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Input Methodologies Review Updated draft decision on cost allocation

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 a submission to the Commerce Commission (Commission) on 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 Commission retains the avoidable cost allocation methodology (ACAM) as a stand-alone option within the input methodologies (IMs) subject to materiality thresholds, at least until substantial new evidence is identified that justifies removing ACAM. ACAM:
  - does no harm to consumers of regulated or unregulated services
  - does not have a material effect on prices charged to consumers
  - is likely to deliver results that are closer to workably competitive market outcomes than the accounting based allocation approach (ABAA), as the ABAA allocation does not reflect efficient pricing between services with different demand responsiveness
  - helps to meet the legislative requirement to not unduly deter investment in unregulated services as many EDBs use ACAM for this purpose rather than the more complex and costly optional variation to the accounting based allocation approach (OVABAA).
- The Commission does not undermine regulatory certainty by changing its mind without new evidence. No new evidence has been presented to justify a change from the previous draft decision and regulatory certainty is harmed by the Commission changing its mind in the absence of new information.
- The Commission assesses this issue in the context of what is material for regulated prices or revenues as this relates to consumer outcomes under Part 4. The Commission places some weight on dollar value calculations provided by Contact Energy but this information says nothing about materiality (it is also not new).
- Ring-fencing is not further considered as it is not an appropriate option under Part 4. Cost allocation is the best means of defining the boundary between regulated and unregulated services.

- The Commission reviews the OVABAA option by December 2017 to identify if improvements can be made to make the option more practicable and less costly. One option is to provide that any shared costs or asset values that are no longer allocated to an unregulated business are allocated only to the regulated EDB and any other regulated business owned by the EDB.

3. Overview of consultation paper

4. The Cost allocation paper:

- Proposes removing ACAM as a stand-alone option from the cost allocation IM for EDBs and GPBs.[1]
- Considers that the benefits to consumers from sharing in efficiency gains are likely to exceed any one-off costs of changing cost allocation systems.
- Considers that retaining the OVABAA option will mean that suppliers can allocate shared costs away from unregulated businesses up to the point at which they are not unduly deterred and that this is sufficient to comply with section 52T(3) of the Commerce Act 1986 (the Act).
- Proposes that these changes would take effect from 1 April 2018 for EDBs and will therefore first apply to the 2019 disclosure year and the 2020 price reset for EDBs.

4. No basis for removing ACAM

4.1. What has changed?

5. The ENA is somewhat surprised the Commission has changed its draft decision regarding ACAM in the absence of any new information being presented to justify this decision. To illustrate this view, we briefly summarise the timeline of debate on this issue:

- December 2010 – the original IMs included the ACAM option. The Commission considered this would deliver outcomes that were not materially different to the accounting-based allocation approach (ABAA).[2]
- December 2013 – the Merits Appeal judgement was released, which did not overturn ACAM. This judgement noted that ACAM could result in some shared costs being permanently allocated to the regulated business.[3]
- June 2015 – the IM review Problem definition paper was released and did not mention ACAM at all; it did seek views on whether OVABAA should be retained in the IMs as it had not been used to date.[4] Submissions from retailers did not mention ACAM.

[1] ACAM will still be referenced in the IMs, which will continue to require that any allocation of costs under OVABAA cannot allocate more to a regulated business than would be possible under ACAM (current clause 2.1.6(4)).

[2] Commerce Commission, *Input Methodologies Reasons Paper*, 22 December 2010, paragraphs 3.2.63 and 3.2.65.

[3] *Wellington Airport & others v Commerce Commission* [2013] NZHC 3289 at [1877].

[4] Commerce Commission, *Input methodologies review: Invitation to contribute to problem definition*, 16 June 2015, paragraph 481.

- February 2016 – the Electricity Retailers' Association of New Zealand (ERANZ) raised concerns regarding ACAM in its submission on the emerging technologies workshop paper, noting that under ACAM all non-avoidable costs could be allocated to the regulated business.[5]
- March 2016 – in a presentation to the Downstream Conference, the Commission's Deputy Chair stated that the cost allocation IMs were "largely fit for purpose".[6]
- June 2016 – in its original draft decisions for this IM review, the Commission upheld the view that ACAM should be retained (albeit with a reduced revenue materiality threshold) and that ACAM with suitable materiality thresholds would deliver outcomes that would not be materially different to ABAA.[7]
- August 2016 – submissions received from energy retailers challenged the use of ACAM, generally in the context of EDB investments in emerging technologies. Contact Energy discussed the potential scale of cost allocation under ACAM using dollar values.[8]
- September 2016 – the Commission released its updated draft decision on cost allocation, which is to remove ACAM as a stand-alone option.

6. The key reasons put forward in the paper for the change in approach seem to be:

> *"ACAM materiality thresholds based on a percentage of revenue or costs are not necessarily appropriate"*[9]
>
> *"allowing ACAM to continue to be applied on a permanent basis… may allow a significant amount of shared costs (in absolute dollar terms) to be permanently allocated to the regulated service"*[10]
>
> *"Allocations under OVABAA can continue to be used up to the ACAM limit on a temporary basis, consistent with s 52T(3), in circumstances where any other allocation would cause the unregulated service to be not provided or discontinued".*[11]

7. It is somewhat confusing that these are the reasons being relied upon when all of these points were known at the time of the June 2016 IM draft decision and earlier:
   - As noted above, the High Court in 2013 had pointed out that ACAM could permanently allow costs to be allocated to the regulated business, so this was known by the Commission before the time of the problem definition paper and was apparently not

[5] ERANZ, *Submission on Emerging Technologies – Workshop and Pre-workshop paper*, 4 February 2016, page 22.

[6] http://www.comcom.govt.nz/dmsdocument/14146

[7] Commerce Commission, *Input methodologies review draft decisions: Topic paper 3 – The future impact of emerging technologies in the energy sector*, 16 June 2016, paragraph 116.

[8] Contact Energy, Input Methodology Review, 4 August 2016, page 15.

[9] Cost allocation paper, paragraph 22.

[10] Cost allocation paper, paragraph 23.

[11] Cost allocation paper, paragraph 33.

deemed to be a significant issue. Similarly, ERANZ raised this point in February 2016 so it must have been considered and rejected as grounds for changing the IM prior to the draft decision.

- It seems the only new information provided in submissions on the draft decision was Contact Energy's calculation of shared costs as absolute dollar values, rather than percentage values. However, this information is not very relevant as it does not address the materiality of the issue (which we discuss further below). It also should not have been new information for the Commission.
- With regard to OVABAA, in 2010 the Commission decided to introduce IMs that contained both ACAM and OVABAA options.

4.2. Materiality remains small

8. The Commission's previous view that the amounts that can be allocated under ACAM are not material in the context of EDBs' regulated businesses is correct. Provided materiality thresholds are properly set, they should not affect regulated revenues (and therefore regulated prices) by more than 1%-2%. The absolute dollar amounts identified by Contact Energy may seem large but are in fact very small on a per customer basis.

9. The ENA considers that the Commission's view at the time of the original IMs and at the time of July's draft decision remains correct – ACAM is appropriate in the context of Part 4 as it will deliver outcomes that are not materially different from ABAA.

10. We note in this context the High Court's view that the materially better standard should be assessed in the context of the overall IM and that small changes within an IM are unlikely to meet this standard.[12]

4.3. There is no harm in retaining ACAM

11. The ENA does not consider that the Commission or other stakeholders have identified harm being caused by ACAM.

12. From a consumer perspective, provided the materiality thresholds are set appropriately, ACAM will deliver prices that are materially the same as under ABAA. As ACAM will also promote investment in other services that will, over time, develop into businesses that can share common costs and provide other services consumers demand, the retention of ACAM has some long-term benefits for consumers.

13. From the perspective of a party that may compete with an EDB in the provision of an unregulated service, we remain unconvinced that the impact on these other markets would be material. The dollar values highlighted by Contact are not very large and any EDB contemplating investment in a new business venture would be likely to seek a larger scale of business than is feasible under ACAM. As such, the competition concerns should be muted.

[12] *Wellington Airport & others v Commerce Commission* [2013] NZHC 3289 at [168]-[169].

4.4. Costs of changing cost allocation methods

14. The Cost allocation paper seeks views on the costs to regulated suppliers of changing their cost allocation systems.[13] The ENA considers that:

    - Even if the system costs are manageable (which is not clear), we question whether they should be incurred as the overall impact on regulated revenues will be small.
    - The costs of applying OVABAA, which would be more likely to be applied, will be higher but these are currently unknown.
    - The risks associated with OVABAA also need to be factored into the cost-benefit assessment. As we discuss in section 6 of this submission, OVABAA may not be able to be successfully applied in practice. As such there is a risk that certain unregulated activities will be unduly deterred and the cost of this should be considered.

4.5. Relationship with ring-fencing debate

15. The Cost allocation paper clarifies that the updated draft decision to remove the ACAM option is not designed to address concerns raised regarding EDB investment in emerging technologies:[14]

> *"Our proposal to remove ACAM does not depend on any of the possible wider benefits that might arise if removing ACAM were to mitigate some of Contact's concerns [regarding emerging technologies]. We consider that the long-term benefits from ensuring regulated consumers are not permanently precluded from sharing in the efficiency gains from supplying regulated and unregulated services together are sufficient to outweigh any short-term costs from changing allocation approaches."*

16. The ENA considers that the cost allocation IM defines the boundary between regulated and unregulated services. It is the appropriate IM for this purpose (i.e. there is no other IM listed in section 52T(1) that delivers this outcome). The cost allocation methodology as applied by the Commission is an appropriate means of allocating costs between businesses.

17. We therefore remain of the view that there is no need for ring-fencing of emerging technology or other services and the cost allocation methodology can deliver workable outcomes in this area. An adjustment to the cost allocation IM such as removing ACAM (although we do not support this) is a more reasonable approach and more consistent with Part 4 than ring-fencing would be.

4.6. Recommendations

18. The ENA recommends that:

    - The Commission retains ACAM as a stand-alone option within the IMs subject to materiality thresholds, at least until substantial new evidence is identified that justifies removing ACAM. ACAM:
        - does no harm to consumers of regulated or unregulated services
        - does not have a material effect on prices charged to consumers.

[13] Cost allocation paper, paragraph 40.

[14] Cost allocation paper, paragraph 29.

- The Commission assesses this issue in the context of what is material for regulated prices or revenues as this relates to consumer outcomes under Part 4.
- Ring-fencing is not further considered as it is not an appropriate option under Part 4 and cost allocation is the best means of defining the boundary between regulated and unregulated services.

5. Regulatory framework issues

5.1. The proposal undermines certainty

19. In our submission on the Framework for the IM Review, the ENA noted a concern that IMs can and have been changed frequently without a clear assessment framework for making decisions. We considered the Commission's undertaking to only change IMs where the pros outweigh the cons was not very helpful as the assessment of pros and cons will always be subjective.[15]

20. Our concern with the current consultation paper is similar. It is difficult to achieve a stable regulatory regime if the Commission decides to change an IM on the basis of information that it has previously considered but rejected as grounds for a change to the IM. There will be limited certainty if suppliers and consumers consider that a previous decision can be overturned without new evidence being supplied. The Commission should be careful to ensure that the rationale for its decisions is clear and should avoid changing its mind where there is no new evidence to support this.

5.2. Consistency with workably competitive market outcomes

21. When the IMs were set in 2010 the Commission considered the cost allocation IM in the context of workably competitive market outcomes. The Commission noted that it was important for the cost allocation IM to promote workably competitive market outcomes as otherwise consumers would not benefit from efficiencies from the provision of multiple services by EDBs.[16]

22. The IM Reasons Paper considered that in the long-term some shared costs should be allocated to the unregulated businesses, but acknowledged that:[17]

> *"where an EDB and/or GPB also provides unregulated services, the demand-responsiveness of each regulated service will in a number of cases be lower than that for unregulated services. In such instances, an allocation of a larger proportion of shared costs to regulated services is consistent with outcomes in workably competitive markets. In those situations only some of the benefits of efficiency gains would be expected to be shared with consumers of regulated services."*

[15] ENA, *Input Methodologies review, Framework for the IM review: Submission to the Commerce Commission*, 4 August 2016, paragraphs 15-16.

[16] IM Reasons Paper, paragraph 3.2.31.

[17] IM Reasons Paper, paragraph 3.2.61.

23. As such, the Commission considered that ACAM (subject to materiality thresholds) was unlikely to produce materially different outcomes from those that would be achieved in workably competitive markets.

24. Where there is lower demand-responsiveness for regulated services than for unregulated services, the workably competitive markets outcome is for the unregulated services to bear a larger portion of the shared costs. ABAA, in contrast, results in more even sharing of shared costs between business units. This may appear more "fair" but is less consistent with efficient pricing approaches and workably competitive market outcomes.

25. An outcome that is likely to be consistent with workably competitive markets is for unregulated services to bear fewer shared costs than the regulated services. ACAM is more likely to deliver an outcome closer to this point than is ABAA.

5.3. Recommendations

26. The ENA recommends that:

- The Commission does not undermine regulatory certainty by changing its mind without new evidence.
- ACAM is retained as it is likely to deliver results that are closer to workably competitive market outcomes than ABAA (as the ABAA allocation does not reflect efficient pricing between services with different demand responsiveness).

6. OVABAA may not meet the Act's requirements

6.1. Discussion

27. Section 52T(3) of the Act requires:

> *"Any methodologies referred to in subsection (1)(a)(iii) [i.e. allocation of common costs] must not unduly deter investment by a supplier of regulated goods or services in the provision of other goods or services"*

28. The Cost allocation paper considers that this objective will be achieved even if ACAM is removed through the OVABAA mechanism. We agree that in theory OVABAA could ensure that the provision of unregulated services is not unduly deterred by an allocation of common costs. However, this has not been confirmed. We are unaware of any regulated business that has successfully applied OVABAA to its businesses.

29. Our concern is that if it turns out that OVABAA cannot successfully be applied by EDBs, or is too complex and costly to apply, then some unregulated activities will be unduly deterred and the objective of the Act will be frustrated.

30. In 2015 the Commission itself queried whether OVABAA was "so overly complex that suppliers have chosen not to apply it".[18] OVABAA is challenging to apply as it involves subjective

[18] Commerce Commission, *Input methodologies review: Invitation to contribute to problem definition*, 16 June 2015, paragraph 481.

judgement about when a business would be "unduly deterred" and becomes particularly complex where the EDB has multiple business activities that are at risk of being unduly deterred.

31. In addition, as OVABAA allocations are capped at the ACAM level, applying OVABAA requires applying all of the ACAM, ABAA and OVABAA tests. Then this assessment needs to be re-applied each year to test if OVABAA is still required and to identify if the OVABAA allocation amount has changed. This would require EDBs to bring in multiple accounting systems or processes to simultaneously apply cost allocation in different ways.

32. OVABAA could also deliver results that are not consistent with workably competitive market outcomes over time. In workably competitive markets, new business ventures may make a loss in early years but, if successful, make higher profits in later years that offset early-year losses. Over time the business would expect to earn a normal return on average. However, an EDB may choose to apply OVABAA in years when the business incurs losses but may be prohibited from applying OVABAA in years when it is profitable – this could result in outcomes that are not consistent with workably competitive markets, where businesses would not require a new business to carry a full share of common costs simply because it has reached a the stage of providing an accounting profit or is cashflow positive.

33. We continue to support OVABAA being retained in the IMs, particularly if ACAM is removed. We agree with the Commission that removing both ACAM and OVABAA would not be consistent with section 52T(3).[19]

34. If ACAM is removed and OVABAA is therefore to be relied on more to deliver the section 52T(3) outcomes, OVABAA should be reviewed to ensure it is as workable and straightforward as possible. There may be insufficient time to carry out this review by December 2016, but it could be completed by December 2017 in a similar timeframe to the related party transactions review. We consider that this is justified if more reliance is now being placed on OVABAA to deliver outcomes required under the Act than had been the case previously (i.e. stakeholders may have paid more attention to OVABAA in this IM review if there had been an indication that ACAM was to be removed).

35. For example, one option for simplifying OVABAA (without materially affecting the outcomes of the cost allocation IM) would be to allocate the unduly deterred costs to regulated business units only, as explained below:

    - Clause 2.1.7 of the IMs requires that any shared operating costs or regulated service asset values that are allocated away from a business under OVABAA (i.e. a business that would otherwise have been unduly deterred) must then be reallocated between the EDB, other regulated businesses and other unregulated businesses. Then, if the other unregulated businesses would be unduly deterred the process needs to begin again.

    - Our suggestion is to amend this clause to provide that any operating costs or regulated service asset values that are allocated away from an unregulated business under OVABAA are then allocated to regulated businesses only. This will make the assessment and application of OVABAA more straightforward and cost effective.

[19] Cost allocation paper, paragraph 37.

6.2. Recommendations

36. The ENA recommends that:

- ACAM is retained in the IMs as it helps to meet the legislative requirement to not unduly deter investment in unregulated services. Many EDBs use ACAM for this purpose rather than the more complex and costly OVABAA.
- The Commission reviews the OVABAA option by December 2017 to identify if improvements can be made to make the option more practicable and less costly. One option is to provide that any shared costs or asset values that are no longer allocated to an unregulated business are allocated only to the regulated EDB and any other regulated business owned by the EDB.

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
Centralines
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