



MAJOR ELECTRICITY USERS' GROUP

24 May 2013

John Groot
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear John

Orion CPP proposal

1. This is a submission by the Major Electricity Users' Group (MEUG) on Orion's Customised Price-Quality Path (CPP) proposal dated 19th February 2013 and the Commerce Commission paper "Invitation to have your say on Orion's proposal to change its prices and quality standards – Issues to explore and consider" dated 1st May 2013¹ (the "Issues paper").
2. Several MEUG members are supplied line services by Orion and will be materially affected if Orion's proposal is accepted. MEUG also has an interest in:
 - Precedents that the process and decisions on this first ever CPP application will set for future applications; and
 - How the Commission determination might affect how Orion and other regulated electricity and gas businesses manage future risks.
3. It is important to recognise that there will be future unexpected events just as there have been such events in the past. For example the failure of cables in Auckland CBD in 1998. Future events may have a greater impact on GDP than the Canterbury earthquakes of 2010 to 2012 and events may even occur in Canterbury. Further CPP applications to manage such events can be expected. The Commission in exercising its absolute powers to decide a CPP determination for Orion must be cognisant of the need for a principled basis for decisions to apply to both the current CPP proposal and future applications. While Canterbury has suffered severely due to the earthquakes, that is no reason to be swayed by arguments of fairness by parties such as Orion's shareholders. The "long-term benefit of consumers" is the only test that matters².

¹ <http://www.comcom.govt.nz/orion-cpp/>

² Per s. 52A "Purpose of Part" in Part 4 of the Commerce Act 1986

4. Immediately below are responses to the questions in the Commission's paper of 1st May 2013. Other comments are set out in the concluding section of this submission.

Question	MEUG response
<p>1. Should prices charged to consumers increase from April 2014 to recover costs Orion has already incurred in responding to the Canterbury earthquakes? If so, should all of these costs be recovered from consumers or only some of these costs (with the rest borne by Orion)?</p>	<p>Not sure customers should bear all if any of the unexpected higher operating costs or forgone revenues (Q. 2 below).</p> <p>See paragraphs 5 to 8 below for our detailed response.</p>
<p>2. Should Orion be allowed to increase its future prices to consumers from April 2014 to compensate it for the lower than expected revenues it earned over the period from the time of the earthquakes to April 2014? If so, should consumers make up all or only some of the revenues Orion expected to earn?</p>	<p>See response to Q. 1 above.</p>
<p>3. Do consumers in Orion's network area consider that the highest priority goal for Orion's electricity distribution network for the next five years is:</p> <ul style="list-style-type: none"> a) reducing the risk of power outages and how long it takes to restore power b) improving the network's ability to cope with high impact but infrequent events (like severe storms or earthquakes) or c) limiting the increase in prices consumers have to pay? 	<p>The priority should be to limit increases in Orion charges and given that limit for Orion to demonstrate it is applying resources to the highest priority work that customers will benefit from. It's for customers to signal if the highest incremental benefit to them is managing High Impact low Probability (HILP) events or outage restoration times. The closer Orion can reflect costs in charges to different classes and located customers, the better those customers will be able to understand the cost of meeting their preferences and consider alternatives they may have, and hence the more efficient the outcome.</p>
<p>4. Do consumers in Orion's network area prefer smaller price increases, even if this may mean a greater chance of being without power? Or is it more important to minimise the risk of electrical faults?</p>	<p>We agree with the conclusion and proposed approach by the Commission in the Issues paper to consider alternatives to Orion's investment plan³. This approach should assist the Commission answer this and many of the other questions.</p>

³ CC Issues paper, paragraphs 75 to 77

Question	MEUG response
<p>5. Would consumers in Orion's network area prefer to pay higher prices and have two cables supplying Rawhiti and Waimakariri, or are you willing to accept the possibility of, say, a two hour localised loss of power if the existing cable fails?</p>	<p>Refer response to Q 4 above.</p> <p>We would be very surprised if the final determination accepted the Orion proposal given the independent verifier had concerns on both the proposed capital⁴ and operating cost⁵ forecasts.</p> <p>The Commission should find a way to encourage Orion to adopt a beneficiaries pay approach to pricing to align customer needs and benefits with network expansion and operating costs. This would overcome the current impasse where Orion's pricing regime sends poor pricing signals and the Commission has to theorise customer true preferences and willingness to pay and alternatives that customers might exercise (eg different energy sources or say more insulation or re-location) despite the poor price signals.</p> <p>By poor price signals, MEUG means that Orion has a propensity to have a pricing regime that socialises costs leading to cross-subsidies and therefore distorts pricing signals for efficient network and end user investment decisions. That propensity for socialising costs might be driven by its shareholders though we have not investigated if that is the driver.</p>
<p>6. Would consumers in Orion's network area prefer the power cable to Rawhiti to be placed underground, even if this has a higher total cost, or would you prefer the cable to Rawhiti to be constructed at the least possible cost?</p>	<p>See response to Q 5 above.</p> <p>The views of the independent verifier are relevant to this question⁶:</p>

⁴ Geoff Brown & Associates Ltd, Orion's CPP Verification Report, 18th February 2013, included in Orion, Application for a CPP, 19th February 2013, section 5 Certification, appendix 7, Executive Summary. Underlined text highlighted by MEUG: "Orion's major project capex forecast is reasonable on the basis of the planning criteria it is currently using. However, if the planning criteria are changed, the forecast should be revised."

While some increase in expenditure on asset replacement is warranted the forecast increase in asset replacement and renewal capex over past levels of expenditure appears very high. Orion should be required to provide further justification for the level of expenditure in its forecast. This could include a sensitivity analysis of the impact of lower levels of asset replacement expenditure on failure rates and supply reliability.

Forecast capex in other areas is generally reasonable. However, reinforcement and connections and extensions capex requirements are driven by the rate of growth in demand and the location of new customer connections and these are areas with very high levels of uncertainty in the post-earthquake environment"

⁵ Ibid, Executive Summary:

"The forecast for some other non-network opex line items including communications and engagement, special projects, corporate information systems, and system management and operations appears high, particularly in the latter years of the forecast period. In most of these areas, there appears to be an assumption that the resources needed to support the peak of the earthquake rebuild effort in FY14 and FY15 will need to be retained through to the end of the forecast period. We question the validity of this assumption on the basis that by FY19 aggregated network capex and opex expenditure is forecast by Orion to be 32% lower in real terms than the corresponding expenditure at the peak of the rebuild."

⁶ Ibid, Executive Summary

Question	MEUG response
	<p><i>"It is unclear whether Orion's current planning criteria are still appropriate in the post-earthquake environment. In particular we think the requirement that all 66 kV subtransmission circuits in urban areas be constructed underground should be reviewed as overhead lines are much less costly to build, have significantly shorter repair times and greater earthquake resiliency. We also think Orion should consider whether its N-2 security criteria should be relaxed and this could allow the construction of some subtransmission projects to be deferred. As N-2 contingencies are relatively uncommon, this may not have a significant impact on overall network reliability."</i></p>
<p>7. Would consumers in Orion's network area prefer to accept some risk of power outages from faults, or high impact but infrequent events from storms or earthquakes, if it meant delaying part of the proposed price increases? Or is it more important to improve the architecture of the network as quickly as possible?</p>	<p>See response to Q 4 above</p>
<p>8. Would consumers in Orion's network area prefer that Orion leaves older network assets in place, where safety is not impacted, to minimise the price impact of spending to replace such assets, even if this means a higher level of risk of power outages from faults in the future?</p>	<p>No comment.</p>
<p>9. Would consumers in Orion's network area prefer a smaller initial increase in price if It means accepting larger ongoing annual price increases?</p>	<p>No comment.</p>
<p>10. Do consumers in Orion's network area prefer to pay higher prices beyond 2019 for costs Orion will incur before 2019, or would they expect prices to more quickly reflect the costs of Orion's proposed expenditure?</p>	<p>No comment.</p>

Claw-back

5. Orion proposes to claw-back⁷ \$86m for higher than expected operating costs and revenue foregone due to the earthquakes. This is a material cost Orion is asking customers pay for.
6. The Commission has absolute discretion as to whether any claw-back is needed⁸.
7. There are many reasons why Orion's customers should not bear any claw-back costs, eg:
 - Many businesses in Canterbury suffered a loss of revenue and or higher than expected operating costs due to the earthquakes. Those businesses cannot unilaterally raise prices as a claw-back and therefore why should Orion? In other words in a workably competitive market businesses do not as a matter of course have recourse to claw-back for such events.

The major shareholder of Orion, the Christchurch City Council, has diversified business holdings. It would be interesting to know if those other City Council owned businesses also incurred higher operating costs and lower revenues and expect to claw-back those from customers.

- Orion has suggested it is different because as a regulated business it is restricted to only recovering costs including a fair return on capital. The "fair return on capital" is the WACC set by the Input Methodology and is greater than the cost of debt only. The "fair return on capital" includes an element for risk borne by Orion's shareholders commensurate with observed systematic risks borne by shareholders in equivalent utilities worldwide. One of the risks facing utilities world-wide are natural disasters such as earthquakes. Similarly one of the risks facing utilities world-wide is an inability to insure at reasonable cost parts of the network. Arguably the business risk (the asset beta) incorporates a systematic risk for such circumstances.

In this instance an extreme risk has been realised and shareholders must bear the cost. This risk and cost has been reflected in the "fair return on capital" to Orion's shareholders.

Orion's shareholders could have diversified to manage the non-systematic or business specific risk. As noted above the Christchurch City Council has done so with shareholdings in other business. The fact that the Council may have mismanaged that diversification by being Canterbury centric points to other policy problems (ie should Councils be owners of businesses) that should not be solved by the Commission granting claw-back.

- If customers are asked to cover all claw-back claims then in effect Orion would be a riskless entity. In this case Orion would be kept whole by its customers irrespective of any unexpected event. Customers would bear unlimited downside risk. In this case the rate of return should be at the risk free rate plus any adjustment for customer credit risk. This pure cost plus model, subject to a prudency test that actual costs are efficient, where WACC is simply the cost of borrowing and credit risk does not apply to DPP or CPP regulated firms in New Zealand because the WACC includes a positive equity beta. Shareholders do take some risk. If it's not this type of natural disaster risk; then Orion should explain what risks do shareholders bear?

⁷ CC Issues paper, paragraph 43

⁸ Commerce Act s. 52D and s. 53V

- There is a risk of customer disinvestment if claw-back is accepted because the higher line tariffs may be the tipping point for customers to cease business or relocate. With the Orion proposal whereby 100% of risks and costs ultimately lie with customers and customers also pay a WACC higher than the risk free rate, then in an extreme case a death spiral could occur with multiple catastrophic events leading to a series of claw-backs on an ever diminishing customer base. This illustrates how adding costs that have no purpose in terms of efficient price signalling, such as the claw-back claim, can lead to unintended consequences such as inefficient customer divestment and re-location.
- Orion anticipated the risk of earthquakes and spent monies in advance to mitigate harm. Orion claims that investment reduced the impact on customers; that is the duration of unplanned outages. That investment also mitigated the foregone revenues and even higher operating costs that Orion would have had to bear. It was Orion's choice on how much of its pre-earthquake DPP revenue cap to spend on this risk and how much to defer and take that saving as profits. If Orion is granted 100% of the claw-back claim then it will have less incentive to assess and manage potential large risks in the future. Similarly the incentive on other regulated utilities to mitigate these risks will diminish if the Commission agree to claw-back because the utilities will then know that irrespective of the length of time service and quality was impaired or revenues collapsed, they will be kept whole.
- Take the case where an even more extreme catastrophic event occurred and demand for electricity in Christchurch collapsed entirely and a decision had been made to abandon the city and relocate. In that case Orion would have no future customer base to recover the value of assets written down and revenue foregone from any remaining years in a DPP. The full cost would borne by Orion's shareholders.

We think that the case where 100% of the network needs to be abandoned and shareholders take all the risk should be the default position for any fraction of the network affected or revenue foregone. To shift from that default to having a partial allocation of the risk to customers and line owners can only be made in a principled way. We do not believe Orion has demonstrated the need for such a change.

8. Orion has argued strongly that without 100% recovery of claw-back their incentives to invest in the future will be reduced. We do not think Orion has articulated how decision making will differ or given examples of what might change if 100% of claw-back is not achieved. Nevertheless we do not rule out that there might be a problem and therefore recommend the Commission explore scenarios to determine how real this risk might be. For example the Commission could:
 - Consider the impact on Orion's shareholders if there is no claw-back. For example could the owners sell the business and would a new entrant have sufficient incentives to invest?
 - As noted in the comments in the preceding paragraph, if Orion are claiming shareholders do not bear risks for these types of extreme natural disasters (ie unlimited cost recovery from customers), then exactly what risks are shareholders bearing to justify the WACC set in the Input Methodologies?
 - Ask Orion to adopt a pricing and contracting regime that is based on a beneficiaries pay approach. A beneficiaries approach will lead to better alignment of the scope and timing of new investment with the need and therefore mitigate any disincentive Orion might have to invest.

Other comments

9. We fully support the Commission considering alternatives to the Orion proposal. The lack of alternatives being identified and included in the rationale for the proposal may be due to a shortcoming in the Input Methodologies (IMs) or other procedural reasons. It may be worthwhile making changes to IMs or other regime parameters to ensure CPP applicants consider all feasible alternatives.
10. One alternative not considered is to supply expected customer demand growth in the north of Orion's area from an augmented Mainpower network.
11. We have been disappointed that Orion has not published the spreadsheets that form part of the CPP application. Resource and information asymmetry has been a high barrier for effective customer participation in the consultation on the CPP proposal. Access to the spreadsheets would have lowered the cost of our participating and improved our ability to review more detail in the application. For example in the proposed claw-back calculation we ran out of time to precisely understand and replicate Orion's request including the cost of debt used for the time value of money between revenue foregone and receipt of claw-back payments from customers. There are probably many other details we would have wished to explore but access to the spreadsheets hindered our ability to even follow through on the above initial question let alone consider other questions. MEUG is also unsure if Orion's refusal to publish the spreadsheets was contrary to the regulatory requirements.
12. We look forward to participating in the next consultation round.

Yours sincerely



Ralph Matthes
Executive Director