

27 June 2013

John Groot
Orion CPP Project Manager
Commerce Commission
WELLINGTON



Vector Limited
101 Carlton Gore Road
PO Box 99882, Newmarket
Auckland 1149, New Zealand
www.vector.co.nz
Corporate Telephone
+64-9-978 7788
Corporate Facsimile
+64-9-978 7799

Dear John,

Release of expert reports for public consultation

1. Vector welcomes the opportunity to submit on the Commerce Commission's (Commission) expert report from Professor George Yarrow on the Orion customised price-quality path (CPP) (the Yarrow Report). Please also find attached a report from Castalia on this matter "Orion CPP Application: submission on Professor Yarrow's Expert Advice", 26 June 2013.
2. Vector supports in full the submission made by the Electricity Networks Association on this matter.
3. Vector's contact person for this submission is:

Robert Allen
Senior Regulatory Advisor
robert.allen@vector.co.nz
09 978 8288
4. No part of this submission or the accompanying report from Castalia is confidential and Vector is happy for them to be publicly released.

Overview of Vector's concerns with the Yarrow Report

5. In Vector's view, the Yarrow Report provides limited assistance to consideration of the Orion CPP application. This is because the report does not engage with the regulatory regime in place in New Zealand. In particular:
 - a. The Yarrow Report is based on a premise regulated suppliers should be compensated for catastrophic events on an *ex ante* basis (by way of higher default price-quality path (DPP) revenue allowance). Neither the previous Part 4A price paths nor the current DPP provide allowance for *ex ante* compensation of catastrophic events, so compensation must be based on *ex post* recovery. The Yarrow Report provides limited or no guidance as to how the regulator should compensate a regulated supplier if it has not provided *ex ante* compensation
 - b. Relevant to (a.) above, the Yarrow Report does not refer to the fact that a decision was made by the Commission not to provide for catastrophic risk in the WACC input methodology (IM) and/or that regulated suppliers are not compensated for catastrophic risk in the DPP.
 - c. Nor does the Yarrow Report refer to the Commission CPP IM which expressly envisages claw-back from the date of the catastrophic event to the date of

the determination of a CPP application, in order to address the regulatory delay. The Commission stated this was intended to provide regulated suppliers with certainty that they could address issues in response to an emergency (and raise funds if necessary) without being concerned that they would be prejudiced by delay and/or unable to recover their prudent additional costs.

- d. Finally, in Vector's view, the Yarrow Report does not correctly apply the Part 4 purpose statement. The purpose of Part 4 is to promote outcomes consistent with workably competitive market outcomes such that objectives (a) to (d) are promoted. There is no discussion of outcomes (a) to (d) in the Yarrow Report. The Report considers workably competitive markets in the abstract and does not consider the impact of allocation of risk of catastrophic events on incentives to invest, including in replacement, upgraded and new assets (as per s 52A(1)(a)) which is highly relevant to a situation such as faced by Orion where substantial investment is required to repair the network.
6. These issues with the Yarrow Report reflect the terms of reference provided by the Commission. The terms of reference do not engage with the current regulatory position for claw-back for CPPs or bring Yarrow's attention to key relevant information, including relevant parts of the Commission IM and DPP decisions.
 7. It is unclear to Vector why the Commission is relitigating decisions on ex ante/ex post compensation for catastrophic events it has made in the Input Methodology determinations and as part of its DPP as part of the review of the Orion CPP application. If it wishes to change its approach it would need to amend the IMs and/or address this in the next DPP.
 8. The Commission needs to recognise that by signalling through consultation that it is open to considering options that would preclude regulated suppliers from being properly compensated for the risks of operating a network, and/or adopting an approach that is inconsistent with its own IMs (in a manner detrimental to Orion) it could undermine certainty, heighten the risks to regulated suppliers of applying for a CPP (be it perceived risk or actual risk) and reduce confidence about the ability of regulated suppliers to recover their (efficient) costs; particularly costs associated with dealing with a catastrophic event. Regulated suppliers need to be able to be confident that approaches under the IMs are applied by the Commission as they were reasonably understood by interested parties at the time the IMs were determined.

Relevant decisions made under the current regulatory environment

9. The Yarrow Report needs to be considered within the context of the decisions the Commission has made on the treatment of catastrophic events.
10. A number of submissions on the Commission's initial Orion CPP consultation reminded the Commission that it has not made *ex ante* allowance in DPPs for the risk of catastrophic events.

11. The Commission has explained that:¹

... if a material catastrophic event occurs for a supplier on a DPP, then the appropriate way to deal with that will generally be for the supplier to apply for a CPP that takes account of their particular circumstances ...

The Commission's role if a catastrophic event occurs is to provide certainty to a supplier that it can recover the prudent costs of supplying regulated services, including rectifying for catastrophic events, while providing appropriate incentives for suppliers to manage risk, etc.

12. Overall the decisions in the DPP and the IMs (as explained below) adopt an *ex post* recovery approach for catastrophic events. This approach envisages that Orion is able to recover the prudent and efficient costs incurred as a consequence of the earthquake.²

WACC IM decision

13. The Commission's 22 December 2010 Input Methodologies (EDBs & GPBs) Reasons Paper gave consideration to the appropriate treatment of Type 1 asymmetric risks (which include catastrophic events) and determined not to adopt an *ex ante* allowance for Type 1 risks either in the form of a "reserve fund" or adjustments to the cost of capital.³

14. The Reasons Paper also raised the possibility of a "self-insurance fund, with payments into the fund allowed to be borne as an operational expense subject to pre-determined conditions on the management and operation of the fund".⁴ However, this was not taken further.

15. This possibility was also raised again in the Commission's subsequent Process and Issues Paper "Additional Input Methodologies for Default Price-Quality Paths", 9 December 2011. The Process and Issues Paper asked "whether we should allow for a notional self-insurance premium in calculating starting price adjustments",⁵ but again, this option was not taken further by the Commission. No mention of self-insurance was made in the draft and final amendments of the IMs.

16. We note that the Commission subsequently sought "views on whether NZ's market risk premium, as assessed before the Canterbury earthquakes, would have included an implicit insurance premium on a national basis, and what the implications of this premium would be for our treatment of insurance."⁶ This comment was in direct contradiction to the decision already made by the Commission that the WACC IM (that is, any part of the WACC IM including the market risk premium) was not the mechanism for addressing Type 1 risks. Again this point was not taken further and no amendment was made to the WACC IM. Indeed the Commission cannot retrospectively change the decision made at the

¹ Paragraphs 8.4.23 – 8.4.25. Input Methodologies (EDBs & GPBs) Reasons Paper, 22 December 2010 (2010 IM Reasons paper).

² An appropriate approach to any *ex post* prudency testing is set out in Vector's submission on the Orion CPP Issues Paper dated 24 May 2013 and the accompanying Castalia report.

³ Paragraphs H12.10 – H12.13, 2010 IM Reasons paper.

⁴ Paragraphs H12.12, 2010 IM Reasons Paper.

⁵ Paragraph 160, Process and Issues Paper "Additional Input Methodologies for Default Price-Quality Paths", 9 December 2011 (2011 IM Processes and Issues Paper).

⁶ Paragraph 161 2011 IM Processes and Issues Paper).

time the WACC IM was decided. The Yarrow Report appears to be based on the premise that regulated suppliers should be (and/or are) compensated on an *ex ante* basis (through a higher DPP revenue allowance) for the risk of catastrophic events, rather than an *ex post* basis (through the CPP). This is not particularly helpful given regulated suppliers are not compensated through the DPP.

17. The Yarrow Report also appears to miscomprehend the Commission's decision to adopt a 75th percentile WACC as an allowance that should be treated as compensation for Type 1 risks, notwithstanding the Commission's explicit determination against such compensation in the WACC. The 75th percentile was chosen to mitigate the risk of regulatory error in estimation of WACC because the consequences of regulatory error are asymmetric. The use of the 75th percentile would not achieve this purpose if the Commission also retrospectively expanded the usage of the 75th percentile WACC to account for other risks, including Type 1 asymmetric risks. It would need to select a higher WACC than the 75th percentile in order to accommodate any such additional risks in the future.⁷

CPP IM decision

18. The Commission has also been clear that allowing for claw-back in the CPP IM for catastrophic events was required to ensure regulated suppliers could be confident they would recover the prudent additional costs incurred from the time of the event, notwithstanding the regulatory delay before a decision could be made. In response to "valid" concerns⁸ about how the costs incurred prior to a CPP being determined could be recovered, the Commission in its IM reasons paper stated that:⁹

... it is appropriate to explicitly reflect in the IM that the claw-back provision under s 53V(2)(b) may be applied in response to a catastrophic event to allow for the recovery of prudent additional costs incurred in responding to the event prior to the CPP taking effect. Doing so would provide certainty in the event that suppliers need to obtain financing immediately after a catastrophic event. The IM includes a requirement that CPP applications arising from catastrophic events must be made within 24 months of the event occurring. This would reduce prolonged, unnecessary delays to any subsequent price increases and will increase certainty for consumers, while still allowing sufficient time for suppliers to focus on responding to events first, and submitting CPP applications second.

19. The CPP IM specified the relevant period for claw-back was from the time of the catastrophic event to the time the CPP application is made.
20. In short, the Commission expressly recognised that regulated suppliers should not be prejudiced by the delay before a CPP application could be determined. This approach was adopted so that regulated suppliers did not have to prioritise fast-tracking a CPP application when their focus should be on dealing with the event. The Commission also recognised that, without this assurance, regulated suppliers may not be able to obtain financing or otherwise may not be incentivised to undertake urgent work.
21. While the Commission has discretion under the Act as to whether and how much claw-back will be applied, the Commission has provided clear guidance to

⁷ H11 The Cost of Capital Range, 2010 IM Reasons Paper.

⁸ Paragraph 8.4.26, 2010 IM Reasons Paper

⁹ Paragraph 8.4.27, 2010 IM Reasons Paper

suppliers in the IMs that they could have confidence their prudent costs would be recovered notwithstanding the delay between the catastrophic event and the CPP determination. This is the regulatory context in which the Orion decision is being made.

22. The Yarrow Report, however, makes no reference to the regulatory delay that can occur from the time of the catastrophic event and the determination of the CPP. This could be a period of three years, consisting of the time the regulated supplier has to make the CPP application after the catastrophic event (24 months) and the time-frames provided for in the Act for the Commission to make a CPP determination (approximately one year).¹⁰ Nor does the Yarrow Report make any reference to the Commission's CPP IM decision and reasoning in relation to claw-back and delay.

Yarrow Report

23. As set out above, we do not consider that the Yarrow Report has correctly applied the purpose of Part 4 of the Commerce Act as he has focused on "workably competitive markets" in the abstract and not the outcomes set out in s 52A(1)(a) to (d).
24. The Yarrow Report states that "It can be noted ... that workably competitive markets come in a variety of shapes and sizes, exhibiting a range of different structures and patterns of business conduct" and that "Given the variation in contexts in which workable competition can be found, we might reasonably expect to find the existence of a range of different risk sharing mechanisms, and possibly also a range of different risk sharing outcomes."
25. As Vector's submission highlighted, in the event of a natural disaster, there can be winners and losers with increased business opportunities for many life-line service operators i.e. services required to ensure that the community/businesses are housed and have access to infrastructure services such as power and telecommunications. Even providers of non-essential services, such as bars and restaurants, can benefit if their premises are still able to operate but many of their competitors have had to shut down.¹¹
26. The Castalia Report provides evidence that Public Private Partnerships (PPPs) are: (i) an example of workably competitive markets that have reasonable parallels with regulated suppliers; and (ii) commonly get compensated for force majeure situations (such as catastrophic events) on an ex post basis.
27. What ultimately matters, in terms of the purpose of Part 4 of the Commerce Act, is what approach best promotes objectives (a) to (d) to the long-term benefit of consumers; with relevant considerations being consumer desire for prudent investment and maintenance in the network to occur and for recovery from

¹⁰ This consists of 40 working days to determine whether the proposal complies with the input methodologies (s 53(s)(1)), additional 40 working days for the regulated supplier to remedy any deficiencies in the proposal by providing additional information (s 53(2)(b)), 150 working days to make a determination on a proposal after receiving a complete proposal (s 53(T)(2)), and provision for extension of timeframes of up to 30 working days for the above two steps (s 53U).

¹¹ This is highlighted vividly in the following article <http://www.stuff.co.nz/national/6706418/Straights-have-gay-old-time-at-nightclub>.

natural disasters to occur in a timely manner. The Yarrow Report looks at one particular aspect of consumer interest, namely risk exposure, without giving consideration to factors specified in the purpose statement such as investment incentives. The Yarrow Report suggests that "the question [or workably competitive market outcomes] is probably best approached first by the application of some general principles to the very specific events that have triggered the application for claw-back" and then limits its consideration to risk stating that "given the size of the potential losses from disruption to electricity supplies, and given that they are positively correlated with other losses likely to be suffered, electricity consumers would place significant value on some degree of insurance or real income protection in the face of such risks."

28. This is illustrated by the Yarrow Report's statement that he "would advocate ... explicitly determining risk sharing arrangements *ex ante*, in a way that ... allocates the risk burden principally to suppliers ..." If this suggestion is accepted an implication is that regulated suppliers should bear the risk of natural disasters **but** the quid pro quo is that regulated suppliers should be compensated for bearing this risk.
29. It is unfortunate the Yarrow Report does not explicitly say what the Commission should do in relation to Orion's CPP given that risk sharing has not been provided on an *ex ante* basis in this manner. That is the question that is relevant to the CPP application. The omission of this key question severely curtails the value of the Yarrow Report.
30. The commentary in the Yarrow Report may be useful for considering/reviewing the way that the Commission should approach Part 4 in the future (and changes to the IMs would be required), but is not so relevant to whether Orion should be compensated for the losses it is and has incurred (both decreased revenue and heightened costs) as a consequence of the Christchurch earthquakes. The Commission is presently operating Part 4 in a way that regulated suppliers do not receive compensation for the risk of natural disasters in their DPPs and therefore should not be expected to bear the risk of natural disasters.
31. The Yarrow Report incorrectly states that the risk of earthquakes and catastrophic events can be diversified away and, therefore, may not need to be compensated for. Professor Yarrow claims that "the capital-asset pricing model (CAPM) assumes full portfolio diversification against localised events such as an earthquake ... That is, the cost of earthquake risk would be negligible if such an assumption were warranted."
32. Professor Yarrow's view, that the idiosyncratic risk component of the earthquake can be diversified by investors, will only be correct if Orion's returns compensate investors for that risk. In other words, an investor can diversify their risk by having a mix of high risk, high return stocks and low risk, low return stocks. But for this to be an effective strategy, each stock must provide a return that compensates for associated idiosyncratic risks.
33. As PricewaterhouseCoopers have noted: "The key effect of a catastrophic event ... is not to increase the volatility of Orion's returns (and thereby possible [sic] create an argument that investors require a greater risk premium), but rather to increase

the costs that it faces (i.e., the need to repair assets, loss of revenue, etc.). This is a cost that would have been borne irrespective of who owned the assets – it is a function of that fact that electricity infrastructure needs to be constructed in the location of consumers, and this is where the earthquake occurred.”¹²

34. If regulated suppliers are not fully compensated under either the DPP or the CPP, or a combination of the two, for any reasonably incurred losses, in such circumstances, it would signal that they should not necessarily expect – even if they operate as an efficient service provider – to earn a normal return on their assets/investment.
35. The principal discussion in the Yarrow Report is consequently not helpful for consideration of the Orion CPP application. The Report effectively says that Professor Yarrow disagrees with the way the Commission is operating price control, and that the DPP price resets should provide for an additional revenue allowance to act as a form of insurance against the risk of natural disasters.
36. Similar comment can be made of the Terms of Reference for the Yarrow Report.
37. The question “would the costs and risk of a catastrophic event such as an earthquake be borne by businesses or by consumers in workably competitive markets characterised by the existence, on the supply side, of long-lived specialist assets?” is relevant to the determination of the methodology for determining the DPPs, but is not relevant to the matter of Orion’s CPP application. The same can be said of the third question in the terms of reference which asks whether Orion should be allowed claw-back.

Claw-back

38. The Yarrow Report suggests “that use of claw-back is something that good-practice regulation tends to seek to avoid *where feasible*” and suggests that claw-back “by regulators to ‘correct’ what have come to be perceived as over-generous regulatory settlements in the past” and that claw-back in such circumstances “can encourage hindsight bias and increase regulatory uncertainty”.
39. This would suggest that the Commission should not have applied claw-back in its recent DPP setting.
40. The Yarrow Report goes on to express concern that “*ex post* adjustments ... may come to be associated with the more active use of prudency reviews.” The comments Professor Yarrow makes here suggest it would not be a good idea to enable general re-openings, as it could risk “reversion to cost-plus price setting”. This is not particularly relevant to the Orion CPP application. The Orion CPP has been made in exceptional circumstances and would accord with the Yarrow Report’s suggestion of avoiding claw-back “where feasible”. Avoiding claw-back is not feasible in the event of catastrophic natural disaster where the regulator has made no allowance for the risk of natural disaster in its *ex ante* price setting.
41. Further, as set out above, the Yarrow report takes no account of the CPP IM and the IM Reasons paper. The Commission reassured suppliers that claw-back would

¹² Page 25, Letter from PWC to Orion, Long-term incidence of cost recovery following a catastrophic event”, 17 December 2012.

be applied so that suppliers would not be prejudiced by the fact it takes some time before a CPP determination can be put into place. This was intended to provide suppliers with confidence they could focus on the catastrophic event rather than needing to prioritise fast-tracking a CPP application. The Yarrow Report does not refer to the regulatory delay that can occur from the time of the catastrophic event and the determination of the CPP and the Commission's IM Reasons Paper in this regard.

42. Orion's CPP application is seeking to put Orion in the position it would have been had it been able to have a CPP determined at the time of the catastrophic event. Pass-through in the DPP would have been another mechanism to avoid prejudice because of delay in the case of catastrophic events. Indeed suppliers sought pass-through in the DPP for catastrophic events. The Commission considered that this was unnecessary referring to the application of claw-back in the CPP.

Costs and risks

43. The Yarrow Report states that "Looking at matters *ex ante*, it is reasonable to anticipate that a regulator will allow for the recovery of efficiently incurred, expected costs (whereby expected costs is meant the mathematical expectation or mean of probabilistic cost projections). Expected costs caused by catastrophic events are properly included in this calculation."
44. Again, this statement is a relevant critique of the way the Commission sets its DPPs. There is no allowance for "Expected costs caused by catastrophic events" based on "probabilistic cost projections". The Commission's forecast of current and projected profitability makes no allowance for catastrophic events. The relevance of the Yarrow Report's statements is that given no allowance has been made for catastrophic events in the DPP (and it appears Professor Yarrow believes there should be) then the Commission has no alternative but to provide Orion with ex post compensation through the CPP for the cost/lost revenue from the Christchurch earthquakes.
45. The same statements can be made about Yarrow's comments on self-insurance. The Commission has not made an allowance for self-insurance against natural disasters in the DPPs. To the extent that Orion can be demonstrated to have insured/self-insured and this was reflected in Orion's DPP it is reasonable to conclude that Orion should not be ex post compensated for these insured risks through the CPP. Such amounts could be readily verifiable as, if they existed, they would be explicitly included in the Commission's DPP model.

The distinction between revenue risks and cost risks

46. The Yarrow Report states that "it is simply not the purpose of the NZ legislation to protect businesses against [foregone business revenues resulting from reduced electricity consumption following the earthquakes]." Vector respectfully submits that there is no basis for this statement (and we refer to our discussion of the regulatory regime above). Further, if this was true the New Zealand legislation would distinguish between increased cost/decreased revenue and make clear claw-back only applies to the former. The New Zealand legislation makes no such distinction.

47. In terms of the impact of an earthquake on a regulated supplier increased cost and decreased revenue has exactly the same impact. The only meaningful difference is that the regulated supplier may have more control of the former e.g. it could forego necessary investment following an earthquake. To take advantage of such a distinction, however, would amount to regulatory opportunism. Such regulatory opportunism may not be very effective as foregoing necessary investment/opex could be used to mitigate both uncompensated costs and the losses arising from decreased revenue.
48. If regulated suppliers are to have incentives to invest and maintain their networks they need to expect to at least be able to earn a normal return. They need to be either compensated for the risk of catastrophic events on an *ex ante* (DPP) or *ex post* (CPP) basis. Other than being allowed to keep destroyed assets in the RAB, the Commission has not provided for *ex ante* compensation. If regulated suppliers are not properly compensated for the risk of natural disasters and also do not expect to be fully compensated for lost profits (higher costs/decreased revenue) following a natural disaster their incentives to invest, including following a natural disaster, will be dampened. This would not be to the long-term benefit of consumers.

Concluding remarks

49. The Yarrow Report does not provide a sound basis for concluding any part of Orion's application for compensation for losses/higher costs/lost revenue arising as a consequence of the Christchurch earthquakes should not be accepted.
50. If the Commission now believes that regulated suppliers should bear the cost of catastrophic events, this would need to be dealt with through amendments to the IMs and a change to approach to the determination of DPPs, including an uplift in allowed revenues to cater for this additional risk. Whether this should be done is a matter that is not relevant to Orion's CPP application.
51. Vector believes the overarching consideration, from a consumer/long-term benefit of consumer perspective, should be to ensure regulated suppliers have an expectation that they will be able to recover reasonably incurred costs and earn, at least, a normal rate of return. This is needed to ensure regulated suppliers have incentives to invest and maintain their networks, including for recovery from natural disasters to occur in a timely manner, consistent with s 52A(1)(a) of the purpose of Part 4 of the Commerce Act. Vector believes aspects of the Commission's consultation on the Orion CPP application are counter to achievement of this objective. The Commission is signalling, whether intentionally or not, it is willing to consider options that could preclude regulated suppliers from being properly compensated for the risks of operating a network, and adopting an approach that is inconsistent with its own IMs.

Yours sincerely,



Bruce Girdwood
Regulatory Affairs Manager