the option and thus in itself that creates a barrier that may deter some investment in unregulated businesses.

20. We support retention of the OVABAA option in the IMs, but only if ACAM is removed. In principle it is a potentially useful tool for businesses that are unable to apply ACAM but have a business that could not yet bear a full share of common costs.
21. Powerco has not had to apply OVABAA as ACAM has been available. Since the updated draft decision came out we have reviewed the OVABAA methodology. Based on that review, we are unlikely to apply OVABAA, as it is currently drafted, even where an unregulated business would be unduly deterred (i.e. discontinued) due to an ABAA allocation.
22. This is because the cost, complexity, subjectivity and director risk associated with applying OVABAA probably will not be worth it to support business ventures that are not very material to the Powerco Group.
23. We do not agree with the Commission's assertion therefore that the removal of ACAM results only in a one-off or short term cost.
24. The problems with applying OVABAA are:
 - 24.1 Powerco would need to apply ABAA and ACAM and OVABAA all at the same time to identify the OVABAA allocation amount
 - 24.2 Powerco would need to apply the OVABAA test (including ABAA, ACAM and OVABAA allocations) annually.
 - 24.3 When OVABAA is applied, Powerco would then need to reallocate the costs among all other businesses and then start the process again to see if any of those businesses are unduly deterred. This process is illustrated in appendix A of this document.
 - 24.4 Powerco's directors would be required to make a very subjective decision about whether or not a business would, in effect, be discontinued solely due to the shared costs or asset values it is allocated under ABAA. The Commission has stated that a "significant amount of information" would be likely to be required to support a certification.³ We are unconvinced any prudent directors could confidently make such a certification
 - 24.5 It is not clear how the methodology, or directors, would distinguish between costs and asset values when determining whether an allocation would unduly deter an unregulated business
 - 24.6 Additional disclosure requirements would be required; although these should not be particularly material.
25. We think the most likely outcome is that EDBs and GPBs will consider whether to apply this method, decide it is too hard and just apply ABAA. Any business that cannot carry an ABAA allocation of costs will not be viable for an EDB or GPB to continue operating. The effect will therefore be that these businesses are unduly deterred.

³ IM Reasons Paper, paragraph 3.3.37.

26. We support the recommendation of ENA for a review of OVABAA to identify ways to reduce the cost and complexity of this option. This is particularly important if ACAM is removed as otherwise there will be no other way for the cost allocation IM to avoid unduly deterring investment in unregulated businesses.

8. Costs created by the new allocation approach

27. With the introduction of the Input Methodologies in 2010, Powerco undertook significant investment to develop a bespoke regulatory asset ledger. This ledger holds unallocated RAB and allocated RAB values for all assets. It also holds the adjusted depreciation values on an unallocated and allocated basis. By applying ACAM, Powerco has only assets shared between its regulated gas and electricity businesses to allocate (for instance, furniture, information systems and hardware). The allocation between the regulated businesses is based on a single allocator. We have used this tool for all asset-based regulatory reporting and other ad-hoc reporting as required.
28. If we can no longer apply ACAM we will probably not incur the costs of changing the current system to apply ACAM allocations to a number of assets or asset classes due to the cost involved. Instead we will most likely use the system to manage the unallocated RAB and need to make manual adjustments separately to manage and roll forward the actual RAB each year. This undermines our objective of having a single source of asset valuation data and adds additional costs and risks of error into our asset base information processes.
29. This highlights the importance of certainty in the regulatory regime. Powerco is considering updating its various systems, including the regulatory asset ledger into an ERP system. Had we known ACAM was likely to be removed we would have considered including this functionality within the specification requirements of our new ERP system. This may still be achieved, but the additional cost is uncertain, and we will need to consider how we could allocate costs of assets such as poles between regulated and unregulated services.

9. Ring fencing

30. The consultation paper states that concerns raised by retailers about EDB investments in emerging technologies are not the driver of the changed draft decision. We support this view. Regulating to limit EDBs' ability to invest in unregulated services would be inconsistent with Part 4, as the Commission has previously acknowledged.
31. The paper also states that it does not address the question of 'ring-fencing' for specific emerging technology-related assets. Powerco submits that if the Commission were to materially change its draft decision in relation to ring-fencing of emerging technology assets it would be good process to consult on the changed decision before the final decision, as it is doing with the updated cost allocation draft decision.
32. In general, amending the cost allocation IM (although we don't think it is justified) is more reasonable and consistent with the Part 4 regime than introducing ring-fencing requirements.

10. Transition and CPP implications

33. The Commission proposes that EDBs and GPBs will no longer be able to use ACAM after the 2018 disclosure year. Thus from 1 April 2019 Powerco will need to apply ABAA or OVABAA for disclosure purposes.
34. We appreciate the Commission's clarification that this proposed change, should it go ahead, would not affect any price resets before 1 April 2020 for EDBs and 2022 for GPBs, or any CPPs in effect prior to 1 April 2020. Therefore we consider that any CPP applications in this regulatory period would be determined based on costs and asset values that are reported using the current IMs, i.e. with ACAM being an available option. It would not be practicable to redevelop a cost allocation process at the same time as preparing a CPP application.
35. We note there will be a misalignment between prices and disclosures where prices are set based on the ACAM approach but our disclosures will report using ABAA (probably not OVABAA, as explained in section 7). This could result in some ROIs appearing higher than expected and this will need to be recognised in any Summary and Analysis that is undertaken by the Commission.

Contact for submission

Thank you for the opportunity to provide comments on this consultation. If you wish to discuss any of the points made, or clarify any matters, in the first instance please contact Lynette Taylor tel. (06)968 6235, email lyn.taylor@powerco.co.nz.

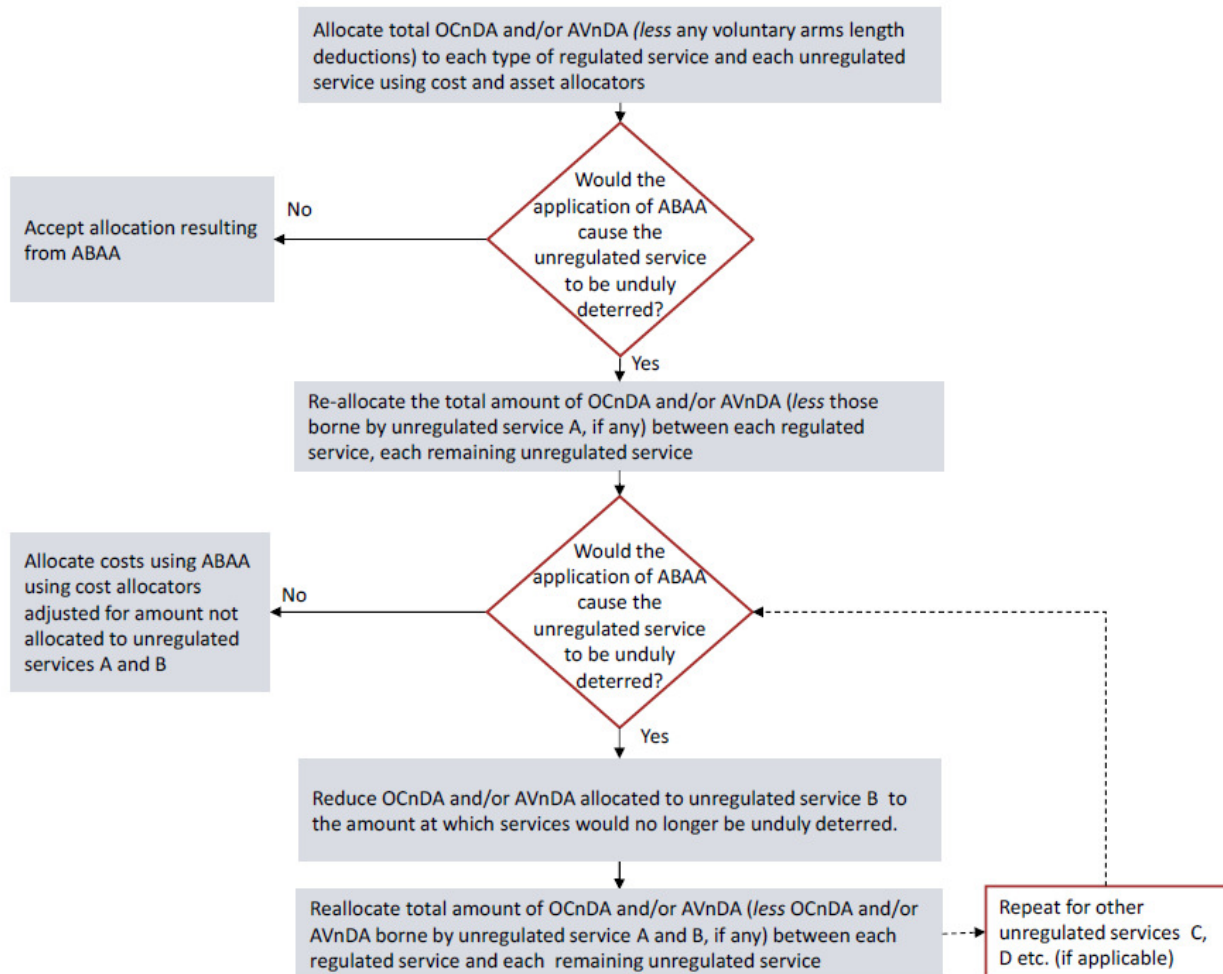
Yours sincerely

A handwritten signature in black ink, appearing to read "Richard Fletcher".

Richard Fletcher

General Manager Regulation and Corporate Affairs

Appendix A – the OVABAA decision tree⁴



Note: OCnDA means operating costs not directly attributable. AVnDA means regulated service asset values not directly attributable. ABAA means accounting-based allocation approach.

⁴ Commerce Commission, Information Disclosure for Electricity Distribution Businesses and Gas Pipeline Businesses: categorising and allocating operating costs and asset values, Information Disclosure seminar hand-out, March 2013, table 7.1.