
Submission

Input Methodologies Review: Updated Draft Decision on Cost Allocation

13 October 2016

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1 Introduction

Aurora welcomes the opportunity to submit in relation to the Commerce Commission's *Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016* (the "Updated Draft Decision").

No part of our submission is confidential and we are happy for it to be publicly released.

If the Commission has any queries regarding this submission, please do not hesitate to contact Alec Findlater:

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Aurora supports the submissions from ENA and PwC on this matter.

2 Aurora does not support the Updated Draft Decision

Aurora does not support the proposal to remove ACAM as a stand-alone option under the cost allocation Input Methodology (IM), or the previous decisions to reduce the potential application of ACAM.

We have a number of concerns with the Commission's reasoning in the Updated Draft Decision. In summary:

- *Weak justification:* The justification for the change seems to be that if the costs that regulated suppliers can allocate to their EDB or GPB is further limited, then this will result in lower electricity distribution and gas pipeline prices. Just because a change results in lower prices doesn't necessarily make it a good idea. Consideration should be given to the implications for cost recovery on incentives to invest, including in the provision of other goods or services;
- *Lack of supporting evidence:* Aurora is concerned that the Commission's Updated Draft Decision, and reliance on ERANZ and electricity retailer submissions for support, lacks an evidential basis – a potential repeat of the mistakes made with the original WACC percentile decision;
- *Identification of cross-subsidies:* ACAM is an economically-sound approach for identifying whether cross-subsidies exist – one of the concerns that electricity retailers have raised in relation to EDB engagement in emerging technology; and
- *Tax on non-regulated activities:* The further the cost allocation IM shifts away from ACAM, the larger the effective 'tax' on EDBs and GPBs engaging in other business activities – not only does such other activity need to recover its incremental (or avoidable) cost, but also the allowed revenue foregone under the DPPs.

This is precisely why Telecom (now Chorus) submitted on cost allocation when the current rules were being established – it faced the prospect of competitive tenders from EDBs for the Government's UFB initiative – but has shown no subsequent interest in the matter.

The last two points are illustrated by the following stylised example:

Box 1: Stylised example

EDB 1 and EDB 2 have identical network (or stand-alone) costs (and allowed revenue (MAR): \$10.

Corporate overheads are \$4. Electricity network specific costs (incremental cost) is \$6.

EDB 1 decides to engage in other, non-regulated, activities. The incremental cost (or avoidable cost) of the other activity is \$2.

For simplicity, assume that under an accounting-based cost allocation, corporate overheads are allocated evenly across business activities.

Under the accounting-based cost allocation:

- EDB 1's allowed revenue would become \$8;
- It would only be financially viable for EDB 1 to engage in the other activity if the revenue it could obtain was \$4 (even though the incremental cost is \$2);
- The cost allocation rules would impose an effective 'tax' on other, non-regulated activities, of \$2; and
- If EDB 1 obtained revenue between \$2 and \$4 from the other activity, it would (incorrectly) appear that it is being cross-subsidised.

3 Updated Draft Decision lacks evidential support

The Commission has based its decision on the assertion 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*"¹.

This Commission's assertion, when broken down, is based on several assumptions:

- There are "*potentially significantly longer-term benefits*" from removal of ACAM;
- There are no long-term costs associated with the removal of ACAM;
- The only costs from removing ACAM are limited to short-term (one-off) accounting system costs; and
- The decision on whether to remove comes down to whether "*the short-term costs of removing ACAM outweigh the potentially significant longer-term benefits*"².

The discussion in the following sections demonstrates that this is incorrect, and there are potential long-term costs from removal of ACAM that the Commission has not taken account; in particular, ACAM provides an appropriate economic-basis for identifying cross-subsidies (one of the main concerns raised by ERANZ and retailers), and the further the cost allocation IM moves away from ACAM, the higher the effective 'tax' on regulated suppliers engaging in other activities/the less competitive regulated suppliers will be.

¹ Commerce Commission, Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016, paragraph 29.

² Commerce Commission, Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016, paragraph 27.

Moreover, when stripped down, the argument against ACAM is, basically, if the costs that regulated suppliers can allocate to their EDB or GPB is further limited, then this will result in lower electricity distribution and gas pipeline prices, which should be treated as a benefit. Care should be taken as the same could be said, for example, of systematic under-estimation of costs in the DPP price resets. Any such impact should be assessed in terms of “reasonable investment expectations”³, and assurance that regulated suppliers will have incentives to invest (and improve efficiency). The Updated Draft Decision either ignores the potential implications for cost-recovery or, implicitly, assumes that whatever shared and common costs aren't allowed to be recovered from the regulated business will be able to be recovered from other activities.

We are also concerned that the Commission's Updated Draft Decision is based on qualitative judgement, and not based on evidence or quantified analysis.

The Commission has put the onus on regulated suppliers to provide evidence that its Updated Draft Decision is wrong. In particular, the Commission seeks evidence from stakeholders “on the likely costs of implementing our proposal”⁴ and on “any short-term costs below”⁵. However, the Commission imposes no similar obligation on itself to prove the changes are to the long-term benefit of consumers. We consider the onus or burden of proof should lie with the party, or parties, advocating change to the IMs.

Further, given the Commission has drawn on support from Contact and ERANZ for removal of ACAM, we reiterate that some of the retailer concerns reflect incorrect assumptions, or misunderstandings of how the cost allocation IMs work. For example, application of ACAM does not mean 100% of shared operating costs are allocated to the regulated business⁶. ENA detailed the misunderstandings in their submission⁷.

We also reiterate that ERANZ' and other electricity retailer submissions have lacked evidential support⁸.

The responses to these criticisms has been strictly limited. Mercury, for example, “notes that a number of submitters have commented on ERANZ putting forward unsubstantiated positions to the negative consumer impacts. However as battery storage is an emerging technology with a number of different prices and features, it is also apparent that there is no hard evidence as to how these technologies may provide a long term advantage to consumers. Only a small number of EDB's are in initial trial stage with reliability and cost effectiveness yet to be tested” (emphasis added).⁹ Mercury's position doesn't explain, if ACAM and the cost allocation IM are such a problem, why evidence has not been produced of ACAM's negative impact on established markets regulated suppliers are engaged in, such as smart metering services.

³ WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], paragraph [605].

⁴ Commerce Commission, Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016, paragraph 2.

⁵ Commerce Commission, Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016, paragraph 27.

⁶ Aurora Energy, Cross-submission Input Methodologies Review: Draft Decision and Determination Papers, 18 August 2016, page 6.

⁷ ENA, Input Methodologies review – Topic paper 3, impact of emerging technologies, 4 August 2016, paragraph 29.

⁸ For example: Aurora Energy, Cross-submission Input Methodologies Review: Draft Decision and Determination Papers, 18 August 2016, page 6.

⁹ Mercury, Input methodologies review - Cross Submission, Topic paper 3: The future impact of emerging technologies in the energy sector, 18 August 2016.

The Commission has suggested that “removing ACAM as an option is not inconsistent with the High Court’s judgment”¹⁰, but it is also worth remembering the Court’s statement that “Where a proposition is simply asserted ... we give it little or no weight”¹¹.

4 ACAM is appropriate for identification of cross-subsidies

Electricity retailers have expressed concerns about EDBs cross-subsidising activities in emerging technology, such as solar PV and battery storage.

For example, the Commission noted¹² Contact’s concern about the “ability for regulated monopolies to operate in contestable markets using regulated funding” [emphasis added]¹³.

It is widely recognised that the test for identifying whether a cross-subsidy exists is that:

1. the revenue from the EDB activity is greater than stand-alone cost (economic rents are required to fund any subsidies), and
2. the revenue from the other (emerging technology) activity is below incremental (or avoidable) cost.

ACAM is the only methodology, in the existing cost allocation IM, that can identify whether the conditions for a cross-subsidy exist. Cost allocation methodologies based on arbitrary or accounting, rather than economic, allocation of shared and common costs produce false-negatives; e.g., disclosure of information which suggests that the other activities are operating at a loss when, in fact, the revenue is above incremental (or avoidable) cost¹⁴.

The ability of ACAM to test whether cross-subsidies exist is precisely why ACAM was introduced in the first place; in the 1999 version of the then Electricity (Information Disclosure) Regulations, and also in the Telecommunications Disclosure Regulations 1999, the Kiwifruit Information Disclosure Handbook (1999 and 2004)¹⁵ and the Apple and Pear Information Disclosure Handbook under the now repealed Apple and Pear Export Regulations 1999¹⁶.

ACAM is also consistent with the Electricity Authority’s distribution pricing principles for EDBs (reflected in the Commission’s pricing methodology Information Disclosure requirements), and the types of tests the Commission applies to test for predatory pricing and anti-competitive conduct (for example, the Commission has used Average Incremental Cost (AIC) and similar measures to help determine whether prices are below cost).

Given the electricity retailer concerns about cross-subsidisation we would question the logic of their opposition to ACAM. Aurora would fully expect if claims were made that an electricity retailer was

¹⁰ Commerce Commission, Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016, paragraph 27.

¹¹ WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], paragraph [1745].

¹² Commerce Commission, Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016, paragraph 20.

¹³ Contact Energy, Submission on IM review draft decisions papers - Input methodology review, 4 August 2016, page 14.

¹⁴ Refer to Box 1: Stylised example.

¹⁵ <http://maxa.maf.govt.nz/mafnet/rural-nz/profitability-and-economics/producer-boards/kiwifruit/kiwifruit02.htm>

¹⁶ The Ministry of Economic Development was also going to adopt ACAM under the Gas (Information Disclosure) Regulations, including rules to disclose the stand-alone cost of combined gas and electricity networks (to address any double-counting issues) before responsibility for Information Disclosure was transferred to the Commerce Commission.

using profits from its retail business to subsidise generation (or vice versa) the retailer would want this to be tested on an incremental (or avoidable) cost basis, rather than the accounting-based approaches they have advocated for EDBs.

5 The Updated Draft Decision increases the ‘tax’ on unregulated activities

The Commission's assessment of the impact of removing ACAM does not take into account that, when regulated suppliers consider engaging in other activities, they have to consider not only whether the (unregulated) revenue would recover the incremental cost of the investment, but also the foregone revenue from the network (regulated business). The foregone revenue is, effectively, a tax on a regulated supplier's entry into unregulated business activities, and acts as a disincentive or barrier to engaging in such activities¹⁷.

This could actively deter regulated suppliers from investing in other business activities, where those activities:

- could be operated profitably, and (at least) recover incremental (or avoidable) costs, but where a requirement to apply an alternative cost allocation methodology to ACAM would render those business activities uneconomic, and
- even if the business activity is viable, the requirement to apply an alternative cost allocation methodology to ACAM would make the regulated supplier less competitive and force up their prices (relative to incremental cost).

In this respect, it is notable that Telecom (now Chorus) was incentivised to submit on the original development of the cost allocation IM given, at that time, it faced the prospect of competitive bids from EDBs in the Government's UFB tender¹⁸. A Commission decision away from ACAM (or the possibility of such a decision) had the potential to hamper EDBs' ability to price competitively; reflecting incremental cost (and the benefits of economies of scope). Chorus has shown no interest in the matter since.

Electricity retailers now have the same incentives as Chorus did; they would be commercially advantaged if EDBs are precluded from engaging in emerging technology markets, or if EDB's faced artificially higher costs from engaging in such activities. The arguments used are much the same (*"There is a risk that EnDBs will ... allocate shared costs between regulated and unregulated businesses (such as fibre-optic telecommunications infrastructure) inefficiently and/or inappropriately by allocating all shared or common costs exclusively to the regulated business"*¹⁹) if "fibre" is interchanged with "emerging technology".

Similar, competition limiting, behaviour has been observed by supermarket and petrol companies using the resource consent process to thwart or stall competition by objecting to competitors' proposals for new retail outlets, which was why Part 11A "Act not to be used to oppose trade competitors" was added to the Resource Management Act in 2009.

¹⁷ Refer to Box 1: Stylised example.

¹⁸ Telecom, Submission on the Commerce Commission's Draft Reasons and Proposed Regulation of Input Methodologies under Part 4 of the Commerce Act 1986, 9 August 2010.

¹⁹ Telecom, Submission on the Commerce Commission's Draft Reasons and Proposed Regulation of Input Methodologies under Part 4 of the Commerce Act 1986, 9 August 2010, paragraph 7.

6 Concluding remarks

Aurora is concerned that the Commission's Updated Draft Decision lacks evidential basis or support, and does not take into account all the potential detriments from a further shift away from ACAM.

The efficacy of the Commission's proposals should be assessed in terms of:

- the appropriate tests for identifying cross-subsidies (which are reflected in ACAM);
- the increase in the 'tax' (not quantified in the Updated Draft Decision) on a regulated supplier's investment in unregulated business activities from a further shift away from ACAM;
- the consequential reduction in regulated suppliers' competitiveness (including adverse price impacts) in other markets; and
- the potential impacts of the changes on "reasonable investor expectations", and the ability of regulated suppliers to fully recover shared and common costs (which appears to be assumed away or ignored in the Updated Draft Decision).

Aurora also notes that the Updated Draft Decision "*propose[s] to continue to allow EDBs and GPBs to allocate up to the ACAM level across all regulated services under OVABAA, because this would ensure that consumers will, over time, share in efficiency gains from suppliers providing regulated and unregulated services together, while not unduly deterring investment in other regulated or unregulated services, consistent with s 52T(3)*"²⁰. These comments should be revisited in the context of PwC's observation that no regulated supplier has applied OVABAA, and the reasons PwC give why this may be the case²¹. If the Commission is going to rely on the OVABAA provisions, to allow limited use of ACAM, it should consider whether changes are needed to ensure OVABAA can be, and is, used going forward.

²⁰ Commerce Commission, Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 22 September 2016, paragraph 9.

²¹ PwC, Submission to the Commerce Commission on Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 13 October 2016.