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Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
Commerce Commission
44 the Terrace, Wellington 6140

By email: im.review@comcom.govt.nz

Dear Keston**,**

Vector submission on the draft decision on cost allocation for electricity distribution and gas pipelines

1. This is Vector's submission on the Commerce Commission's (Commission) Input Methodology (IM) review draft decision on cost allocation for electricity distribution and gas pipeline businesses, published on 22 September 2016. Vector has read the Electricity Networks Association's (ENA) submission and supports its recommendations.

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

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3. No part of this submission is confidential.

Removing the avoided cost allocation methodology for cost and asset allocation

4. The Commission is proposing to remove the avoided cost allocation methodology (ACAM) as a permissible asset and cost allocation methodology for electricity distribution and gas pipeline businesses regulated under Part 4 of the *Commerce Act 1986* (the Act).

5. In deciding to remove the application of ACAM, the Commission considered:

   "the additional benefits to consumers, from sharing in those [shared asset/cost] efficiency gains, are likely to exceed any one-off or short-term costs incurred by suppliers in changing from ACAM to the other cost allocation options."

6. The Commission noted at the time when ACAM was included as a permissible cost allocation that the impact on regulated revenues would not be greater one-to-two percent. The Commission has not suggested the impact on regulated revenues now exceeds the impact

originally estimated when ACAM was first considered. Rather, there is now concern from the Commission about supplier use of ACAM resulting in a permanent sharing of assets/costs to the regulated service.

7. The Commission also acknowledged that it has been persuaded by submissions from the Electricity Retailers Association of New Zealand (ERANZ) and Contact Energy about EDB investment in new technology assets potentially distorting competitive market outcomes. The Commission singled out Contact Energy's concern that:

> *"ACAM could allow EDBs to invest hundreds of millions of dollars in emerging technology assets operated in contestable markets using regulated funding."*[1]

Emerging technology concerns

8. ERANZ and Contact Energy have suggested EDB investment in emerging technologies provides a competitive advantage against any other party wishing to enter emerging technology markets. The market distortions raised by ERANZ and Contact Energy are speculative as opposed to being based on evidence of EDB investment distorting competitive new technology markets.

9. A case in point is Vector's recent commissioning of New Zealand's largest grid sized battery – providing two megawatt hours of stored energy at our Glen Innes sub-station. In this instance the emerging technology asset was an alternative investment to investing in a traditional asset to cater for the rising peak demand in the area. Given the volatility of peak demand across Vector's network in the recent years, this investment is considered more economically prudent and provides the right network architecture to deal with uncertain long-term demand. The Glen Innes asset was driven by network requirements rather than seeking to earn unregulated revenue or distort new technology markets.

Asset sharing by EDBs

10. Indeed the most common form of EDB asset sharing is with telecommunications network service providers. This includes partnering with ultra-fast broadband (UFB) providers to accelerate the roll-out of fibre-to-the-premises networks. In this respect, ACAM has been successful with encouraging infrastructure collaboration to fulfil the government's communications infrastructure agenda.

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[1] Commerce Commission, *Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses*, 22 September 2016 p. 5.

11. Given the extent of some EDB sharing with UFB providers, it is difficult to see how such EDBs could invest hundreds of millions of dollars in emerging technology assets without exceeding the ACAM thresholds specified by the IMs.

Regulatory certainty

12. Vector is concerned with such a significant change being proposed without much regard to the impact of the change on stakeholders. The concern that ACAM results in a permanent sharing with the regulated service is not a new issue and must have been deliberated upon when ACAM was first considered as a cost allocation methodology for the IMs. In this respect, we are apprehensive about the Commission's reactive changes to ACAM based on very little evidence.

13. We encourage the Commission to adhere to the expectations of IMs to provide certainty to stakeholders to achieve the Part 4 purposes. It is very difficult for this to occur when the Commission demonstrates a willingness to make sudden changes to IMs when confronted with targeted lobbying and no evidence for the benefits of change.

14. Suppliers have relied on the assurance the asset/cost allocation rules have provided to make commercial decisions. Had suppliers been aware of that asset/cost allocation rules would change radically as part of the IM review then commercial terms for shared services may be significantly different to that delivered with ACAM.

15. The timing of the IM review occurring well into the maturity of the UFB program also heightens the financial consequences for suppliers where a significant number of assets are shared with UFB providers.

Permanent sharing

16. Vector is concerned with the Commission's issue about ACAM resulting in a permanent sharing of costs/assets with the regulated service. It is our understanding that the ACAM thresholds for revenue, costs and assets were set to ensure this cost allocation was only applicable up to a certain *de-minimis* threshold.

17. In this respect, the Commission's concern about permanent sharing appears to be misplaced as the extent of any cost sharing is not of a magnitude to cause any detriment to consumers. Where a supplier exceeds the ACAM thresholds, it is required to use the other cost allocation approaches. Accordingly, the IMs already have safeguards to ensure consumers are not paying more for the regulated service.

18. Vector considers the cost/asset allocation IMs currently provide the right balance of meeting the low cost nature of default-price path regulation and safeguards for consumers from disproportionate cost/asset allocation to the regulated service.

The Commission's final pricing principle for Chorus' Unbundled copper local loop service

19. We also have concerns about the timing of the change to EDB cost allocation rules after the Commission has recently finalised its final pricing principle (FPP) for Chorus' unbundled copper local loop service (UCLL). In the UCLL FPP there was significant debate about the extent of aerial deployment of the UCLL and asset sharing with EDBs. In deciding on the modelling assumptions used for the hypothetical efficient operator, the Commission suggested the hypothetical efficient UCLL operator and EDB "would negotiate for the hypothetical efficient operator to pay a fee to use the EDBs' poles."[2]

20. The Commission also satisfied itself that the percentage of aerial deployment was appropriate by having regard to information provided by Northpower and Ultra Fast Fibre regarding their UFB roll out.

21. Accordingly, the resolution of the UCLL FPP, in part, on evidence relating to the level of "real world information" on aerial deployment and asset sharing with EDBs may have overstated the extent of sharing had ACAM not been a permissible asset/cost allocation methodology encouraging asset sharing by EDBs.

22. The proposed change to ACAM does create the risk of unintended consequences where previous evidence relied on by the Commission for resolving the FPP becomes tainted from subsequent changes to regulatory policy.

Other cost allocation approaches

23. The Commission has suggested where ACAM is being used as an allocation approach with an unregulated service, it is still possible for the supplier to continue supply the unregulated service on similar terms by using the optional variation accounting based allocation approach (OVABAA). However, to date there has been no successful use of this cost allocation approach due to the complexities of its application. The challenges with applying OVABAA include annually revisiting the justification for the allocation between regulated and unregulated activities.

[2] Commerce Commission, *Final pricing review determination for Chorus' unbundled copper local loop service* [2015] NZCC 37, 15 December 2015, p. 330

Conclusion

24. Vector encourages the Commission not to make significant changes to IMs such as that proposed for the removal of ACAM on speculation rather than evidence.

Yours sincerely
For and on behalf of Vector Ltd

Richard Sharp
Head of Regulatory and Pricing