



**Submission to the Commerce Commission
on Orion CPP Issues Paper**

24 May 2013

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Executive Summary

Introduction and background

1. Orion has made an application for a Customised Price-quality Path (CPP) in order to recover (claw-back) the post-quake costs of running its network business where the default price-quality path (DPP) did not allow for this cost recovery.
2. The Orion CPP application has been developed in difficult circumstances for both the company and its consumers. A large investment programme has been and will continue to be required in order to repair and replace the electricity network infrastructure damaged in the Canterbury earthquakes. It seems clear that it is in the long-term interest of Orion's consumers for the network repairs to proceed and to proceed in a timely manner.
3. As the first CPP application made under Part 4, the Orion application will have significant precedent value and will provide an opportunity to test and assess the effectiveness of the CPP application and decision-making process. The Commerce Commission's (Commission) decisions, and decision-making process, on the CPP will directly affect the risk assessment that regulated suppliers make when considering whether to apply for a CPP.

Claw-back

4. The Commission has raised the prospect that Orion may not fully recover (claw-back) the losses it suffered due to the earthquakes from its consumers and that Orion's shareholders should bear some of the losses. In this context "losses" means investment (both capex and opex) to repair Orion's network following the earthquakes plus lost revenue due to a reduction in demand following the earthquakes. Recovery of these losses is required to recover post-quake costs of running the network business.
5. Claw-back is provided for in the Commerce Act 1986 (Act) in circumstances where a different price path (either lower or higher) should have applied in the past. The Commission's Input Methodology (IM) determination clarifies that, in relation to CPPs, claw-back is provided for following a catastrophic event.
6. It is relevant to note that the Part 4 regime and the IMs determined by the Commission envisage full recovery of prudent and efficient costs. In Vector's view, Orion has appropriately sought to recover cost, volume and reliability impacts on its business from the date of the Canterbury earthquakes that the default price-quality path (DPP) has not been able to compensate.
7. The Commission's proposal also raises broader policy concerns. If shareholders of regulated suppliers are to be expected to bear the risk of not making a normal return on their investments following a catastrophic event, then the shareholders would reasonably expect to receive a benefit from taking on that risk and/or ask the company to invest to mitigate the risk. However, no such benefit is provided

for in the WACC or elsewhere as part of the DPP. The cost of any such benefit or mitigation, if it were in place, would flow through to consumers.

8. Crucially, a supplier of essential services has legal, moral and humanitarian obligations to restore supply of those services as quickly as possible following a catastrophic event. At least a portion of Orion's losses will result from Orion meeting such obligations.
9. The Commission's proposal risks creating a perverse incentive for regulated suppliers in an area that suffers a catastrophic event to not undertake necessary capital or operational expenditure, above that already provided by a DPP, in order to repair their network. The only way to be sure of capex and opex recovery in these circumstances would be to delay above-DPP expenditure until after a CPP application has been approved, which would be some years later. This incentive would be inconsistent with the business continuity / crisis management plans that regulated suppliers have in place for such circumstances and would not be to the long-term benefit of consumers.
10. Further, Orion's prices were set to recover its costs given a particular level of forecast demand. As actual demand has been lower than expected due to a large catastrophic event, Orion has been unable to recover even its pre-earthquake costs in full. Vector considers that the recovery of post-catastrophic event expenditure is conceptually equivalent to the recovery of post-catastrophic event reduced revenues – both relate to enabling the business to recover its costs.

Status of the input methodologies

11. Vector is concerned that, based on the Issues Paper, the Commission appears to be of the view that it is able to consider approaches and issues that are not provided for in the CPP IMs. For example, comparison of the proposal against options and alternative treatments of damaged assets.
12. These approaches are contrary to and / or not provided for the current applicable IMs. In order to apply these approaches, the Commission must either reach agreement with Orion or consult on amending the IMs (in which case the amended IMs would apply to future CPP proposals but not to Orion's CPP proposal).

Overhead versus underground HV cables

13. The Commission is seeking views on whether certain high voltage cables should be built overhead or underground. Vector notes that the construction cost of an overhead line is much cheaper than that of an underground cable. However, over the life of the asset, maintenance costs of an overhead line, including managing the line corridor, are significantly higher than for a solid underground cable. It is quite possible that the overall life-cycle cost for an overhead line would be higher than that of an underground line.

14. Perhaps the most important factor to consider is public opposition to new overhead lines, especially in built-up areas. This results in political pressure on Council decisions and makes it extremely challenging to gain the necessary consents.
15. As an example, Transpower initially planned to build overhead lines through Auckland in order to deliver the NAaN project. However, on considering this in more detail, they realised that not only would this be extremely complex, and subject to major public pressure, but economically it was more viable to underground the lines.

Issues to consider for future CPPs

16. It appears to Vector that Orion has provided an application that contains approximately the quantity of information that the IMs require. We note that the Commission appears to be of the view that the application did not contain some desirable information and has been seeking more information from Orion.
17. Vector would be interested in exploring with the Commission and other stakeholders why there is an apparent difference of views of the level of complexity and detail required by the IMs.
18. Vector also considers that the CPP process is a cumbersome, expensive and time consuming method of securing urgently needed approval for investment following a catastrophic event. Vector believes a more practicable method should be developed for funding a regulated supplier to address a catastrophic event in its area.

Introduction and background

19. Vector welcomes the opportunity to respond to the Commission's consultation paper *Invitation to have your say on Orion's proposal to change its prices and quality standards: Issues to explore and consider*, dated 1 May 2013 (Issues Paper). No part of this submission is confidential.
20. This submission is accompanied by an expert report from Castalia, *Regulating the Costs of Extraordinary Circumstances* (Castalia report), dated 24 May 2013.
21. As is well known, in 2010/11 the Christchurch and Canterbury area was hit by a series of earthquakes that caused extensive damage, including to Orion's electricity distribution network, and, on 22 February 2011, 185 fatalities. In the aftermath of the earthquakes, Orion invested substantial funds in making repairs to its network in order to restore electricity supply to households and businesses. The earthquakes also caused a significant reduction in electricity demand within Orion's network, leading to Orion receiving lower revenues than had been expected when its prices were set.
22. Orion has made an application for a CPP, including a request for approval to recover (claw-back) the post-quake costs of running its network business where the DPP did not enable this cost recovery.
23. The Orion customised price-quality path (CPP) application has been developed in difficult circumstances for both the company and its consumers. A large investment programme has been and will continue to be required in order to repair and replace the electricity network infrastructure damaged in the Canterbury earthquakes. In Vector's view, it seems clear that it is in the long-term interest of consumers for the investment to proceed and to proceed in a timely manner.
24. As the first CPP application made under Part 4, the Orion application provides an opportunity to test and assess the effectiveness of the CPP application and decision-making process. Stakeholders will be observing this process with interest. For other regulated suppliers, the way this application is handled will be assumed to represent the way future applications may be handled. Hence this application process will directly affect the risk assessment that regulated suppliers make when considering future CPP applications.
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Claw-back of post-earthquake losses

26. This section:

- a) Summarises the relevant legislative framework applying to claw-back following a catastrophic event;
- b) Highlights the key issues raised in the Issues Paper and the Commission's current thinking;
- c) Discusses the likely effect of the Commission's proposals on the restoration of essential services after a catastrophic event;
- d) Discusses two conceptually appropriate reasons for Orion to not recover its post earthquake losses through the CPP – *ex ante* funding (either through the WACC or an insurance premium) and *ex post* prudency testing – the first of which does not apply in this case and the second of which should only be applied on very restricted terms, if at all;
- e) Assesses the possibility of Orion not being able to recover its post-earthquake losses against the Part 4 Purpose; and
- f) Addresses the two issues raised by the Commission as potential reasons for Orion to not recover its post-earthquake losses in full – that others in Canterbury have borne unrecovered losses and that investors in Orion had the opportunity to diversify their risks.

Relevant framework

27. Claw-back is provided for in Part 4 of the Act in circumstances where a different price path (either lower or higher) should have applied in the past. For example, where a DPP is reset following the determination of IMs (s 54K), or a regulated supplier successfully appeals an IM (s 53ZB(2)).¹
28. In relation to CPPs, the Commission may apply claw-back when determining a CPP if it sets a lower or higher price than applied under the DPP (s 52V(2)(b)).
29. While the Commission has a discretion whether to allow some or all of any under-recovery when determining a CPP, the Commission's IM determination clarifies that, in relation to CPPs:²
 - a) Claw-back is permitted following a catastrophic event;³ and
 - b) The period where claw-back should apply is from the date of the catastrophic event until the date the CPP determination comes into effect.

¹ As defined in s 52 D, claw-back is a reference to the Commission requiring a supplier to lower prices to recover all of some of any previous over recovery or allowing a supplier to recover some or all of any shortfall in it revenues that occurred under prices previously charged.

² Commerce Commission, *Electricity Distribution Services Input Methodologies Determination 2012*, (2012 IM Determination) clause 5.3.4(2)(a) and (3). Claw-back in a CPP determination can also apply where the relevant CPP proposal has been deferred in accordance with s 53Z(2) of the Act (again, this reflects that the core function of claw-back which is to address timing issues).

³ See also Commerce Commission, *Input Methodologies Reasons Paper*, December 2010, (IM Reasons Paper) paragraph K1.2, where the Commission states that claw-back is appropriate where a CPP is made in response to a catastrophic event.

30. These clauses in the IMs are appropriate as they reflect the position that a regulated supplier should not be prejudiced in the case of a catastrophic event by the fact it takes some time before a CPP determination can be put in place. Indeed, the IMs create an expectation that, in principle, claw-back could apply from the date of the event.
31. This is in a context where the Part 4 regime and the IMs determined by the Commission envisage full recovery of prudent and efficient costs:⁴

If a regulated firm does not expect to make at least a normal return on its efficient incremental investments going forward, it would be unable to maintain the quality of its services and would have no incentive to invest further in order to meet the growth in consumer demand.
32. The regime and the IMs determined by the Commission also assume recovery of costs for a catastrophic event after the event has occurred.⁵
33. We consider it critical that claw-back is decided on a principled basis within the framework set out above.

Key issues

34. According to the Issues Paper, the core debate regarding the Orion CPP application appears to be as follows:
 - a) Orion prudently incurred costs (by which, in this context, we mean both capex and opex) that were higher than what was provided for in its DPP in restoring services to its consumers in the aftermath of the Canterbury earthquakes;
 - b) Orion received lower revenues than expected as a result of the earthquakes;
 - c) The higher costs and lower revenues (collectively, "losses") were not insured and, we understand, were not economically insurable;⁶ and
 - d) The Commission then questions how these losses should be allocated between Orion's consumers and Orion's shareholders.
35. Our concern is that the Commission's indicative approach (suggesting Orion's shareholders may be best placed to bear this risk, where the risk is being allocated on an *ex post* basis) is inconsistent with the statutory framework, the current DPP and CPP IMs and Orion's legitimate expectations.
36. In Vector's view, the starting point should be that full, rather than part, claw-back of this under-recovery is appropriate. This approach is consistent with the current regime which generally envisages *ex post* rather than *ex ante* recovery of losses due to catastrophic events.

⁴ IM Reasons Paper, December 2010, page 36.

⁵ For example, clause 5.6.4(3) of the IMs anticipates that CPPs may be reopened to address a catastrophic event where the costs of that event are not "fully covered" by a self insurance allowance provided under the CPP or through commercial insurance held by the EDB.

⁶ Vector understands that Orion did insure against some losses. It is our understanding that recovery of those insured losses is not the subject of this CPP application.

37. In our view Orion has appropriately sought to recover cost, volume and reliability impacts on its business from the date of the Canterbury earthquakes that the DPP has not been able to compensate.
38. The Commission should ensure its CPP determination enables Orion to: (i) recover the prudent and efficient costs incurred as a consequence of the earthquake; (ii) earn, at least, a normal rate of return on its assets; and (iii) provide services at a quality that reflects consumer demand.
39. This view is supported by Castalia who find that:⁷

Orion should be entitled to recover past costs associated with the earthquakes that have been prudently incurred. This conclusion is the only way to sensibly apply the rules that were in place at the time of the earthquakes, and is also consistent with the Commerce Act and principles of good regulation.
40. Vector also notes and endorses the discussion in sections 3 and 5 of the Castalia report, highlighting principles that can be used when determining whether a regulated supplier should recover its costs following a catastrophic event and applying these principles to the Orion CPP application.

Commission's current thinking

41. The Commission has raised the option of Orion not recovering all of the losses it incurred due to the Canterbury earthquakes. The Commission considers that it may be appropriate for some of these costs to lie with Orion because:⁸

It is not clear to [the Commission] that consumers in Canterbury are better placed than Orion to bear the risk of not earning a full return following the earthquakes. We are mindful in this context that others in Canterbury have suffered losses that cannot be recovered. In contrast, for example, investors in Orion had the opportunity to spread risks beyond the Canterbury market through diversification of their investments.

42. However, the Commission does recognise that "consumers suffer if the network is not adequately built and maintained, including through additional investment".⁹

Implications of the Commission's proposal for the restoration of services following catastrophic events

43. Vector considers that these comments of the Commission have substantial implications for all suppliers that are regulated under Part 4.
44. A supplier of essential services has legal, moral and humanitarian obligations to restore supply of those services as quickly as possible following a catastrophic event. At least some, and probably more, of Orion's losses will result from Orion meeting such obligations.
45. The Commission's proposal risks creating a perverse incentive for regulated suppliers in an area that suffers a catastrophic event to not undertake necessary

⁷ Castalia report, page 1.

⁸ Issues Paper, paragraph 91.

⁹ Issues Paper, paragraph 100.

capital or operational expenditure above that already provided by a DPP in order to repair their network. The only way to be sure of capex and opex recovery in these circumstances would be to delay above-DPP expenditure until after a CPP application has been approved, which would be some years later. Alternatively regulated suppliers could prioritise preparing a CPP application (in order to submit it earlier) over the network repairs. Such incentives would be inconsistent with the business continuity / crisis management plans that regulated suppliers have in place for such circumstances and would not promote the long-term benefit of consumers.

46. An alternative perverse incentive may be for regulated suppliers to make the investments and not recover them (e.g. due to political pressure). This is also not a desirable or rational outcome.
47. In New Zealand, suppliers of electricity and gas transportation services are listed as lifelines utilities in Part B of Schedule 1 of the Civil Defence Emergency Management Act 2002. Under this Act, lifelines utilities are required to:¹⁰
 - a) Take all necessary steps to undertake civil defence emergency management; and
 - b) Ensure that they are able to function to the fullest possible extent, even though this may be at a reduced level, during and after an emergency.
48. The Commission should be careful not to take decisions that interfere with regulated suppliers' ability to comply with these obligations, including making decisions that would cause regulated suppliers to incur financial losses if they comply with the obligations.
49. Ultimately, Vector does not believe that consumers would welcome suppliers of essential services being distracted from the task of restoring their services or that consumers would prefer to wait for a cheaper, less urgent, form of restoration if that restoration would take longer following a catastrophic event.

Fall in demand

50. In relation to Question 2 in the Issues Paper, the Commission notes that:

...setting maximum average prices for electricity lines companies usually requires these businesses to bear a substantial degree of demand risk. While the environment in Canterbury after the earthquakes is not 'normal', it is rare that businesses are able to raise prices when demand falls, or to recover past amounts of revenue that were lower than expected.¹¹
51. The Commission's discussion on this point does not appear to engage with the claw-back framework, the CPP IM or the Part 4 Purpose (it is unclear how this discussion links with subparts (a) to (d) of s 52A(1)). Further, the suggestion that fall in demand is a risk that Orion should bear is not soundly based given:

¹⁰ Civil Defence Emergency Management Act 2002, sections 59 and 60.

¹¹ Issues Paper, paragraph 101.

- a) Had a CPP applied from the time of the catastrophic event, the fall in demand would have been appropriately addressed by the CPP and the resulting reduction in revenues would not have occurred. The (unavoidable) regulatory delay in setting a CPP is not a valid justification for delivering a different outcome to that which would have occurred had it been possible to implement a CPP immediately after the event.
- b) The demand side risk generally borne by regulated suppliers subject to a weighted average price cap (i.e. they bear the upside risk of increased demand and the downside risk of reduced demand through organic growth or contraction of a network's customer base) is likely to be compensated for through the regulated supplier's WACC. However, catastrophic events have not been provided for through the WACC. Businesses are therefore not compensated for abnormal revenue variation.
- c) The recovery of post-catastrophic event expenditure is conceptually equivalent to the recovery of post-catastrophic event reduced revenues – both relate to enabling the business to recover its costs.
- d) In the light of the Part 4 Purpose to promote investment incentives, it is important that regulated suppliers have confidence that they will be able to recover their costs. A fall in demand following a catastrophic event places them in a position where they will be unable to recover their costs. This would make investors wary about placing their funds in regulated suppliers that face this risk.
- e) The claw-back of under-recovery from the time of the catastrophic event does not enable Orion to earn excess profits. Indeed, Orion is seeking only to recover its actual losses and to continue to earn and to expect to earn a normal return following the catastrophic event.

52. As Castalia advises:¹²

If the Commission is not satisfied that [allowing Orion to recover its losses due to lower than expected post-earthquake revenues] is in the long term interests of consumers, then the Commission needs to initiate a review of the regulatory settings. The options for allocating a greater amount of risk to suppliers all require *ex ante* regulatory decisions—either to provide for specific cash flows, increase the WACC, or decide on specific risks that suppliers will bear. The Commission cannot achieve this risk allocation in the context of Orion's CPP application.

Relevant considerations for post-catastrophic event price recovery

53. In our view there are two conceptually valid considerations for a regulator deciding whether to allow a regulated supplier to fully recover its losses after a catastrophic event. Neither of these points is raised by the Commission within the Issues Paper, but we discuss them in some detail here as they form a useful basis to consider cost recovery following catastrophic events.

¹² Castalia report, page 19.

54. These points are: (a) has supplier's funding accommodated the potential impact of a catastrophic event on an *ex ante* basis; and (b) is an *ex post* prudency review of expenditure warranted and reasonably practicable?

Ex ante funding

55. The Issues Paper suggests that shareholders should bear the risk of catastrophic events without, it seems, any eventual recovery from consumers. As a result, shareholders of regulated suppliers could reasonably conclude that they risk losing any investments they make in order to restore supply following a catastrophic event in their supplier's area. This is an outcome that affects all regulated suppliers, not just Orion.
56. If shareholders of regulated suppliers are to be expected to bear the risk of not making a normal return on their investments following a catastrophic event, then the shareholders would reasonably expect to be compensated for taking on that risk. This compensation (or *ex ante* funding for expected future losses) can in theory be funded by consumers paying a premium on their prices to cover the risk of a future event. This can be done either by means of an additional margin on the WACC or an explicit self-insurance premium.
57. In Vector's view, the risk of catastrophic events is not provided for through the Commission's WACC determination. While the Commission and its expert panel were clear an allowance or adjustment should be made for asymmetric risks, it ruled out including such an allowance in the WACC IM and concluded that "The IM does not make any adjustments to the cost of capital for Type I asymmetric risk".¹³ We also note Castalia's view that WACC adjustments are poorly suited for dealing with asymmetric risks.¹⁴
58. In the absence of a WACC adjustment, to address their risk shareholders could ask the firm to either raise prices to consumers to insure against the risk (if they were permitted to raise prices in this way) and/or to take steps (e.g. investment)¹⁵ to mitigate the risk. The cost of those prices and/or investments would then flow through to consumers. Thus, any approach to providing for the cost of catastrophic events will ultimately be borne by consumers. This of course assumes that shareholders are aware in advance that they would bear the risk, which was not the case with Orion (but might be for EDBs in the future).
59. Irrespective of whether this approach is implemented by means of a WACC adjustment, investment or a self-insurance premium, there is a risk of the *ex ante* allowance being too high or too low. It also raises the issue of determining the point in time at which any fund built up through the *ex ante* allowance is sufficient to cover the cost of the event (e.g. if the *ex ante* allowance has been in place for a short period it is highly unlikely that any fund will be sufficient to cover more than

¹³ IM Reasons Paper, paragraphs H12.10-H12.13.

¹⁴ Castalia report, page 12.

¹⁵ This creates a risk that the supplier may be incentivised to spend more strengthening the assets in advance than is necessary in order to mitigate the risk of post-event losses that could not be recovered. This may not be the most efficient approach.

a fraction of the costs of the event). For such reasons there are varying views as to the desirability of such an approach.

60. However, Vector considers that the debate regarding the merits of *ex ante* funding for catastrophic events, while interesting, is not relevant to the Orion CPP application.¹⁶ The relevant question with regard to Orion is whether there was any form of explicit or implicit *ex ante* funding in the prices it charged consumers prior to the Canterbury earthquakes, or within Orion's current pricing.
61. Vector does not believe there was any such funding included in Orion's pre-earthquake or current prices. Such funding was not a feature of the Part 4A regime and is only allowed for in the recently set DPP prices for EDBs and GPBs where individual regulated suppliers could demonstrate that a captive insurer was in place. This is further reflected in the CPP IM which considers claw-back is appropriate where there is a catastrophic event and is applicable from the date of the catastrophic event. In other words, Orion, like other regulated suppliers, had a legitimate expectation that the costs of a catastrophic event would be funded on an *ex post* basis.¹⁷
62. As Orion has not, we understand, been charging its consumers an *ex ante* premium for uninsurable catastrophic events, it should not be prevented from recovering post-earthquake losses on the grounds that the losses were *ex ante* funded, because they were not.
63. As Castalia advises:¹⁸

it is impossible to separate the pre-event regulatory regime and the post-event liability for costs. It is simply not credible for a regulator to determine the liability for post-event costs in isolation because this has already been determined by the pre-event regulatory regime. This means that the costs of recovering from extraordinary circumstances need to be dealt with in line with the regulatory regime existing at the time of the event (whether or not this is now considered the best way to address the issue).
64. In these circumstances, *ex post* recovery is the only available option for Orion. An *ex post* recovery necessarily requires full recovery of prudent and efficient costs. In our view, to seek to allocate risk on an *ex post* basis, as the Commission proposal would do, is contrary to the Part 4 purpose. It prevents Orion being able to earn a normal return on its investment, where there is no allowance in the WACC or ability to self-insure.

Ex post prudency testing

65. It is clear that regulated suppliers should be permitted to recover their efficient and prudent costs of responding to a catastrophic event.

¹⁶ For the record, subject to the details of any proposal, Vector's preference would be for a hybrid arrangement in which an *ex ante* allowance builds up a fund for dealing with future events and any shortfall in that fund is addressed through an *ex post* adjustment.

¹⁷ Castalia report, page 16.

¹⁸ Castalia report, page 8.

66. As Castalia advises, regulators overseas have chosen to enable regulated suppliers to pass through to consumers the costs of major asymmetric events, where those events are not insurable, where it is not efficient or practical to diversify and it is a low probability, high impact event.¹⁹
67. However, a legitimate consideration in circumstances where expenditure has occurred after a catastrophic event is whether the expenditure was efficient. A regulator may be concerned that if it provides *ex post* approval for all expenditure there may be limited incentives on the regulated supplier to act efficiently following a catastrophic event. A method of resolving such concerns is to apply an *ex post* review of the prudence and efficiency of the expenditure undertaken after the event.
68. However, Vector considers that this theoretical view needs to be tempered with the reality of the situation following a catastrophic event. In this circumstance the priority should be for lifelines services to be restored as quickly as possible. The restoration of services should not be delayed by the need to document decisions and assess possible approaches to a level of rigour that will withstand future review. If suppliers acted in such a way, services would be restored later, unsafe assets would be repaired later and lives could be lost.
69. We also note that, based on the Issues Paper, the Commission does not appear to believe that any of the post-earthquake expenditure was inefficient; at least the Commission does not raise this as a possibility.
70. Further, as Castalia discusses,²⁰ *ex post* reviews have considerable problems as they risk creating an environment in which suppliers are reluctant to invest due to the risk that they will not be able to recover their capital and operational costs through prices. In particular, there is at least a perceived risk that the regulator will, with hindsight, deem expenditure to be inefficient and disallow recovery of it when it had appeared efficient at the time it was made.
71. In Vector's view, *ex post* prudence tests are problematic for these reasons. However, we recognise the Commission may require some assurance that Orion's post-earthquake expenditure was efficient. Any *ex post* prudence testing should therefore only consider investment decisions based on the facts and circumstances that were available at the time the investments were made. The testing would need to recognise that:
- a) The priority of any lifelines supplier after a catastrophic event will and should be to get services restored as quickly as possible;
 - b) Documentation of investment decisions will be limited and this is appropriate;
 - c) Suppliers will have limited opportunity to consider alternative options in detail due to the urgent need for the investment, and this is appropriate; and

¹⁹ Castalia report, page 12.

²⁰ Castalia report, page 13.

d) The ability to test decisions for cost-effectiveness will be limited.

72. On this basis, Vector agrees with Castalia that a lower standard of proof should apply to *ex post* reviews of expenditure following catastrophic events than to other investment reviews (e.g. the forward looking reviews undertaken as part of the CPP).²¹ The Commission should allow the costs (capex and opex) to be recovered unless it can be shown, based only on information available at the time, that the expenditure was clearly imprudent.

Ex post recovery assessed against the Part 4 purpose

73. In terms of assessing the proposal against the purpose statement, we emphasise that Parliament has expressly identified subparts (a) to (d) of s 52A(1) of the Act as the relevant workably competitive market outcomes (not other outcomes that might be observed in a workably competitive market).²² We note that the Commission refers to workably competitive market outcomes in the abstract and separately from the Part 4 Purpose outcomes (a) to (d).²³

74. In relation to (a) to (d), Vector considers that full claw-back of prudent and efficient costs best meets the Part 4 Purpose:²⁴

- a) As discussed above, allowing for recovery of post-earthquake losses will promote incentives to invest, in particular after a catastrophic event has occurred. This will be consistent with demands of consumers for services to be restored as quickly as possible.
- b) Efficiency incentives are promoted through claw-back provided the expenditure was prudent and efficient. Incentives to provide services at the quality consumers demand is supported by claw-back as Orion's efforts to restore supply as quickly as possible were, we understand, consistent with demands of consumers in Canterbury.
- c) Sharing efficiency gains with consumers is not directly relevant to the concept of claw-back in this instance.
- d) Allowing for claw-back does not enable Orion to extract excessive profits as Orion is only seeking to recover its costs, including its return on capital.

Workably competitive markets

75. Vector does not believe that considering workably competitive market outcomes in the abstract is the correct approach to the Part 4 Purpose. However, even if such an approach is correct, we do not believe that the concept of outcomes consistent

²¹ Castalia report, page 18.

²² While the merits review appeal judgment has not yet been released, this position was reflected by the Court during the hearing, for example where Clifford J's noted: "What outcomes produced by a workably competitive market, other than the ones in (a) to (d), matter? if there are other outcomes from workably competitive markets, I'm not sure what they are, but they don't sort of matter". (High Court Transcript at p 121-122).

²³ For example, Issues Paper, paragraph 8.1.

²⁴ The Commission has already determined that claw-back from the date of a catastrophic event is, in principle, consistent with the Part 4 purpose. This should be the starting point when assessing Orion's claw-back against the Part 4 Purpose. The CPP IM was determined on the basis that it was consistent with the Part 4 purpose statement (including the position on claw-back following a catastrophic event).

with workably competitive markets supports the Commission's proposal. For regulatory decision purposes, the Commission has previously adopted the workably competitive market concept of a long-term contract between a willing buyer and a willing seller. It seems likely that consumers in Canterbury would have agreed to contract with Orion to make necessary repairs to the network in the immediate aftermath of the earthquakes, in return for ensuring Orion received its costs of those investments, including its return on capital. As Castalia notes,²⁵ some workably competitive markets enable suppliers to recover the costs of extraordinary circumstances *ex post*.

76. It is conceivable that consumers would have been willing to pay prices above those necessary to provide a normal rate of return in order to regain the essential service as quickly as possible. A useful workably competitive markets analogy here could be that of trade service providers (electricians, plumbers, builders, engineers, etc) in the Canterbury region who have seen demand for their services increase since the earthquakes and hence have been able to increase their profits (and/or recover their post-earthquake losses). However, Orion is seeking only to recover its costs including a normal return.

Assessment of Commission's reasons for Orion's shareholders to bear the costs

77. The Commission puts forward two key reasons for Orion's shareholders to bear (at least some of) Orion's losses following the Canterbury earthquakes:
- a) Others in Canterbury have suffered losses that cannot be recovered; and
 - b) Investors in Orion had the opportunity to spread risks beyond the Canterbury market through diversification of their investments.
78. Vector addresses these below in turn.

Others in Canterbury have suffered unrecovered losses

79. It is unclear how the Commission could legitimately reject Orion's application to recover its post-earthquake losses on the grounds that others in Canterbury have suffered losses that they cannot recover. This is not a relevant consideration under either the statutory framework or the CPP IM.
80. Most others in Canterbury who suffered unrecovered losses will not be suppliers of lifelines services that have obligations to restore those services as quickly as possible. Operators of services such as restaurants could decide to cease providing their service as a way of mitigating losses arising from the earthquake (e.g. where the earthquake caused substantial damage to the premises and/or meant that local demand was severely curtailed). Orion and other essential service providers do not have this option available to them.
81. Further, it is unclear whether the inability of other parties in Canterbury to recover losses from their customers is due to a choice of those parties. In other words, did they suffer unrecovered losses because they chose not to take insurance or

²⁵ Castalia report, pages 13-14.

because the risks were not economically insurable? The scale of the unrecovered losses suffered by these parties is also uncertain. As Castalia notes, some Canterbury businesses have recovered some of their post-earthquake losses under the Canterbury Earthquake Recovery Act.²⁶

Diversification of risk

82. The Commission suggests that Orion should not be able to fully recover the costs of its post-earthquake losses on the basis that investors can diversify their investments. As set out above, we do not believe that this consideration is relevant to claw-back following a catastrophic event.
83. The Commission is correct to state that investors have an opportunity to diversify their investments. However, it is not clear that it is feasible to diversify investments to an extent that offsets the very large losses suffered by Orion. As Castalia advises:²⁷

Prior to 2010 many investors would have been unaware of major earthquake risks in the Canterbury area—indeed, an investor at that time may have had a strategy of investing in Canterbury to diversify away from earthquake risks in another area (such as Wellington) known to be prone to higher earthquake risks.; and

... diversification may not be the most efficient response to the risk of earthquake damage.

Conclusion

84. We consider that the lower revenues and higher costs (capex and opex) that Orion seeks to recover from September 2010 to April 2014 appropriately reflect matters that could have been covered by a CPP had a CPP applied from the time of the catastrophic event. This is because the DPP that applied to Orion did not accommodate the circumstances arising from the earthquakes. In other words, if Orion had been able to put a CPP in place on the day after the earthquakes then the losses incurred through reduced demand would not have occurred and the post-earthquake expenditure would have been funded. The (unavoidable) regulatory delay in implementing a CPP after a catastrophic event should not result in a different outcome.
85. On the basis of the analysis above, Vector **considers** that the approach most consistent with the statutory framework, the CPP IM and the purpose of Part 4, is to permit Orion to recover its prudent and efficient post-earthquake losses in full. However, any prudency testing should account for the circumstances in which the investments were made, should only rely on information that was available at the time of the investments and should allow the expenditure to be recovered unless it can clearly be shown it was imprudent.

²⁶ Castalia report, page 14.

²⁷ Castalia Report, page 12.

CPP statutory framework and status of the input methodologies

86. Under s 53V(1) of the Commerce Act “The Commission may determine any customised price-quality path that the Commission considers appropriate for a supplier that has made a proposal”. However, this power has to be considered in the broader statutory context where the Commission is required to:
- a) Determine IMs:
 - i) for the matters listed under s 52T(1) (cost of capital etc);
 - ii) relating to the CPP proposal, including requirements that must be met by the regulated supplier and criteria that the Commission will use to evaluate the proposal (s 52T(1)(d));
 - b) Apply these IMs when determining the CPP (s 52S); and
 - c) Only vary an IM with the agreement of the regulated supplier (s 53V(2)(c)).
87. A regulated supplier's CPP proposal must also comply with IMs relating to the process for, and content of, CPP proposals (s 53Q(2)(a)), and must apply or adopt all relevant IMs (s 53Q(2)(d)).
88. Overall, the IMs for CPPs are akin to a code covering the information a supplier must provide and how the Commission must determine a CPP. The Commission still has discretion when determining a CPP to the extent this is provided for in the IMs. For example, under the IMs, the Commission has a degree of discretion when considering capital expenditure and operating expenditure against the expenditure objective (in relation to what is prudent and efficient).²⁸ However, it would be contrary to the Act if the Commission introduced approaches that were inconsistent with the IMs and / or in relation to a subject matter that should be or is covered by the IMs. This would amount to effective amendment of the IMs outside of the required process.
89. This does not mean that the Commission has no ability to adapt to uncertainties, such as those presented by the Christchurch earthquakes. In this case the Commission may amend an IM with the agreement of Orion (s 53V(2)(c)).²⁹ Going forward, the Commission is able to amend the IMs under s 52X, where consultation is required in relation to any material amendment.
90. Vector is concerned that, from the Issues Paper, the Commission appears to be of the view that it is able to consider approaches and issues that are not provided for in the CPP IMs. For example, the Commission appears to be of the view that:
- a) Orion should have presented alternative options in its CPP proposal and / or the proposal can be assessed by the Commission against an alternative CPP;

²⁸ Vector and others have argued that the broad expenditure criteria provide the Commission with too much discretion, creating uncertainty, (particularly when considered with the other risks associated with a CPP application).

²⁹ S 53V(2)(c) further reinforces the position that matters outside of the IMs cannot be unilaterally introduced by the Commission when determining a CPP - otherwise s 53V(2)(c) has no effective application.

- b) A wash-up mechanism is desirable to reduce the risk of error through demand forecasting; and
- c) Different treatment should be applied to impaired or destroyed assets than what is provided for in the IMs.

91. As explained below, these approaches are contrary to and / or not provided for in the current applicable IMs. In order to apply these approaches, we consider that the Commission must either reach agreement with Orion or follow the required process to amend the IMs (in which case the amended IMs would apply to future CPP proposals but not Orion's CPP proposal).

Wash-up mechanism

92. In Vector's submission, application of a wash up mechanism to reduce risk or error through demand forecasting is not permitted under the Act unless Orion agrees to an amendment to the IMs. Such contingency measures relate to forecast capital expenditure and operating expenditure, where the way in which expenditure forecasts are provided and analysed is set out in the IMs.³⁰

Treatment of impaired or destroyed assets

93. In various places in the Issues Paper,³¹ the Commission states that:

We are unclear at this stage to what extent Orion is proposing to retain in its asset base, assets that have been impaired or destroyed by the earthquake.

94. However, the IMs only provide limited opportunities to remove assets from a regulated supplier's RAB as part of the roll forward. The IM definitions of disposed asset and lost asset clearly do not include assets that are damaged. Therefore the IMs require Orion to retain these assets within its asset base. Again, in our view, it is not open to the Commission to apply a different approach without agreement from Orion.

95. Application of the current IM (without amendment) would best promote the long-term benefit of consumers. If such assets were removed, Orion would need to include a loss on disposal of the assets in its regulatory profit statement, leading to a lower reported financial return and higher prices. The rate shock for consumers is unlikely to be desirable.

96. Vector is therefore unsure why the Commission considers that Orion should make any proposal in this regard. The IMs provide clear guidance that the assets must be left in Orion's asset base. Any amendment to the IMs on this point for the purposes of this CPP proposal would require agreement with Orion.

Alternative approaches

97. The Issues Paper appears to criticise Orion's proposal for containing limited information on possible alternatives to its proposal.³² This stance is inconsistent

³⁰ 2012 IM Determination, clauses 5.4.28 - 5.4.31 and 5.2.1(d).

³¹ For example, footnote 19.

with the IMs. It is also inconsistent with the final IM Reasons Paper, where the Commission stated:³³

The Commission will assess each proposal on its merits using the evaluation criteria and not against any alternatives (including the DPP applying to the supplier).

98. Consistent with this view, the IMs do not require the provision of information on possible alternatives. Rather, Orion's proposal would arguably be inconsistent with the IMs if such alternatives were included. For example, the consultation requirements in the IMs require that Orion consult on its proposal, not alternatives.³⁴
99. It is therefore unreasonable to expect Orion to have included alternatives within its CPP proposal when this was clearly not required by the IMs.
100. The Commission also appears to consider that it should assess Orion's proposal against alternatives.³⁵ Again, the IMs do not provide for the Commission to assess Orion's proposal against an alternative proposal. Indeed, a reference to assessment against an alternative proposal was expressly removed from the draft IMs. Specifically:
- a) The evaluation criteria in the draft IMs provided that the CPP proposal would be assessed against the Part 4 purpose and an alternative CPP proposal (among other things).
 - b) The reference to assessment against an alternative CPP proposal was removed in the final IMs (following submissions arguing against this criterion).
101. The Commission is able to test Orion's proposal against the evaluation criteria in the IMs, for example, whether forecast capital expenditure is prudent and efficient. This assessment might require consideration of whether there are other more efficient ways to achieve a particular aspect of proposed capital expenditure. However, such testing should not amount to assessment against an alternative proposal. Vector recognises there is a fine line between these two concepts but the Commission's decision as expressed in the Reasons Paper is clear and should be adhered to.
102. We believe the approach set out in the Reasons Paper and IMs of not assessing against an alternative CPP proposal is reasonable because:
- a) Questions regarding desirable service quality and network configuration involve substantial judgment and knowledge of the network, where the supplier generally has the best understanding of the issues.

³² Issues Paper at paragraphs 76 and 77, including where it states that limited information on alternatives means that it is "difficult to assess whether Orion's proposed investment represents the most efficient cost that a prudent electricity lines company would incur to manage the expected demand for its services".

³³ IM Reasons Paper, paragraph 9.4.6.

³⁴ 2012 IM Determination, clause 5.2.1(f), p 12 and clause 5.5.1.

³⁵ See for example, Issues Paper at paragraphs 75, 78.2 and 82.

- b) The Commission, given information asymmetries, is not well placed to substitute its own judgment for that of the regulated supplier when assessing the optimal investment decision to make.
- c) Assessing consumer preferences in relation to price/quality trade-offs is inherently challenging and the Commission cannot assume it is necessarily better at making such assessments than the supplier on the ground.
- d) The supplier, rather than the Commission, is and will be held accountable for network performance.

Status of verification report

103. Vector understands the verifier's role in the Commission's review of the CPP application is likely to be limited. We note that the verifier is required under Schedule F of the IM Determination to sign a deed agreeing to a duty of care to the Commission. There does not appear to be any evidence that the verifier has breached this deed. In fact, the Commission has repeated several quotes from the verifier that are critical of Orion's CPP proposal in the Issues Paper.
104. Vector understands the Commission has engaged its own consultant reviewer, which appears to be duplicating the work of the verifier. The policy intent behind the CPP IM was that the verifier would be independent and the Commission could rely on its report, hence improving the efficiency and cost-effectiveness of the CPP application process. We note and support the Commission's view of the verifier as expressed in the IM Reasons Paper and **recommend** this view does not change without analysis and consultation:

A key aspect of the Commission's expenditure approach is the use of pre-submission verification (prescribed by the Commission) of proposed expenditure by an independent verifier. This should promote certainty for suppliers as to how their expenditure will be assessed, as well as assist the Commission in managing the tight statutory timeframes for assessment. Suppliers have an opportunity to rectify any concerns raised by the verifier before it applies for a CPP and the process should allow the Commission to focus on the most important aspects of the CPP proposal during its assessment period.³⁶

Conclusion

105. Vector is not opposed to amendments to the IMs. Indeed, we would expect that the process of the Orion application will highlight areas where the CPP IMs can be improved, for example the application of CPP IMs to catastrophic events, discussed below.
106. However, the Commission is prevented under the Act from retrospectively amending and applying IMs without Orion's agreement. We also note that seeking to retrospectively amend IMs with regard to an application that has already been made (whether by altering requirements in the IMs or adopting approaches that were not provided for in the IMs) is contrary to the purpose of the IMs, which is to

³⁶ IM Reasons Paper, paragraph 9.5.13.

promote certainty for suppliers and consumers in relation to the rules, requirements and processes that apply (s 52R). For example, a supplier in such a situation would be subject to an evaluative process it had no opportunity to address in its CPP proposal.

107. The Commission's apparent willingness to depart from the IMs when considering a proposal will further reduce the attractiveness of a CPP to the industry and reduce the willingness of regulated suppliers to make a CPP application, even where it would promote the long-term benefit of consumers.
108. Vector **recommends** Orion's application is reviewed on the basis of the IMs that were in place at the time of the application, subject to agreeing any amendment with Orion under s 53V(2)(c).

Other points highlighted by the Issues Paper

Comparison of Orion's and Vector's security standards

109. In the Issues Paper, the Commission compares Vector's security standards to those of Orion.
110. We note that the summary of Vector's quality of supply criteria contains an error. In industrial and commercial areas of Vector's network, we undertake to maintain supply after a single fault for at least 98% of the year (not 95% as stated).

Assessment of overhead versus underground high voltage cables

111. The Commission is seeking views on the relative merits of placing 66kV cables underground or overhead through suburban Christchurch.
112. Vector notes that the construction cost for an overhead HV line is considerably lower than that of an underground cable. However, other factors associated with overhead construction can significantly impact on the cost proposition and even lead to the cost for a line approaching that of a cable. This includes the cost of obtaining land for the line route, which in an urban area could involve buying out properties, the court process to get consent to build a line and measures to mitigate the environmental impact (aesthetics /noise).
113. In built-up areas, finding an appropriate line route is very difficult. It requires a substantial route corridor, most likely involve major land purchases and clearing of existing structures.
114. Over the life of the asset, maintenance costs of an overhead line, including managing the line corridor, is significantly higher than for a solid (XLPE or similar) underground cable. Reasons for this include an increased risk of damage from weather and vegetation events. It is quite possible that the overall life-cycle cost for an overhead line would be higher than that of an underground line.
115. Perhaps the most important factor to consider is public opposition to new overhead lines, especially in built-up areas. This results in political pressure on Council decisions. In Auckland it would be almost impossible to secure permission to build overhead lines, especially at high voltage, within built-up areas. Even if permission was granted, the consent process would most likely be subject to multiple challenges in court and there are also likely to be public protests, all of which would cause delays to construction and higher costs. In our experience in Auckland, the public appetite for highly visible, high voltage equipment in close proximity to particularly residential areas is very low.
116. As a practical example, Transpower initially planned to build overhead lines through Auckland in order to deliver the NAaN project. However, they realised that not only would this be extremely complex, and subject to major public pressure, but economically it was more viable to underground the lines. This view was

accepted by the Electricity Commission, which assessed the proposal under the Grid Investment Test.³⁷

Status of the Commission's consultation

117. Vector also queries whether it is appropriate for the Commission to seek to consult directly with Orion's consumers. Orion conducted its own consultation process while developing its CPP application and it is unclear why the Commission believes it will succeed in gaining a significant response from consumers.
118. Vector is also concerned with the basis for questions 5 and 6 of the consultation paper. These questions seek views on whether consumers would prefer to pay more to have a more reliable supply to Rawhiti and Waimakariri. Presumably the response of consumers to such a question will depend upon whether they live or work in Rawhiti or Waimakariri, given the cost of the investment will most likely be spread across all consumers. Responses of consumers based on the area of the Orion network they live in would not form a sound basis for the Commission to form a view on appropriate trade-offs.

³⁷ <http://www.ea.govt.nz/industry/ec-archive/grid-investment-archive/gup/2007-gup/north-auckland-and-northland-proposal-history/>

Issues to consider for future CPPs

CPP scale and content

119. It appears to Vector that Orion has provided an application that contains approximately the quantity of information that the IMs require.
120. Vector notes the Commission's views that: "Orion's proposal complies with the relevant rules and requirements relating to the process for, and content of, proposals seeking a CPP" and "Orion has produced a thorough and high-quality proposal".³⁸
121. However, the Issues Paper appears to take the stance that Orion's CPP application does not contain enough information. For example, the Issues Paper indicates that the Commission believes Orion should have provided more information on:
- a) Alternative options and discussion of trade-offs (as discussed above);³⁹
 - b) Information regarding consumer engagement on trade-offs;⁴⁰
 - c) Information regarding the extent that expenditure increases are driven by particular assumptions;⁴¹
 - d) Information regarding the impact of the proposed timing of operating expenditure on the capital expenditure replacement programme;⁴² and
 - e) The treatment of impaired or destroyed assets.⁴³
122. Vector would be interested in exploring with the Commission and other stakeholders why there is an apparent difference of views of the level of complexity and detail required by the IMs. We would support a change to the CPP IMs and process that removed any requirements for unnecessary and overly complex information to be provided. Vector also **recommends** that if the Commission considers the Orion application contains more, or less, detail than is necessary, the Commission explicitly identify the relevant areas – this would be useful to other regulated suppliers who may be considering making CPP applications.
123. We note in this context the comments of the draft Australian Productivity Commission report on Electricity Network Regulatory Frameworks regarding the excessive cost and detail of Australian regulatory proposals and decisions.⁴⁴ We agree with the Productivity Commission's view that the level of detail in such proposals and decisions is unnecessarily detailed, complex and costly. Vector is concerned that New Zealand CPPs may take the same route and experience the same problems as the level of detail Orion has been required to apply does seem

³⁸ Issues Paper, paragraphs 5 and 40.

³⁹ Issues Paper, paragraph 76.

⁴⁰ Issues Paper, paragraph 86.

⁴¹ Issues Paper, paragraph 88.

⁴² Issues Paper, paragraph 88.

⁴³ Issues Paper, footnote 19.

⁴⁴ Australian Productivity Commission, Electricity Network Regulatory Frameworks draft report, 18 October 2012, pages 23-24.

very large and we are not convinced it was necessary for the Commission to require all of this information.

124. Vector **recommends** the Commission engage with stakeholders regarding the required and desirable content of future CPP applications to ensure both that they are not “too long” and that they contain all of the information that is necessary for an application to be considered. This may well require amendment to the IMs (noting that any material amendment to the IMs would require consultation under s 52V).

Is a CPP an appropriate solution to a catastrophic event?

125. Vector considers that any regulated supplier in a position of responding to a catastrophic event in their area has an important job to do. The provision of lifelines services to an area recovering from a disaster should be a high priority. In addition, employees of the supplier will generally have been affected by the disaster themselves and will have personal issues to address. It is questionable whether it is appropriate or sensible to require regulated suppliers and their staff to provide a detailed and complex CPP proposal in these circumstances. The application process will distract from the work needed to repair the network and is likely to add to employee stress levels.
126. Vector **recommends** the Commission engage with stakeholders to design a more practicable method than a full CPP application of funding a regulated supplier to address a catastrophic event in its area. For example, the costs could be accommodated through a DPP re-opener. This should be subject to some Commission scrutiny but with less costly reporting, forecasting and analysis than is required in a full CPP proposal.