Aurora
ENERGY LIMITED

Cross-submission

Input Methodologies Review: Updated Draft Decision on Cost Allocation

25 October 2016

DELTA
THINK.INFRASTRUCTURE

PREPARED FOR AURORA ENERGY LTD
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1 Introduction

Aurora welcomes the opportunity to cross-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 cross-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 ERANZ and Part 4

ERANZ has suggested that "*Realising [the full benefits of new technologies] benefits is best achieved by ensuring that the provision of services through competitive markets is not stifled and that monopoly providers do not inefficiently cross-subsidise their offerings of new services*"[1].

We do not disagree with this statement.

Where ERANZ starts to become unstuck is its suggestion that "*monopoly providers have advantages as a result of the regulatory environment*", "*commercial risk is underwritten by consumers of the regulated service*"[2] and "*A firm in a workably competitive market that enters or establishes a new market is able to cover the costs of that move from its established business(es). However, if that new endeavour makes a loss during its early stages that loss is a cost to the business and ultimately the shareholders. A firm in a workably competitive market cannot increase prices to consumers in that market in order to fund the cost of a foray into a new market. The business faces the risk of not recovering its investment or other costs involved in entering the new market and that risk is ultimately borne by its shareholders, not its consumers*"[3].

The workably competitive market outcomes ERANZ describes are precisely what happens under the operation of Part 4. If a regulated supplier makes losses from competitive market activities it is not able to raise its regulated prices. The losses would simply result in overall lower profits (to the detriment of shareholders). There is no "advantage" or underwriting by consumers as a result of the regulatory

[1] ERANZ, SUBMISSION TO THE COMMERCE COMMISSION ON UPDATED DECISION ON COST ALLOCATION FOR ELECTRICITY DISTRIBUTION BUSINESSES, 13 October 2016, page 5.

[2] ERANZ, SUBMISSION TO THE COMMERCE COMMISSION ON UPDATED DECISION ON COST ALLOCATION FOR ELECTRICITY DISTRIBUTION BUSINESSES, 13 October 2016, page 5.

[3] ERANZ, SUBMISSION TO THE COMMERCE COMMISSION ON UPDATED DECISION ON COST ALLOCATION FOR ELECTRICITY DISTRIBUTION BUSINESSES, 13 October 2016, page 7.

environment (as our previous submission explained how the Cost Allocation IM imposes a 'tax' on engaging in other activities)

3 Submissions against ACAM misunderstand how it works

Aurora notes Chorus has changed its position on ACAM, and now supports it.

There is nothing in the submissions made against ACAM that give us cause to change our position on the matter.

The submissions made by Contact Energy and ERANZ reinforce our view that their opposition to ACAM reflects a misunderstanding of how ACAM works and what it does.

Contrary to Contact Energy's view, ACAM does not necessarily enable EDBs ACAM "*to allocate the full cost of an asset/ service to regulated consumers while also generating unregulated revenue/ value for EDB shareholders*"[4]. The allocation depends on what is avoidable and genuinely unavoidable. It is disappointing that errors such as this are being perpetuated in submissions. ENA, for example, detailed the misunderstandings in their earlier submission[5] which Contact Energy would have been aware of when it wrote its latest submission.

Our submission detailed how 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. The ERANZ submission appears to misunderstand ACAM, and what a cross-subsidy is, with the comment that a benefit of removing ACAM includes "*limiting the period over which regulated suppliers are able to cross-subsidise their unregulated/competitive market activities …*"[6].

Contact Energy and ERANZ' errors or misunderstandings are illustrated by the stylised example the Commerce Commission provided on cost allocation in the High Court IMs Merit Appeal case[7].

Electricity lines and fibre (broadband)

Services provided separately

Service	*Total asset base*	*Poles*	*Other assets*
Electricity lines	100	25	75
Fibre	100	25	75

Services provided together

<table>
<tr><th>Service</th><th>Total asset base</th><th>Poles</th><th>Other assets</th></tr>
<tr><td>Electricity lines</td><td rowspan="2">180</td><td rowspan="2">30</td><td>75</td></tr>
<tr><td>Fibre</td><td>75</td></tr>
</table>

[4] Contact Energy, Input Methodologies Review – updated draft decision on cost allocation, 12 October 2016, page 1.

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

[6] ERANZ, SUBMISSION TO THE COMMERCE COMMISSION ON UPDATED DECISION ON COST ALLOCATION FOR ELECTRICITY DISTRIBUTION BUSINESSES, 13 October 2016, page 1.

[7] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], from paragraph [1829].

Under Contact Energy's interpretation, in which ACAM enables EDBs "*to allocate the full cost of an asset/ service to regulated consumers*", $105 would be allocated to the EDB RAB ($75 of electricity lines assets plus $30 of shared poles).

But the Commerce Commission explained that only $25 of the shared poles would be allocated to the EDB, not the "full cost", resulting in a (correct) stand-alone cost of $100 allocated to the EDB. The Commerce Commission noted "*Under ACAM ... stand-alone cost is allocated to the ELS ($100M) and incremental or "avoidable" cost is allocated to fibre ($80M)*" and "*it is not correct that under ACAM all "shared costs" (as defined by the Commission) are necessarily allocated to the regulated service*"[emphasis added].

The High Court confirmed this analysis noting "*the shared accounting cost of $30 million is greater than the economic common costs of $20 million*"[8]. It seems that Contact Energy has failed to appreciate this important distinction when voicing its views on ACAM.

Service	*Total asset base*	*Poles*	*Other assets*
Electricity lines	100	25	75
Fibre	80	5	75

Under ACAM, the EDB would be able to recover $100, under the DPP, and would need to earn enough revenue from the fibre business to recover $80 asset base. A cross-subsidy would only exist if the Commerce Commission allowed recovery of excessive returns (beyond that required to recover $100 of assets), and the fibre business failed to recover the $80 of assets. Whether or not a cross-subsidy exists would be transparent under ACAM.

Under ABAA, false 'evidence' of cross-subsidies could be produced.

The Commerce Commission's stylised example resulted in the following ABAA cost allocation:

Service	*Total asset base*	*Poles*	*Other assets*
Electricity lines	90	15	75
Fibre	90	15	75

This would suggest that if an EDB was able to recover $95 from its EDB, and $85 from its fibre business a cross-subsidy of $5 would exist. However, no cross-subsidy exists as the fibre business is profitable and recovering $5 more than its incremental or avoidable cost.

If the Commerce Commission used ABAA to limit the EDB to recovering $90, it would not be profitable to invest in fibre because, while the fibre business is able to recover $5 more than its incremental or avoidable cost, it needs to recover $10 more than its incremental or avoidable cost to compensate for the foregone EDB revenue allowance. The ABAA allocation, effectively, imposes a $10 tax on unregulated services.

This puts the EDB at a competitive disadvantage. For example, an electricity retailer investing in solar only needs to recover its incremental cost, and could fully leverage any economies of scope. Using the above fibre figures, the EDB would face a $10 cost disadvantage/need to set its competitive market price offering $10 higher than otherwise. Aurora does not consider this would achieve the level playing field ERANZ and electricity retailers purport to advocate.

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[8] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], from paragraph [1830].

Given these misunderstandings or errors have been repeatedly commented on, including in our most recent submissions, we would expect that if Contact Energy and ERANZ disagree they would detail this in their respective cross-submissions, including why the Commerce Commission's evidence in the IMs Merit Appeal case was incorrect.

4 Problems with reliance on AVOBAA

ERANZ also suggests "*OVABAA provides a better pathway for regulated suppliers to invest in unregulated activities by minimising the extent of cross-subsidy from consumers of the regulated service and ensuring that consumers of the regulated service share in the benefits of efficiencies (including through lower prices*"[9].

The problems with reliance on OVABAA have been well documented both by the Commerce Commission, and by regulated suppliers and their advisors (refer, for example, to the submissions of ENA, Powerco, PwC, and Vector).

The Commerce Commission has questioned whether OVABAA was "*so overly complex that suppliers have chosen not to apply it*"[10]. Submissions from regulated suppliers and their advisors have been in the affirmative.

For example, Powerco went into some detail explaining why it considers that "*OVABAA is too expensive and complicated to rely on*"[11]. Adding to this, Vector noted "*The challenges with applying OVABAA include annually revisiting the justification for the allocation between regulated and unregulated activities*"[12]. PwC suggested that "*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"[13].

The Commerce Commission should consider whether the OVABAA rules could be amended to make OVABAA a more workable option, before making a decision to remove ACAM, particularly given it relies on OVABAA in its reasoning in favour of removal of ACAM. Regardless, we agree with ENA's recommendation that "*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*"[14].

Various of the submissions commented on how the OVABAA rules could be improved.

5 Promoting regulatory certainty and workably competitive market outcomes

[9] ERANZ, SUBMISSION TO THE COMMERCE COMMISSION ON UPDATED DECISION ON COST ALLOCATION FOR ELECTRICITY DISTRIBUTION BUSINESSES, 13 October 2016, page 3.

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

[11] Powerco, Submission on Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 13 October 2016, section 7.

[12] Vector, Vector submission on the draft decision on cost allocation for electricity distribution and gas pipelines, 13 October 2016, paragraph 23.

[13] 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, paragraph 16.

[14] ENA, Input Methodologies Review Updated draft decision on cost allocation, 13 October 2016, paragraph 3, final bullet-point.

Aurora agrees with the submissions which express concern that the Commerce Commission has changed its position on ACAM despite a lack of evidence to support the change. This is a concern we have repeatedly raised in our submissions. Our last submission, for example, noted that the justification for the change is weak and "*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*"[15].

We note the following comments from ENA, Powerco and Vector respectively:

> "*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.*"[16]
>
> "*The Commission has released its updated draft decision very late in the process and without any new or compelling evidence that ACAM causes problems for consumers and / or results in materially inefficient outcomes. The earlier rounds of the IM review process did not identify that ACAM was a problem or that the Commission intended to make major changes in this area.*"[17]
>
> "*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.*"[18]

We acknowledge the High Court position that "*… some degree of sharing of efficiency gains would occur in workably competitive markets, with implications for incentives to invest and innovate. The mandatory use of ACAM would not allow any such sharing*"[19]. However, as pointed out by Unison, ACAM is consistent with the workably competitive criteria that "*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*"[20].

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[15] Aurora Energy, Submission, Input Methodologies Review: Updated Draft Decision on Cost Allocation, 13 October 2016, page 1.

[16] ENA, Input Methodologies Review Updated draft decision on cost allocation, 13 October 2016, paragraph 20.

[17] Powerco, Submission on Input methodologies review: Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses, 13 October 2016, paragraph 7.

[18] Vector, Vector submission on the draft decision on cost allocation for electricity distribution and gas pipelines, 13 October 2015, paragraph 12.

[19] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], from paragraph [1876].

[20] Unison, UNISON SUBMISSION ON AMENDED DRAFT DECISION TO REMOVE ACAM AS A COST ALLOCATION OPTION FROM THE INPUT METHODOLOGIES, 13 October 2016, page 2.