COMMERCE COMMISSION
NEW ZEALAND
Te Komihana Tauhokohoko

ISBN 978-1-869455-40-8
Project no. 17.01/15081

Public version

Input methodologies review

Updated draft decision on cost allocation for electricity distribution and gas pipeline businesses

Date of publication: 22 September 2016

Associated documents

Publication date	Reference	Title
16 June 2016	978-1-869455-10-1	Input methodologies review draft decisions: Framework for the IM Review
16 June 2016	978-1-869455-12-5	Topic paper 3: The future impact of emerging technologies in the energy sector
22 June 2016	978-1-869455-16-3	Input methodologies review draft decisions: Report on the IM review
22 June 2016	1178-2560	Draft amendments to *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26
22 June 2016	1178-2560	Draft amendments to *Gas Distribution Services Input Methodologies Determination 2012* [2012] NZCC 27
22 June 2016	1178-2560	Draft amendments to *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28
14 September 2016	978-1-869455-36-1	Input methodologies review – Process update paper

Commerce Commission
Wellington, New Zealand

CONTENTS

PURPOSE AND SCOPE OF THIS PAPER 1
UPDATED DRAFT DECISION 2
FRAMEWORK FOR DECISION-MAKING 2
REASONS FOR OUR UPDATED DRAFT DECISION 3
ORIGINAL REASONS FOR INCLUDING ACAM AS A COST ALLOCATION APPROACH 3
DRAFT DECISION ON ACAM IN THE IM REVIEW 4
SUBMISSIONS ON OUR DRAFT DECISION REGARDING ACAM 5
WHETHER SHORT-TERM COSTS OUTWEIGH LONG-TERM BENEFITS TO CONSUMERS 9
IMPLEMENTATION AND NEXT STEPS 9
TRANSITIONAL PROVISIONS 9
INVITATION TO MAKE SUBMISSIONS 10
INTERACTION WITH TECHNICAL CONSULTATION 10

[BLANK PAGE]

Purpose and scope of this paper

1. The purpose of this paper is to seek stakeholders' views on our updated draft decision on cost allocation as part of the input methodologies review (**IM review**). Having considered relevant submissions and cross-submissions on our IM review draft decision package, this paper sets out:

    1.1 our updated draft decision to remove the avoidable cost allocation methodology (**ACAM**) as a cost allocation option from the cost allocation IM for electricity distribution businesses (**EDB**s) and gas pipeline businesses (**GPB**s); and

    1.2 our reasons supporting our updated draft decision.

2. We welcome stakeholders' views on our updated draft decision and reasons and, in particular, on the likely costs of implementing our proposal, including any evidence to support stakeholders' views.

3. The updated draft decision in this paper applies to EDBs and GPBs.[1] This paper may also be of particular interest to:

    3.1 electricity retailers who raised concerns about ensuring there is a 'level playing field' between regulated and non-regulated markets; and

    3.2 other parties interested in emerging technologies in the electricity sector, or in any type of unregulated service supplied by electricity distribution or gas pipeline businesses.

4. This paper relates to the generic application of the cost allocation rules and does not address the question of 'ring-fencing' for specific emerging technology-related assets. Therefore, this paper is not seeking any further submissions on the question of ring-fencing, which will be dealt with in our final decisions on the IM review in December 2016.

5. The deadline for submissions is **5pm Thursday 13 October 2016**.

6. We will also be seeking cross-submissions on this paper. The deadline for cross-submissions is **5pm Tuesday 25 October 2016.**

[1] Under the cost allocation IMs for airports and Transpower, ACAM is not an available option.

Updated draft decision

7. We propose removing ACAM as a stand-alone option from the cost allocation IM for EDBs and GPBs. Therefore, all materiality tests associated with whether ACAM may be applied would also be removed. Doing so will ensure that consumers are not permanently precluded from sharing in efficiency gains from suppliers providing regulated and unregulated services together, consistent with s 52A(1)(b) and (c) of the Commerce Act 1986 (the **Act**).

8. We consider the additional benefits to consumers, from sharing in those efficiency gains over the long term, are likely to exceed any one-off or short-term costs incurred by suppliers in changing from ACAM to the other cost allocation options of:

   8.1 the accounting-based allocation approach (**ABAA**); or

   8.2 the optional variation to the accounting-based allocation approach (**OVABAA**).

9. We propose 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).

Framework for decision-making

10. In our draft IM Review framework paper we explained that we have only proposed changing the current IMs where this appears likely to:

    10.1 promote the Part 4 purpose in s 52A more effectively;

    10.2 promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); or

    10.3 significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).[2]

11. Deciding whether or not to make a change to the IMs requires us to exercise judgement, taking into account both the pros and the cons of making the change. In order for a change to more effectively promote the s 52A purpose, it is necessary that the positive impact on the long-term benefits to consumers (pros) resulting from the change outweigh any negative impact the change has on the long-term benefit of consumers (cons).

[2] Commerce Commission "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016), para X16.

Reasons for our updated draft decision

Original reasons for including ACAM as a cost allocation approach

12. In our 2010 IM reasons paper for EDBs and GPBs, we explained that the way costs are allocated between regulated and unregulated services has an important bearing on how efficiency gains from supplying both types of services together are shared with consumers of regulated services over time (ie, s 52A(1)(b) and (c)), as well as whether investment by regulated suppliers in the provision of other services is not unduly deterred (ie, s 52T(3)).[3] We provided for three complementary cost allocation approaches: ABAA, OVABAA and ACAM.

ABAA

13. ABAA most closely allocates costs to the service to which they relate. ABAA ensures an allocation of shared costs across all types of services, and in many circumstances is expected to move the allocation of shared costs closer to those in workably competitive markets than when applying ACAM.[4] Therefore, ABAA is the default cost allocation approach in the IMs.

OVABAA

14. Use of OVABAA is considered appropriate in those situations where the application of ABAA might unduly deter investments in unregulated services. This reflects outcomes produced in workably competitive markets where some services may bear most of the shared costs while others bear little (eg, during the start-up phase of a new service).[5] Allocations under OVABAA are constrained by the requirement that the allocation to the regulated services be no higher than the allocation resulting from ACAM applied to those services in aggregate.[6]

ACAM

15. We concluded that the application of ACAM will, in most instances, not promote cost allocation and efficiency sharing outcomes consistent with those that occur in workably competitive markets. ACAM leads to none of the efficiency gains associated with the provision of regulated and unregulated services together being shared with consumers of regulated services.[7]

---

3 For example, Commerce Commission "Input methodologies (electricity distribution and gas pipeline services) reasons paper" (22 December 2010), Table X1 and para 3.2.2.

4 Commerce Commission "Input methodologies (electricity distribution and gas pipeline services) reasons paper" (22 December 2010), para 3.3.3.

5 Commerce Commission "Input methodologies (electricity distribution and gas pipeline services) reasons paper" (22 December 2010), para 3.3.4.

6 Commerce Commission "Input methodologies (electricity distribution and gas pipeline services) reasons paper" (22 December 2010), para B2.6.

7 Commerce Commission "Input methodologies (electricity distribution and gas pipeline services) reasons paper" (22 December 2010), paras 3.2.63 and 3.2.65.

16. Nevertheless, we observed that where regulated and unregulated services have only a small proportion of their costs in common, the use of either ABAA or OVABAA might not move outcomes materially closer to those in workably competitive markets. This is because, where shared costs are not large, an approach that allocates some shared costs to all services (such as ABAA) might not produce cost allocation outcomes that are materially different from an approach that allocates shared costs only to certain services.

17. In those instances, we allowed suppliers to use ACAM, subject to materiality thresholds based on percentages of revenue, operating costs and asset values. The materiality thresholds were based on the change in allocation values that would be required to generate a 1-2% change in total regulated revenues. We concluded that a greater than 1-2% change in revenue would be material from a supplier as well as consumer viewpoint, given that consumers would face higher prices where ACAM is used compared to the other allocation approaches.[8]

Draft decision on ACAM in the IM Review

18. In our draft decision we noted that the use of ACAM by some EDBs, even when under the materiality thresholds, resulted in regulated revenues being likely to increase by more than 1-2%, compared with applying ABAA, with no corresponding benefit to consumers of regulated services. Our draft decision was to lower the revenue materiality threshold from 20% to 10% to ensure that when EDBs or GPBs use ACAM that it would not result in increases to regulated revenue greater than 1-2%, compared to the use of ABAA.[9]

19. We also considered removing ACAM as an option. However, our view was that reducing the revenue materiality threshold would minimise the additional compliance costs that might otherwise be incurred by requiring a larger number of suppliers to change their accounting systems to support the change in cost allocation approach. In addition, we reiterated our original view that, subject to the materiality thresholds, ACAM would deliver outcomes that would not be materially different relative to the generalised use of ABAA.[10]

---

8 Commerce Commission "Input methodologies (electricity distribution and gas pipeline services) reasons paper" (22 December 2010), paras B3.1-B3.2.

9 Commerce Commission "Input methodologies review draft decisions: Topic paper 3 – The future impact of emerging technologies in the energy sector" (16 June 2016), paras 112-113.

10 Commerce Commission "Input methodologies review draft decisions: Topic paper 3 – The future impact of emerging technologies in the energy sector" (16 June 2016), para 116.

Submissions on our draft decision regarding ACAM

Submissions in favour of removing ACAM

20. ERANZ and Contact Energy submitted that we should remove ACAM as a stand-alone cost allocation option.[11] Contact highlighted the potential impact of applying ACAM in absolute dollar terms, rather than just as a percentage of revenue or asset values. Contact argued that the use of ACAM could allow EDBs to invest hundreds of millions of dollars in emerging technology assets operated in contestable markets using regulated funding.[12]

21. ERANZ submitted that, if we instead decided to retain ACAM, then the materiality thresholds should be reduced to a level sufficient to ensure that ACAM is only applied in circumstances where the unregulated activity is insignificant both to the EDB and to competitors operating in the unregulated market. However, ERANZ noted that, in any event, there is an incentive for EDBs to keep their prices in the unregulated business as low as possible for as long as possible to prolong their ability to use ACAM.[13]

22. We agree with ERANZ's and Contact's proposal to remove ACAM. We are now of the view that ACAM materiality thresholds based on a percentage of revenue or costs are not necessarily appropriate, especially for suppliers with relatively large cost bases (regulated asset base or operating expenditure).

23. Assuming the materiality thresholds are working as intended, then removing ACAM as an option should have no more than a 1-2% impact on the revenue of regulated suppliers. However, allowing ACAM to continue to be applied on a permanent basis for all or some of the costs of some regulated suppliers may allow a significant amount of shared costs (in absolute dollar terms) to be permanently allocated to the regulated service. As a result, potentially significant efficiency gains from the supply of regulated and unregulated services together will not be shared with consumers of regulated services now, or in the future. The magnitude of these foregone benefits appears likely to significantly outweigh any costs of removing ACAM, particularly in the case of larger regulated suppliers.[14]

24. In the IM merits appeal judgment, the High Court acknowledged we had included materiality thresholds relating to the application of ACAM, and also acknowledged our view that, where shared costs are low, the application of ACAM may result in

---

11 ERANZ "Submission to the Commerce Commission on input methodologies for emerging technology" (4 August 2016), para 134; Contact Energy "Submission on IM review draft decisions papers - Input methodology review" (4 August 2016), p. 15.

12 Contact Energy "Submission on IM review draft decisions papers - Input methodology review" (4 August 2016), pp. 14-15.

13 ERANZ "Submission to the Commerce Commission on input methodologies for emerging technology" (4 August 2016), paras 135-136.

14 These costs largely relate to changing regulatory accounting systems, and are therefore likely to be one-off or short-term in nature.

allocation outcomes that do not stray far from those in a workably competitive market.[15] The Court noted that:[16]

> Falling below the materiality thresholds essentially reflects two possible circumstances:
>
> (a) first, the early days of the provision of an unregulated service alongside a regulated service but where the unregulated service has the capacity to grow to become a contributor to the combined businesses above those thresholds; and
>
> (b) second, where provision of an unregulated service continues to be an incidental aspect of the regulated supplier's business.

25. If we remove ACAM as an option, retaining OVABAA, which allows allocations up to the ACAM level, should deal with the first of these two circumstances. We consider that the second of these two circumstances is dealt with by the flexibility to choose appropriate causal (or proxy) allocators under ABAA. If the provision of an unregulated service is an incidental aspect of the regulated supplier's business, then the regulated supplier should be able to apply allocators under ABAA that reflect that.

26. The Court also observed that "in workably competitive markets sharing between businesses would not … be permanently limited to ACAM sharing."[17] In particular, in the case of already well-established unregulated services, the Court stated that:[18]

> No argument has been put to explain why efficiency gains associated with such provision should be permanently exempt from sharing.

27. Consequently, we consider that removing ACAM as an option is not inconsistent with the High Court's judgment. In our view, doing so would promote the Part 4 purpose more effectively, specifically s 52A(1)(b) and (c), unless the short-term costs of removing ACAM outweigh the potentially significant longer-term benefits. We seek further evidence concerning any short-term costs below.

28. Contact also submitted that the ability for regulated monopolies to operate in contestable markets using regulated funding, as a result of applying ACAM, has the potential to seriously distort competitive market outcomes. Contact's concerns are not only about the possible impact on unregulated markets (eg, spot and ancillary markets, nascent markets providing emerging technology products and services), and investment by non-EDBs in emerging technologies at 'grid scale', but also

---

15 For example, *Wellington Airport & others v Commerce Commission* [2013] NZHC 3289 at [1824] and [1827].

16 *Wellington Airport & others v Commerce Commission* [2013] NZHC 3289 at [1874].

17 *Wellington Airport & others v Commerce Commission* [2013] NZHC 3289 at [1859].

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

whether consumers of regulated services obtain the maximum benefits from emerging technologies.[19]

29. 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. 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.

30. Although submissions on this matter primarily related to the topic paper on emerging technologies (as well as associated parts of the Report on the IM Review), the concerns raised by Contact and ERANZ about the sharing of efficiency gains are just as relevant for any regulated and unregulated service. Therefore, our proposal to remove ACAM would apply to all regulated electricity distribution and gas pipeline businesses, and would make no distinction in respect of certain types of unregulated services.

Submissions in favour of retaining ACAM

31. Regulated suppliers considered that the existing ACAM arrangements should be retained. For instance, in response to some specific concerns raised by Contact, ENA submissions included the following points.

    31.1 Contact's concern about substantial investment in batteries has not considered feasible commercial scale considerations. In the ENA's view, the amount of $260 million (for Vector) may sound like a large number, but this would only procure 13,000 batteries sufficient to be deployed at approximately 2.5 % of Vector's ICPs. Having deployed batteries on a network up to the point where the ACAM threshold is met (which is still a small proportion of the network), an EDB would then have to start applying ABAA if it wanted to deploy any additional batteries. If the business case for the batteries relies on ACAM, the business will never reach full competitive scale and EDBs would be unlikely to target opportunities in reliance on this IM approach.

    31.2 Contact has concerns about the amount of revenue generated by EDBs from ripple control, but in ENA's view this is a very small sum (ie, $15 million in revenues since 2009). The primary benefit is to manage network constraints and defer investment where appropriate, rather than using ripple control in unregulated markets.

    31.3 Contact has concerns that EDBs' solar and battery trials are leveraging regulated funding by making all consumers pay for them, but in ENA's view it

[19] Contact Energy "Submission on IM review draft decisions papers - Input methodology review" (4 August 2016), p. 14.

> is prudent for EDBs to invest in trialling the effects of solar PV and battery technologies on their networks so they can understand the likely impacts if and when consumers start investing in these technologies on a large scale.[20]

32. Vector submitted that the assurance provided by s 52T(3) and the ACAM threshold in the IMs incentivised many EDBs to partner with ultra-fast broadband (UFB) service providers to assist with the rollout of their networks. Vector suggested that lowering the ACAM threshold will have a material bearing for some EDBs where they have shared infrastructure with UFB partners with the ACAM threshold in mind. Suppliers might have to revisit asset sharing arrangements and renegotiate agreements for shared services to ensure the changes do not erode value.[21]

33. We consider that, rather than retaining ACAM and the existing thresholds, which potentially allow ACAM to be used permanently, the submissions on behalf of regulated suppliers support retaining the OVABAA option. Allocations under OVABAA can 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.

34. This view concerning OVABAA is supported by ERANZ:[22]

> The requirement in s 52T(3) of the Commerce Act that any methodology for the 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 is met through the OVABAA option. In ERANZ's view, ACAM's only relevance should be as the absolute limit to which regulated suppliers can vary from ABAA in order for a non-regulated investment to not be unduly deterred.

35. ENA also submitted that the purpose of ACAM is to facilitate investment in start-up and growing businesses and that once those businesses reach a certain scale they should carry a larger proportion of the shared costs.[23] We agree, and consider that the OVABAA option is intended to achieve just that.

Submissions in favour of allowing ABAA only

36. Contact went further than ERANZ and submitted that not just ACAM but OVABAA should also be removed. ABAA would therefore remain as the only cost allocation approach.

37. We consider this would not deal with situations where investment in unregulated services might be unduly deterred under ABAA, particularly during the 'start-up

---

20 ENA "Input methodologies review draft decisions – Cross submission" (18 August 2016), p. 11.

21 Vector "Submission to Commerce Commission on the IM review draft decision and IM report" (4 August 2016), para 160; and Vector "Vector cross submission on IM review submissions" (18 August 2016), para 51.

22 ERANZ "Submission to the Commerce Commission on input methodologies for emerging technology" (4 August 2016), para 134.

23 ENA "Input methodologies review draft decisions – Cross submission" (18 August 2016), para 33.

phases' of such investments. Therefore, only allowing ABAA would be inconsistent with s 52T(3), so we propose removing ACAM but retaining OVABAA.

Whether short-term costs outweigh long-term benefits to consumers

38. We have considered whether the one-off or short-term costs of removing ACAM would likely outweigh the benefits. We note that only a small number of businesses exclusively use ACAM for allocating both shared operating costs and shared asset values.[24] This means that the rest must have at least partly implemented the necessary regulatory accounting systems for ABAA, and therefore the one-off costs associated with implementing ABAA for regulatory accounting purposes will likely have already been incurred for most businesses.

39. Therefore, weighing the short-term costs against the long-term benefits is unlikely to support the continued use of ACAM. On the cost side, the costs are likely to have already largely been borne. On the benefit side, we have seen that in some instances (as above) the consumers of the regulated service are likely to benefit materially from allocating shared costs out of the RAB.

40. Although we do not consider the costs of changing allocation methodology are likely to be large, we welcome stakeholders' views on this, along with supporting evidence. If the costs do turn out to be significant for any particular businesses, we would be open to compensating those businesses at the next default price-quality path reset, based on evidence of actual efficient incremental costs incurred in changing regulatory accounting systems from implementing ACAM, to ABAA and/or OVABAA.

41. As an alternative to compensating specific businesses, we have considered whether to allow smaller EDBs (eg, those with less than 150,000 ICPs, as per s 54D(1)(d)) to continue to use ACAM. However, we do not currently favour this option as we consider that compensating specific businesses (if necessary) for any incremental costs would provide greater ongoing net benefits to consumers.

Implementation and next steps

Transitional provisions

42. We propose introducing the proposed changes to the cost allocation IM to apply to both EDBs and GPBs for information disclosure purposes from (and including) the 2018/19 disclosure year. These changes would therefore affect default price-quality paths set for EDBs from the 2020 reset, and for GPBs from the 2022 reset. Changes would affect customised price-quality paths that take effect in or after 2020 for either EDBs or GPBs.

43. Introducing the changes from the 2018/19 disclosure year would give regulated suppliers more than a year to make any necessary changes to their regulatory

[24] Commerce Commission "Input methodologies review draft decisions: Topic paper 3 – The future impact of emerging technologies in the energy sector" (16 June 2016), Table B1.

accounting systems in advance of the 2018/19 disclosure year. It would be appropriate to introduce the changes to information disclosure for both EDBs and GPBs for the same disclosure year. That is because regulated suppliers which supply both electricity distribution and gas pipeline services must ensure that an ACAM allocation acts as an overall constraint for allocations between unregulated services and both types of regulated services in aggregate.

Invitation to make submissions

44. We invite submissions on this paper by **5pm on Thursday 13 October 2016**. We then invite cross submissions by **5pm on Tuesday 25 October 2016**.

45. Please address submissions and cross submissions to:

Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
im.review@comcom.govt.nz

Interaction with technical consultation

46. As we indicated in our process update paper published on 14 September 2016,[25] we anticipate publishing revised draft determinations for technical consultation in mid-October 2016.

47. We recognise that consultation on this paper will not be completed by the time the technical consultation package is released. So that interested parties can make submissions on the proposed implementation of the updated draft decision set out in this paper, the revised draft determinations that we anticipate publishing in October will include proposed drafting to reflect the removal of ACAM as a cost allocation option.

48. For the purposes of technical consultation for a scenario where we decide against removing ACAM as a cost allocation option, we intend to refer submitters to the drafting included in our 22 June 2016 draft determinations.[26]

[25] Commerce Commission "Input methodologies review – Process update paper" (14 September 2016), para 13.

[26] [DRAFT] amendments to Electricity Distribution Services Input Methodologies Determination 2012 [2012] NZCC 26; [DRAFT] amendments to Gas Distribution Services Input Methodologies Determination 2012 [2012] NZCC 27; [DRAFT] amendments to Gas Transmission Services Input Methodologies Determination 2012 [2012] NZCC 28.