Auckland Energy Consumer Trust

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Dr Mark Berry

Chairman

Commerce Commission

9 August 2010

Dear Dr Berry,

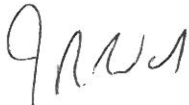
AECT Submission on cost allocation

I attach the Auckland Energy Consumer Trust (AECT) submission. It deals with one specific aspect of cost allocation – how to ensure that the climate for investment in the government's ultra-fast broadband initiative is set appropriately.

While we have engaged with the Part 4 regulatory process on a range of other issues previously – and of course reserve the right to do so subsequently in the course of cross submissions – we are concentrating here on this single issue. In part this is because we are confident that other submitters will address points that are of concern to us, and in part because it is one that we think is important and unlikely to be drawn to your attention by others.

As noted in the submission the Trust is not a typical owner and has a responsibility that allows it to appreciate the delicacy of the task the Commission faces.

Yours sincerely,



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Chairman AECT

Confidential

Cost allocation:

Looking toward the roll out of broadband

Report to AECT

August 2010

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1. Introduction

As part of the regulatory development process under Part 4 of the Commerce Act, the Commerce Commission released two input methodology documents in June 2010. Submissions on various aspects of these releases close over the next several weeks.

In this brief note we address one aspect of the Commission's proposal on cost allocation for Electricity Distribution Businesses (EDBs) and Gas Pipeline Businesses (GPBs)[1]. The issue relates to the investment incentives associated with one particular new investment. It is about the treatment of existing assets when these will become common capital as the EDB takes part in the roll out of high speed broadband fibre – an objective sought and encouraged by the government.

2. AECT

The Auckland Energy Consumer Trust (AECT), the owner of 75% of Vector Limited, is an elected body that operates on behalf of its income beneficiaries, who are consumers of Vector's services. As owner, the trust reflects consumers' concerns over the long term outlook – more than 60 years - inherent in the lifetime of the trust. The need to keep its consumers happy requires trustees to take an interest in the delivery of better service at appropriate prices; while sustaining and growing the business demands an emphasis on investment and efficiency.

Overall, therefore, to fulfill its aims AECT faces trade offs similar to those included in Section 52A of the Commerce Act:

> The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
>
> (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
>
> (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
>
> (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
>
> (d) are limited in their ability to extract excessive profits.

[1] While there are similar issues associated with the gas business, such as the potential for the use of gas ducts to enable cable distribution, for ease of drafting we have discussed the question of concern in terms of electricity distribution only.

The Trust is thus sympathetic with the aims of Part 4 and is seeking to assist the Commission in its implementation role.

There are many points in the June documents that have been the subject of past AECT submissions and comments. Aspects of these remain of concern, but we are confident others will be raising those issues, and so are restricting comments in this submission to the single issue associated with cost allocation as it might affect the broadband roll out.

3. The regulatory issue

In the proposal on input methodologies[2] (IM) the Commission's section 3.2 discusses the decision-making framework for their proposals. This supports the general result of the adoption of an accounting based methodology for cost allocation. Where there is potential for capital to be used by more than one activity the suggestion is that the gains inherent in this situation be shared, including with the consumers of the regulated activity (electricity distribution). While there may be an argument for this, to the extent it is a potential outcome of the process it seems worth thinking through its implications.

AECT's specific interest is in ensuring that the overall regulatory outcome, while being appropriate in terms of the aims of Part 4, also supports the potential for EDBs to be active participants in the government's Ultra-fast Broadband Initiative. This is a publicly supported and funded programme which has been given high policy priority. It is also something the Trust sees as valuable for its consumers.

If an EDB makes an investment in the broadband roll out, the position adopted in the IM documents, of accounting based cost allocation, will inevitably mean that the recovery from the electricity business will be lower than otherwise; and this may not be offset by the inflows from the new business. if a risk of this type were to deter the roll out investment then there would be no "extra" unregulated business with which electricity consumers could share the costs of the existing assets, such as poles.

We see that there is room within the regulatory framework to strike an intertemporal balance which will include the interests of regulatory (electricity) consumers in the longer term, while promoting efficient investment in this technology in the shorter term.

In the discussion of the practical way shared facilities are already operated in the IM document, it is accepted that there are circumstances where the strict application of the accounting allocation methodology would not meet the full set of aims of Part 4 – including 52 1 (a). Included here are the dynamic impacts of mergers where benefits evolve over time, as well as creating the right climate for investment in new services. Such investments, especially those with heavy front-ended capital costs[3], are usually

[2] Commerce Commission (2010) *Input Methodologies electricity distribution services Draft Reasons Paper* (similar issues arise in the gas IM paper).

[3] Broadband roll out is inevitably "build it before they will come."

unprofitable initially, as the system costs are unavoidably well ahead of usage, which takes time to build up. An obvious way of addressing the problem of these investments being inhibited, is to limit the impact they have on other parts of the business until they are performing adequately, and thereby available to compensate for this negative cross effect.

So, restraining the extent to which existing consumers share in the potential economies of scope for an initial period is a way of preventing investment from being discouraged. Those consumers will only be missing a discount that is contingent on the new investment.

The IM documents do allow for departures from the pure accounting based method. The way this is approached is through two options to the standard approach to cost allocation. Given the generic nature of the problem as discussed there, these alternatives are set about with tests to ensure they do not create unforeseen consequences.

There are issues with these tests but as the focus here is solely with the question of the climate for investment in the broadband initiative, we will only discuss what might be improved in that regard.

The key problem is that the tests are structured so as to result in relatively high bars to be passed to allow the application of the alternative cost allocation procedures. And this will inevitably affect the investment in the ultra-fast broadband initiative. If there is any chilling effect there will be no potential for the sharing of benefits. This is another instance of the need to strike a balance within the aims of the Part.

4. The proposal

The concern then is that the procedure to access the optional cost allocation methods, as outlined in the IMs will inhibit efficient investment in a significant government initiative.

It is thus proposed that in the case of investment in the Ultra-fast Broadband Initiative, rather than each EDB having to have Director certification of the inhibition, there be an acceptance that this investment (in terms of assets and their associated operational expenses) can be treated according to ACAM (as under the CAMSC.) We suggest that this last for the full period of the broadband fibre roll out.

As the initiative is still in its early stages, this would strike a reasonable balance between the longer term benefits for electricity consumers and the public interest in investments in the initiative.