Ref: 16/122
E 6/14

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Keston Ruxton
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Regulation Branch

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Dear Keston,

UNISON SUBMISSION ON AMENDED DRAFT DECISION TO REMOVE ACAM AS A COST ALLOCATION OPTION FROM THE INPUT METHODOLOGIES

This letter constitutes Unison's submission on the Commission's draft decision to remove ACAM as an option from the Input Methodologies (IMs).

The Commission is proposing to remove ACAM as a standalone option for allocating common costs and shared assets between regulated and unregulated activities. The proposal also removes the associated materiality tests for when the requirement to use ABAA is triggered. The Commission reasons that because of the availability of the OVABAA rules, EDBs would not be unduly deterred from entering into unregulated business activities. Instead the removal of ACAM would lead to benefits to customers of the regulated service, because common cost and asset sharing would potentially occur even at low levels of unregulated activity. The Commission in its latest draft decision appears concerned that if EDB's unregulated activities do not reach material levels, then customers of EDBs may permanently be precluded from sharing in the benefits of economies of scope achieved in the provision of unregulated activities.

As set out in the ENA's submission, which Unison supports, the Commission has not received new evidence to support the change in approach. The Commission simply appears to have reached a different view on the cost allocation rules that would apply. We can only assume that this change of approach is due to the Commission being swayed by concerns expressed by Contact and ERANZ about the effects of ACAM on competition in the provision of emerging technologies, as set out in paragraphs 20-23 of the Amended Draft Decision.

Unison notes that in forming its draft decision, from a legal perspective, the Commission has taken into account irrelevant considerations about the impact on competition in other markets. The Purpose of Part 4 of the Commerce Act 1986 (the Act) is focussed on the long-term benefit of consumers in markets referred to in section 52 (i.e., regulated service markets"), not the market for other unregulated goods and services. But aside from this legal consideration, Unison submits that there are clear economic principles that suggest the Commission should retain the status quo.

Unison opposes the change for the following reasons:

1. Unison would have to incur costs to change its accounting systems to implement ABAA and, quite likely, OVABAA. These costs have not been provided for in the 2015 DPP reset. Until we undertake the exercise of developing accounting cost allocation models and

considering the impacts on unregulated activities we are unable to definitively estimate the additional compliance costs to change our approach. Our initial view is that we would incur costs to develop new accounting systems to mechanise the cost allocations, but ongoing maintenance of the systems is likely to be minor and substitute for other costs of maintaining our financial systems. Potentially the costs could be $50k to $150k, depending on the need to engage contractor resources to develop the systems. If the Commission does insist on making the change in the IM's, Unison submits that EDBs should be able to recover the costs in the 2020 DPP reset;

2. The proposed change is inconsistent with the requirements of the Act. In particular, the Commission is obliged to regulate on the basis that it reproduces outcomes observed in workably competitive markets. Businesses entering into new markets would not consider overhead cost allocations when developing new products and services, but seek to ensure that the business proposition is the expected NPV>0. The Commission's proposal is that an EDB would, as soon as an activity is "not unduly deterred", allocate some overhead costs to the unregulated activity in proportion to a causal or proxy allocator. No workably competitive market operator would undertake this kind of consideration; and

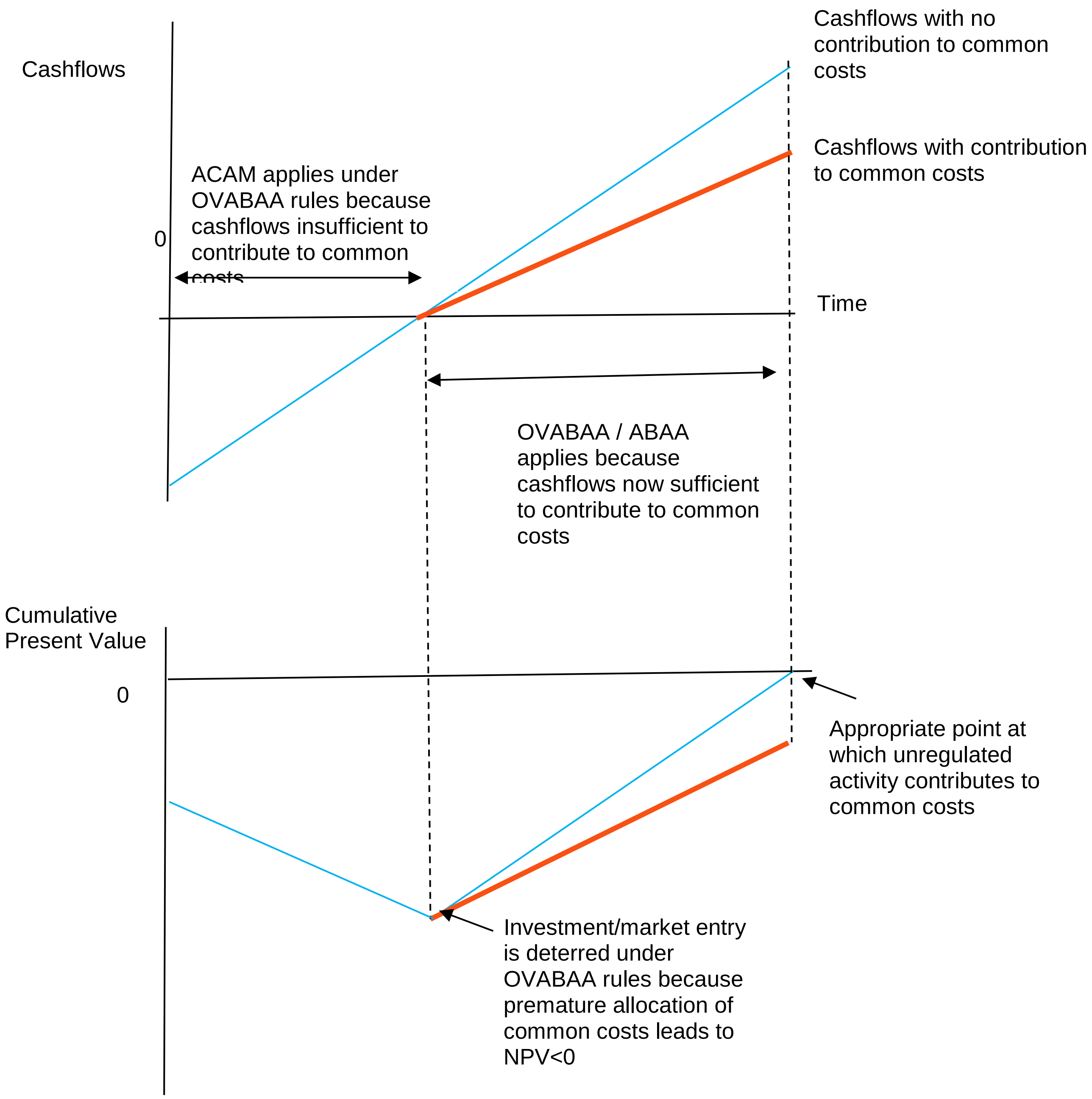
3. If a business finds that accounting-based cost allocations would "unduly deter" the activity, then cost allocations may be reduced only to the point that the activity would not be unduly deterred under the OVABAA rules.

Among other things, business investment decisions are made when the expected net present value of an investment exceeds the required cost of capital. The decision to enter into a new market or provide a new service in a workably competitive market is made independent of corporate overhead costs or the requirement to contribute to shared asset costs. The only constraint in the decision process being that the profits of all business units must be sufficient to cover overhead costs. In workably competitive markets, businesses would not base business investment decisions or continuance of the business on common or corporate costs, because that would lead to potentially incorrect business decisions. Approaches such as ABAA may be used by accountants for reporting purposes, but such use is economically meaningless. While the option to implement OVABAA seeks to better allow for more marginal business units not to have to contribute to common costs or assets, Unison submits that its current formulation does not conform to outcomes that would be observed in workably competitive markets. We are concerned that this may lead to some business opportunities being unduly deterred.

Unison's concern is that the current specification of the OVABAA rules would lead to situations where although in an accounting and/or fiscal sense an unregulated business activity may be in a position to make a contribution to over-head costs, the application of OVABAA part way through a business's life may render the activity NPV negative. Businesses will be in a situation where they have invested in an activity, that would not have been undertaken in the first instance if OVABAA had applied at the beginning.

To illustrate the impact of the OVABAA rules consider the following situation, which is typical of a business making losses in a start-up phase, but moves to a profitable phase as the business matures. OVABAA would lead to premature contributions to common costs prior to a business breaking even from an NPV perspective and therefore may deter some activities. The current approach of permitting ACAM to apply at low levels of materiality assist in better matching outcomes observed in workably competitive markets:

Figure 1: Stylised illustration of effects of application of OVABAA



Unison submits that if ACAM is to be removed, OVABAA must also modified to provide that common cost allocations (e.g., corporate overhead allocations and asset sharing) is only required, when a business becomes economically profitable.

Yours sincerely

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE