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Industry/area of interest:

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Input Methodologies Review: Updated draft decision on cost allocation

Cross-submission to the Commerce Commission

Final

From the Electricity Networks Association

Contents

1. Introduction

1. The Electricity Networks Association (ENA) appreciates the opportunity to make this cross-submission to the Commerce Commission (Commission) on submissions received in response to the consultation paper **Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016 (Cost allocation paper)**.

2. The ENA represents all of New Zealand's 29 electricity distribution businesses (EDBs) or lines companies, who provide critical infrastructure to NZ residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB network), electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

2. Submission summary

3. The ENA recommends that:

- The avoidable cost allocation methodology (ACAM) is retained in the Input Methodologies (IMs) for use by EDBs where materiality thresholds are not exceeded.
- The Commission confirm that the cost allocation IM is appropriate. Contrary to the assertions by the Electricity Retailers' Association of New Zealand (ERANZ), this IM:
  - does not enable EDBs to cross-subsidise unregulated services; because these services must bear at least their incremental cost
  - does not provide EDBs with a guaranteed or risk-free return on investments in unregulated services; if it did, we would expect to see much larger EDB investments in unregulated activities.
- If guidelines for the optional variation to the accounting-based allocation approach (OVABAA) are issued, as ERANZ recommends, they should be practicable to apply and be subject to consultation before they are introduced.
- The Commission does not issue guidance on research and development expenditure by EDBs, as also suggested by ERANZ, without evidence of a problem. Our analysis suggests the materiality of EDB investment in research and development is low.
- If ACAM is removed from the IMs, this should take effect from 1 April 2018 as suggested by the Commission in the Cost allocation paper, not 1 April 2017 as recommended by ERANZ. This is because:
  - the later application date is required to give EDBs time to develop and implement new cost allocation methods
  - ERANZ's argument that the implementation date should be brought forward to help inform the 2020 price reset is only relevant to a subset of EDBs (i.e. only to non-exempt EDBs that currently use ACAM to allocate operating costs). This also highlights the relative immateriality of ACAM, which only directly affects pricing for

a subset of EDBs and even for those EDBs is unlikely to drive materially different outcomes.

- If ACAM is removed from the IMs, the OVABAA option is retained and improved to ensure unregulated businesses are not unduly deterred. The recommendations by Contact and MEUG to remove the OVABAA option would certainly result in IMs that unduly deter investment in unregulated services, contrary to section 52T(3).

3. Overview of submissions received

4. The Commission received 13 submissions on the Cost allocation paper, including 7 from EDBs or their representatives, 4 from electricity retailers or their representatives, 1 from the Major Electricity Users Group (MEUG) and 1 from Chorus. This cross-submission responds to the following submissions:

- ERANZ, *Submission to the Commerce Commission on Updated Decision on Cost Allocation for Electricity Distribution Businesses* (ERANZ submission)
- Contact Energy Limited, *Input Methodologies Review – updated draft decision on cost allocation (Contact submission)*
- MEUG, *Submission on Update draft decision on Cost Allocation* (MEUG submission)
- Chorus Limited, *Submission on Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses* (Chorus submission).

4. Response to ERANZ

4.1. Support for unregulated businesses

5. The ERANZ submission claims that:[1]

> *"regulated suppliers are able to cross-subsidise their unregulated/competitive market activities, while not sharing the efficiency benefits with consumers of the regulated service"*
>
> *"Even under the Commission's proposal EDBs still have the ability to make investments that provide them access to unregulated/competitive markets while effectively having the risk underwritten by consumers of the regulated service and a guaranteed return."*
>
> *"Regulated supplier opposition to removal of ACAM as a stand-alone option may, in large part, be driven by concerns about the profitability of their unregulated activities. OVABAA provides a better pathway for regulated suppliers to invest in unregulated activities by minimising the extent of cross subsidy from consumers of the regulated service and ensuring that consumers of the regulated service share in the benefits of efficiencies"*

[1] ERANZ submission, pages 1, 3 and 11.

6. These are strongly-worded statements and ERANZ does not provide any evidence to sustain them. We consider each of them in turn.

7. In relation to the cross-subsidy point, the cost allocation IM requires that all unregulated businesses are allocated at least their incremental costs. As such the cost allocation IM does not enable cross-subsidisation. There is no harm caused to consumers of the regulated service by the cost allocation IM – they are not paying more than is required to supply the regulated service and in many cases will pay less.

8. Conversely, the unregulated businesses will pay at least their incremental cost and will be expected to bear a greater share of common costs as they expand. We expect this will be similar to other new ventures undertaken by established firms, such as energy retailer investments in emerging technologies, where the new businesses only need to bear incremental cost initially but will carry increasing volumes of shared costs over time. As such, the cost allocation arrangements by EDBs should mirror those in workably competitive markets and not deter investments by other parties in these technologies.

9. In relation to the "guaranteed return" point, the cost allocation IM, with or without ACAM, does not enable EDBs to invest in unregulated markets with the risk underwritten by consumers of the regulated service. Where EDBs undertake an investment or activity that provides both the regulated service and one or more unregulated services, the cost allocation IM requires that:

    - Direct costs are allocated to the relevant service
    - Indirect costs are shared between the services; under ACAM at least any incremental shared costs will be allocated to the unregulated services while under ABAA the costs are shared using causal or proxy allocators.

10. The risk associated with the asset values or costs allocated to the unregulated services sits with those services. As this portion of the asset values and costs are not allocated to the regulated business the risk cannot be guaranteed by regulated consumers. If an EDB operated their unregulated business at a loss this would simply result in lower overall profits, to the detriment of shareholders not consumers.

11. Additionally, non-exempt EDBs have financial incentives to manage their capital appropriately and are required to achieve minimum quality of supply targets. If EDBs invested substantially in assets or activities to provide both regulated and unregulated services, they would need to be confident that the investment would be the best use of regulatory revenues and would help to achieve their quality standards.

12. Exempt EDBs do not have these incentives but are required by their owners to deliver value-for-money services, which should deliver a similar incentive effect.

13. As such, we disagree that investments in unregulated services are risk-free or have a guaranteed return for EDBs. In fact, they are likely to be higher risk in the context of the regulated business. This is probably why, despite retailer concerns, the level of EDB investment in emerging technologies remains very small. If such investments were truly risk-free we would expect to see much more of them.

14. In relation to the allegation that EDBs are concerned about OVABAA due to the profitability of their unregulated businesses, this is not correct. As explained in our previous submission,[2] and in the submissions of other EDBs,[3] our concerns regarding the use of OVABAA relate to the difficulty in applying it and, thus, the risk that it might not be applied and hence unregulated businesses will be unduly deterred.

4.2. OVABAA guidelines

15. The ERANZ submission states:[4]

> *"the Commission will need to closely monitor the circumstances under which the OVABAA option is utilised going forward. This should include development and application of clear guidelines as justification for using OVABAA and especially over what timeframe this can be sustained"*

16. Given the complexity and level of judgement required in applying OVABAA, the ENA could see value in guidelines to give some certainty to businesses and auditors of what degree of evidence is required to determine that a service would be unduly deterred. For this to be valuable the guidelines need to be reasonable (i.e. the degree of evidence must be practicable for EDBs to obtain) and must be subject to consultation before they are finalised. If the guidelines are sufficiently comprehensive, they could negate the need for specific OVABAA certification as auditors would utilise the guidelines when assessing compliance and directors would certify the overall compliance of the disclosures.

4.3. Research and development by EDBs

17. The ERANZ submission suggests:[5]

> *"it might be helpful if the Commission provided some guidelines as to what it regarded as research and development appropriate to the network service as opposed to being for the benefit of the network company in developing its unregulated business."*

18. The ENA considers that guidelines on this matter may be helpful if there was a problem. We are not aware that there is a problem in relation to classification of activities as research and development and ERANZ has not provided any evidence of a problem in this regard.

19. We note that in the year ending 31 March 2016 (using published information disclosure data):

- The total amount of research and development opex disclosed across all EDBs was $2.12m, around 0.4% of total industry opex.
- The total amount of research and development capex disclosed across all EDBs was $2.09m, around 0.3% of total industry capex.

[2] ENA, Input Methodologies Review: Updated draft decision on cost allocation: Submission to the Commerce Commission, 13 October 2016, section 6.

[3] Submissions by Powerco, Unison, Vector, Wellington Electricity and PwC on behalf of 17 EDBs in response to the Cost allocation paper.

[4] ERANZ submission, page 6.

[5] ERANZ submission, page 3.

20. We acknowledge that these values may be under-stated as these disclosures are optional. However, as the 6 EDBs that disclosed research and development expenditure supply 56% of ICPs nationally, their disclosures should give a good indication of the materiality of research and development expenditure in the industry. Thus the evidence suggests research and development spending by EDBs is low, both in absolute and relative terms.

21. If anything, the data suggests the Commission should be looking at ways to incentivise more research and development by EDBs, rather than issuing guidance that may restrict this kind of investment.

4.4. Timing of ACAM removal

22. The ERANZ submission considers the Commission's proposal that the removal of ACAM from the IMs should apply from 1 April 2018. ERANZ argues that:[6]

> *"the change in allocation methodology options should apply from the 2017/18 disclosure year. This would give the Commission the option of relying on more than one year's data, or relying on 2017/18 rather than 2018/19, if it thought this preferable, for the 2020 price reset for electricity distribution services. Applying the change a year earlier would also mean that any implementation issues can be flushed out in that first year."*

23. If ACAM is removed from the IMs, we support the implementation date of 1 April 2018 as proposed in the Cost allocation paper. It would take time for EDBs to develop a reasonable proxy or causal allocators and obtain audit and board approval for these allocators. For example, where EDBs do not use time sheets they may decide to introduce them in order to gather the necessary data to allocate costs, but this would require time to gather usable information.

24. We also note that ERANZ's concerns regarding the dataset for the next price reset can only apply to a subset of EDBs. They would not be relevant to either:

- Exempt EDBs.
- EDBs that allocate asset values between services (as capex forecasts for the DPP do not rely on the 'step and trend' method so the 'base year' issue is not relevant for DPP capex forecasts).[7]
- EDBs who already use ABAA to allocate operating costs or asset values.

25. Thus ERANZ's concerns would only be grounds for removing the ACAM option early from non-exempt EDBs who use ACAM for shared operating costs. This also highlights the relative immateriality of ACAM, which only directly affects pricing for a subset of EDBs and even for those EDBs is unlikely to drive materially different outcomes.

[6] ERANZ submission, page 3.

[7] For clarity, we acknowledge that allocations of asset values will affect parts of the DPP such as opening RAB, the capex wash-up and forecast capex, if this is used to reset the DPP. However, the Commission will have the necessary information for these inputs from the 2019 disclosure year if ACAM is removed from 1 April 2018 – the Commission does not also need data from the 2018 disclosure year to set these inputs.

4.5. Recommendations

26. The ENA recommends that:

- ACAM is retained in the IMs for use by EDBs where materiality thresholds are not exceeded.
- The Commission confirm that the cost allocation IM is appropriate, contrary to the assertions by the ERANZ.
- If guidelines for OVABAA are issued they should be practicable to apply and be subject to consultation before they are introduced.
- The Commission does not issue guidance on research and development expenditure by EDBs without evidence of a problem.
- If ACAM is removed from the IMs, this should take effect from 1 April 2018 as suggested by the Commission in the Cost allocation paper, not 1 April 2017 as recommended by ERANZ.

5. Response to Chorus

5.1. Assets shared by multiple services

27. The Chorus submission stated that:[8]

> *"we agree with the Commission's decision in December 2010, if shared costs are low between the regulated and unregulated service, a cost allocation approach is likely to produce an outcome that is immaterially different to those resulting under ACAM"*
>
> *"cost allocation is problematic when a number of network assets are shared by different regulated and unregulated services".*

28. The ENA agrees with these points. Applying a full accounting-based allocation method to assets shared between multiple services can be a complex exercise, involving judgements about the relative usage of an asset or activity by different services. The usage of the assets or activities by the different services can (and usually do) vary over time, making it more challenging to identify a reasonable and durable allocation method.

5.2. Recommendations

29. The ENA recommends that:

- ACAM is retained in the IMs for use by EDBs where materiality thresholds are not exceeded.

[8] Chorus submission, page 2.

6. Response to Contact and MEUG

6.1. Removing OVABAA from the IMs

30. The Contact and MEUG submissions both argued that the OVABAA option should be removed from the IMs. The Contact submission argued that:[9]

> *"The discretionary nature of OVABAA means it is highly likely to be used to achieve the same outcomes as under ACAM – that is, to generate additional unregulated revenue/ value for EDBs' shareholders. We reiterate our view that OVABAA can (and will) be used to the detriment of regulated lines consumers and should also therefore be removed."*

31. Similarly, the MEUG submission argued that OVABAA could be used to "cross-subsid[ise] forays into non-regulated businesses" and this would be likely to result in "exit or a reluctance of non-regulated suppliers to compete to offer that service".[10]

32. These submissions underestimate the restrictions that are in place within the IMs and also overlook relevant legislative requirements.

33. The Contact and MEUG submissions appear to overlook the following restrictions:

    - The cost allocation IM applies to shared costs and asset values only and thus any directly attributable costs cannot be allocated to different business units under any cost allocation method.
    - As discussed above, the cost allocation IM does not enable cross-subsidisation as, even under ACAM, the unregulated business must still bear its incremental cost.
    - Cost allocation decisions are subject to directors' certification and audit. This provides assurance that costs and asset values are not being allocated inappropriately.
    - OVABAA can only be applied where EDB directors certify that, if OVABAA was not applied, the allocation of costs or asset values under ABAA would be the sole reason for an unregulated business to be unduly deterred (i.e. discontinued). This is a difficult test to meet and a challenging certification for directors to make. We consider that the greater risk is that unregulated businesses will be discontinued due to the costs and risks of making an OVABAA allocation.

34. As acknowledged by the Commission[11] and ERANZ,[12] if ACAM is removed then OVABAA must be retained in the IMs as the only mechanism that can be used to ensure investments in unregulated businesses are not unduly deterred. While we have doubts that OVABAA can be

[9] Contact submission, page 1.

[10] MEUG submission, paragraph 4.

[11] Cost allocation paper, paragraph 37.

[12] ERANZ submission, page 6.

effectively implemented (see our previous submission[13]), without ACAM it must be retained otherwise there is no prospect of section 52T(3) being met.

6.2. Recommendations

35. The ENA recommends that:

- If ACAM is removed from the IMs, the OVABAA option is retained and improved to ensure unregulated businesses are not unduly deterred (noting that the ENA considers ACAM should be retained as there are no strong grounds to remove it).

[13] ENA, Input Methodologies Review: Updated draft decision on cost allocation: Submission to the Commerce Commission, 13 October 2016, section 6.

7. Appendix

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

Alpine Energy

Aurora Energy

Buller Electricity

Counties Power

Eastland Network

Electra

EA Networks

Horizon Energy Distribution

Mainpower NZ

Marlborough Lines

Nelson Electricity

Network Tasman

Network Waitaki

Northpower

Orion New Zealand

Powerco

PowerNet

Scanpower

The Lines Company

Top Energy

Unison Networks

Vector

Waipa Networks

WEL Networks

Wellington Electricity Lines

Westpower