Submission to the Commerce Commission

on

Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses

Made on behalf of 17 Electricity Distribution Businesses

PwC submission on behalf of group of 17 EDBs

13 October 2016

Introduction

Overview

1. This submission responds to the Commerce Commission's (Commission) Consultation Paper, "Input methodologies review, Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses" released on 22 September 2016 (the Consultation Paper). This submission has been prepared by PricewaterhouseCoopers (PwC) on behalf of the following 17 Electricity Distribution Businesses (EDBs or distributors):

    - Alpine Energy Limited
    - Aurora Energy Limited
    - EA Networks
    - Eastland Network Limited
    - Electra Limited
    - Electricity Invercargill Limited
    - MainPower New Zealand Limited
    - Marlborough Lines Limited
    - Nelson Electricity Limited
    - Network Tasman Limited
    - Northpower Limited
    - OtagoNet Joint Venture
    - The Lines Company Limited
    - The Power Company Limited
    - Top Energy Limited
    - Waipa Networks Limited
    - Westpower Limited.

2. Together these businesses supply 26% of electricity consumers, maintain 42% of total distribution network length and service 65% of the total network supply area in New Zealand. They include both consumer owned and non-consumer owned businesses, and urban and rural networks located in both the North and South Islands.

3. The Consultation Paper seeks views on an updated draft decision by the Commerce Commission on the cost allocation IM. The cost allocation IM governs how shared costs and shared asset values are allocated between the regulated electricity distribution service and any unregulated services provided by an EDB. The cost allocation IM currently provides three options for allocating shared costs and asset values:

    - The accounting-based allocation approach (ABAA), which allocates shared costs between business units based on proxy or causal allocators

- The avoidable cost allocation methodology (ACAM), which essentially allocates incremental shared costs to the unregulated businesses and other shared costs to the regulated business. This can only be applied where the unregulated business is not material relative to the regulated business
- The optional variation to the ABAA (OVABAA), which permits the EDB to allocate shared costs away from an unregulated business. This can only be applied where the unregulated business would be 'unduly deterred' (ie discontinued) by having to bear a higher portion of shared costs or asset values.

4. The Consultation Paper proposes to remove the ACAM option from the IMs. This would mean that EDBs could no longer use ACAM to allocate shared costs between different businesses that they operate. Instead, EDBs will need to apply ABAA or, where that approach would cause unregulated businesses to be discontinued, OVABAA.

5. This draft decision would take effect from the disclosure year starting 1 April 2018. It would first apply to the 2019 disclosures and, for those EDBs subject to price-quality regulation, the 2020 default price-quality path (DPP) reset.

6. The EDBs which support this submission also support the submission made by the ENA. The purpose of this submission is to highlight topics of particular interest to the 17 EDBs listed above.

7. We trust this submission provides useful input to your consultation on the Consultation Paper. We would be happy to answer any questions you may have regarding this submission.

8. The primary contact for this submission is:

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Summary

9. The following points summarise our views on matters raised in the Consultation Paper. They are discussed more fully in the body of this submission. This submission responds to the consultation paper by focusing on our preferred options regarding the cost allocation IM and the reasons we support those options.

ACAM should remain in the IMs

10. Our preferred option is for ACAM to remain in the IMs, consistent with the Commission's previous draft decision. We are comfortable with adjustments to the materiality thresholds where these are necessary.

11. Our main reasons for supporting this option are: no new information has been provided to justify a change since the draft decision, ACAM does not disadvantage consumers of regulated or unregulated services, ACAM outcomes remain materially similar to ABAA and it is not clear the OVABAA alternative is workable.

If ACAM is removed, this should apply to larger EDBs only

12. Our second preferred option is to allow smaller EDBs (perhaps those with less than 100,000 ICPs) to continue to use ACAM. The Commission would still be able to review the materiality thresholds to ensure they remain appropriate for the new group of EDBs that use ACAM.

13. This option would reduce the harm caused by removing ACAM as that removal would only affect some EDBs. It would also reduce concerns about the cost of the change as smaller EDBs would be less able to bear the process and system costs of changing their cost allocation methodology.

14. Concerns regarding ACAM (although we do not agree these are valid) should also be less pronounced for smaller EDBs as they have smaller unregulated businesses and these unregulated businesses are more likely to provide services to the regulated business in any case. It is worth noting that, under this option, ACAM would only be able to be applied by EDBs supplying around 35% of New Zealand's ICPs.

The OVABAA methodology should be reviewed

15. Our third preferred option, if the Commission removes the ACAM option, is for a full review of the OVABAA option to be carried out. Without ACAM, OVABAA will be relied on to ensure unregulated services are not unduly deterred and we are not sure the current OVABAA will achieve this.

16. OVABAA appears complicated, difficult to implement and risky for EDB directors to certify. It seems likely EDBs will find the complexity and director liability risks to be substantial hurdles to get across and may choose not to apply OVABAA, with the effect that some businesses are unduly deterred. A review that aims to simplify the method would be very helpful.

Preferred options

17. The EDBs which support this submission disagree with the updated draft decision to remove ACAM from the IMs. We support the Commission's previous (June 2016) draft decision to retain ACAM in the IMs but update, if necessary, the materiality thresholds.

18. This submission puts forward three recommendations for a preferred way forward:

    i. Revert to the previous draft decision and leave ACAM in the IMs, with adjustments to the materiality thresholds if necessary

    ii. Only remove ACAM for the larger EDBs (more than 100,000 ICPs)

    iii. Carry out a full review of the OVABAA option to ensure it is workable and fit for purpose. For clarity, we think this would have value even if ACAM remains in the IMs, but it is essential if the ACAM option is removed.

19. The tables below set out these recommendations and the reasons we support them in more detail.

Table 1: Preferred option: ACAM stays in the IMs

How this would work
• The IMs remain unchanged, subject to any adjustment to the ACAM materiality thresholds that is justifiable.
Reasons this option is supported
• ACAM can only be applied where materiality thresholds are not reached; the Commission's aim is to set the thresholds at levels where the effect on regulated prices will be no more than 1%-2%. Where the materiality thresholds are at the right level the price outcome of ACAM will not materially differ from ABAA. • The most recent evidence regarding the materiality thresholds suggests they are appropriate. In fact, evidence from our previous submission would imply the revenue threshold could be slightly increased.[1] Therefore the effect of ACAM on prices for electricity distribution services remains low. • Submissions on the draft decision provided information regarding the dollar values of amounts that could be allocated under ACAM. This analysis is not very helpful as it does not address the actual materiality of the amounts and it overstates the actual allocations of shared costs that do occur. We note that: o as the Commission's own analysis indicates,[2] most businesses that apply ACAM do not allocate the maximum, or even close to the maximum, amount of shared costs or asset values that is permitted. This reflects the level of restrictions in place – regulatory requirements and audit oversight – which ensure only non-avoidable shared costs and asset values can be allocated under ACAM. o it is unlikely that EDBs would be able to allocate the maximum value of shared costs or asset values under ACAM to their regulated business for very long. Once the threshold

[1] See analysis in Appendix A of PwC on behalf of 17 EDBs, *Submission to the Commerce Commission on Input Methodologies review: draft decisions papers*, 4 August 2016.

[2] Input methodologies review draft decisions – Topic paper 3 – The future impact of emerging technologies in the energy sector, Attachment B.

becomes close an increase in size of the unregulated businesses will mean the threshold is exceeded. Any year in which an EDB uses ACAM to allocate nearly the maximum amount of asset values is likely to be the last year they can achieve this and they would then need to apply ABAA.

- This effect can be kept low through periodic reviews of the materiality thresholds to make sure they are still restricting the effect on regulated prices to 1%-2%, which is consistent with the Commission's view in the June 2016 draft decision.
- Consumers of electricity distribution services are not disadvantaged by ACAM – they do not pay more than the stand alone cost of the service and can expect to pay less due to efficiencies gained from providing multiple services. Consumers of other services are also not disadvantaged as they still pay at least the incremental cost and in some cases more – there is no economic cross-subsidy.
- Several of the EDBs which support this submission use ACAM to ensure their unregulated businesses are viable and not unduly deterred; OVABAA may not successfully help these businesses (problems with OVABAA are discussed below).
- Changing the methodology now is problematic for existing businesses. Some EDBs will have invested in unregulated services on the grounds that they could use ACAM and thus the services would not be unduly deterred. To change the methodology means EDBs will now need to reassess whether their unregulated businesses would still be viable under a different cost allocation approach and potentially they will not be.
- As recognised by the Commission, all EDBs that currently use ACAM will incur costs in changing their systems and processes. Whether or not these costs are material, they should not be incurred where there are no benefits from the change.
- No new evidence was presented between the draft and updated draft decisions to justify changing the IMs (or to challenge any of the points noted above).
- Because no new evidence was presented but the Commission has changed its mind anyway, the objective of the IMs (section 52R) to provide certainty to suppliers and consumers about the rules that apply has been undermined. Certainty can be promoted by the Commission only changing its mind where compelling new evidence has become available.

Table 2: Second Preferred option: ACAM continues to be available for smaller EDBs

How this would work
• For EDBs below the boundary level (smaller EDBs), the IMs would remain unchanged, subject to any adjustment to the ACAM materiality thresholds that is justifiable. • For EDBs above the boundary level (larger EDBs), the IMs would provide that these businesses could not use ACAM as a stand-alone option. • We suggest the boundary between larger and smaller EDBs could reasonably be set at 100,000 ICPs.[3] This would mean that ACAM could only be applied by the EDBs that supply 35% of ICPs nationally.

[3] The Consultation Paper considered a boundary of 150,000 ICPs, based on section 54D(1)(d) of the Act. This would be appropriate but if there was a concern that businesses of this scale should be able to develop an ABAA method, 100,000 ICPs could be more reasonable.

Reasons this option is supported

• It mitigates (although does not resolve for all EDBs) the problems identified in Table 1 regarding the proposal to change the IMs. It also delivers the benefits of ACAM for smaller EDBs and their consumers.
• ACAM is particularly appropriate for smaller EDBs who lack the scale to cost-effectively develop and apply accounting-based allocation approaches.
• The cost burden of changing allocation approaches will be disproportionately felt by smaller EDBs, who have:
  ○ fewer customers over which to spread the costs
  ○ smaller teams, meaning the opportunity cost of developing and applying the new method will be higher.
• If the concerns regarding ACAM are valid (which we do not accept) they should be less significant for smaller EDBs, who tend to:
  ○ operate fewer and smaller unregulated businesses
  ○ operate more unregulated businesses that mainly provide services to the regulated business.
• It could provide a useful test, where removing ACAM is effectively 'piloted' on larger EDBs while the situation for other EDBs remains unchanged. This may help to identify whether the change delivers the benefits suggested by the Commission or the problems we expect to occur.

Table 3: Third Preferred option: OVABAA is reviewed and simplified

How this would work
• The Commission would initiate a process to review the OVABAA clauses within the IMs. • The review would consider potential solutions to the identified problems with OVABAA (see list below). • The review should consider if there are other ways to make OVABAA more straightforward to apply. • The review could also cover the OVABAA requirements in the Information Disclosure Determinations. • We agree with the ENA submission that a robust and comprehensive review could not be completed by December 2016. • The Commission is already reviewing some IM topics in the 2017 calendar year and it could review the OVABAA mechanism in the same timeframe.
Reasons this option is supported
• No EDB has yet successfully applied OVABAA, although we are not aware that any have tried. • As discussed above, EDBs currently use ACAM to ensure that their unregulated businesses are not unduly deterred by an ABAA allocation. • If ACAM is removed as a stand-alone option from the IMs:

- OVABAA would become the only way of not unduly deterring investment in unregulated businesses
- the importance of OVABAA to delivering Parliament's intentions (ie to not unduly deter investments) would significantly increase.

- Thus we consider there are strong grounds to review OVABAA to ensure it is efficient, cost effective and, most importantly, able to be practicably implemented. We are not aware that OVABAA has received much attention through the IM review to date.
- We are concerned OVABAA may not be efficient, cost-effective or able to be practicably implemented because:
  - it is very difficult, perhaps not possible, to reach a defensible view that a business would or would not be unduly deterred due to an allocation of shared costs
  - to certify that a business is unduly deterred exposes EDBs' directors to a risk that is higher than is reasonable as they are being asked to certify something that is very difficult to determine
  - to comply with the IMs, ACAM and ABAA cost allocations must be developed at the same time. This is because ABAA must be done before OVABAA can be applied and ACAM must be developed to demonstrate the OVABAA allocation amount does not exceed the ACAM allocation amount. Therefore considerable effort and cost is involved in applying OVABAA
  - to comply with the IMs, EDBs that use OVABAA must re-apply the method each year (to check whether it is still needed and if the OVABAA amount has changed); this means the need to apply all cost allocation methods is an annual burden
  - OVABAA may need to be applied multiple times each year, as when any business is unduly deterred its portion of shared costs is then redistributed to other unregulated businesses and the process of determining whether they are unduly deterred (ie by the costs allocated from the first unregulated business) begins again
  - OVABAA has never been implemented so there may be other problems we are not aware of.
- We suggest the following changes could be considered by the review as ways to make the OVABAA option more suitable:
  - removing the requirement to calculate ACAM as part of the OVABAA process
  - requiring OVABAA to be assessed only once per regulatory period for non-exempt EDBs and once every five years for exempt EDBs
  - enabling the certification to be qualified to reflect the level of uncertainty about whether a business is or is not unduly deterred (e.g. instead of the test being "would be unduly deterred" it could be something like "would probably be unduly deterred")
  - providing more guidance on the factors to consider to determine whether a business is or is not unduly deterred.