# MAJOR ELECTRICITY USERS' GROUP

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

Friday, 20 September 2013

Dear John

## Orion Customised Price-Quality Path – Response To Draft Determination

### INTRODUCTION

1 This submission is by the Major Electricity Users' Group Inc ("MEUG") in response to the Commission's draft determination on setting a 2014-2019 customised price-quality path ("CPP") for Orion New Zealand Limited ("Orion").

2 MEUG's submissions makes the following points:

(a) We query whether the Commission has jurisdiction under Part 4 of the Commerce Act ("Act") either to determine a single CPP which traverses more than one default price-quality path (DPP); or to claw-back past losses under a CPP without also including the claw-back period within the term of the CPP.

(b) The Commission's proposed decision to apply claw-back for additional net costs of $28.3m risks muddying the conceptual clarity of the Part 4 regulatory scheme. It would fail to allocate risks efficiently, create moral hazard and be inconsistent with outcomes observed in workably competitive markets.

(c) This CPP highlights problems with current input methodologies which should be reviewed, preferably before the Electricity Distribution Businesses' DPP is reset in 2015.

## JURISDICTION

3 MEUG raises two jurisdictional issues which are not addressed in the Commission's determination and which suggest that a minimum of two CPPs are required to address Orion's individual circumstances. These issues are:

(a) Whether the Act intended that a single CPP would traverse more than one DPP: and

(b) Whether any claw-back period should be counted as part of the term of the CPP, meaning that Orion can to claw-back past losses under a CPP without also including the claw-back period within the term of the CPP.

4 These issues are integral to Part 4 and cannot be conveniently set aside for the sake of pragmatism. Were the Commission to allow Orion's proposal for a CPP on a basis that was neither authorised nor intended by the legislation, it would create uncertainty and could undermine the integrity of the regulatory scheme. These issues are discussed in a letter from MEUG's lawyers, Franks & Ogilvie which is included with this submission ("Attachment A").

## THE COMMISSION SHOULD NOT ALLOW ORION TO CLAW-BACK ADDITIONAL COSTS

### The Commission's Draft Decision

5 The Commission has summarised the financial impact of the earthquakes at $148.3m (PV 2014)[1]

| | |
|---|---|
| Claw-back of additional net costs incurred | $28.6m |
| Lower revenue than forecast (demand shock) | $48.4m |
| Recovery of the written down damaged assets | $71.3m |

6 The Commission proposes to:

(a) allow Orion to recover written down damaged assets,

(b) disallow Orion's claim in respect of lost revenue; and

(c) allow full claw-back of all additional net costs.

7 The Commission describes the overall sharing of this impact to fall 33% on Orion and 67% on consumers. However, it acknowledges that this breakdown overstates the impact on Orion as once the CPP takes effect from 2014, Orion's Maximum Average Revenue will be increased to incorporate both the claw-back of costs and lower than forecast revenue from that point onwards. When the prices are reset under the CPP the full financial impacts of the earthquakes will be passed on to consumers.[2]

8 The Commission's justification for its proposed decision to apply claw-back to Orion's "additional net costs (but not lost revenues) is three-fold:

[1] Draft Determination, paragraph [C129]

[2] Draft Determination, paragraphs [C130] [C131] [C125.3]

(a) The Commission is unsure whether, *ex ante*, it was reasonable that suppliers expected to bear all catastrophic event costs[3];

(b) It interprets part 4 of the Act as requiring "risk sharing"[4]; and

(c) Demand shock and cost shock should be considered differently[5]

9 MEUG objects to the Commission's proposal to apply claw-back of the additional net costs.

## Claw-back Would Set a Poor Precedent and Risks Part 4

10 The Commission recognises that a key feature of incentive-based regulation is that cost/revenue assumptions are formed on an *ex ante* (forward-looking) basis, with suppliers assuming the risk - and reaping any rewards - arising from discrepancies between anticipated and realised returns over a set regulatory period.[C80] Despite this acknowledgement, the Commission's draft decision on claw-back amounts to an *ex post* review which would enable Orion to recoup unforeseen losses from consumers. The Commission proposes to apply claw-back in Orion's case as an exception to the way risks are normally apportioned under an *ex ante* price-quality path determination.

11 It is with dismay that MEUG members and other business affiliates in Christchurch have viewed the ease by which a monopolist has been able to persuade the Commission to allow the claw-back of unanticipated costs on an *ex post* basis. From a consumer perspective, it was always assumed that Part 4 created a pure *ex ante* regime where suppliers would bear risks which matured during a regulatory period. The Commission's draft decision appears to treat the system as though it were a hybrid one which permits one-sided, *ex post* reviews within ill-defined parameters. This approach creates an unacceptable degree of uncertainty.

12 MEUG notes that there is not a corresponding ability for the Commission to claw-back excessive returns on an *ex post* basis. The Commission can technically apply a CPP that is less favourable to a supplier and apply claw-back to recover higher prices than those which would apply under the DPP[6]. However, consumers cannot trigger a CPP and the chances of suppliers scoring what would amount to an "own goal" are slim. Section 53P(4) also expressly prohibits the Commission from using starting prices to recover excessive prices earned in a previous regulatory period.

13 MEUG fears that the Commission has been unduly transfixed by the circumstances of the Christchurch earthquake and has not taken proper heed of Professor Yarrow's warnings about allowing *ex post* reviews to distort the risk and cost allocations that are an integral component of price-quality paths set on an *ex ante* basis. As Professor Yarrow points out[7]:

> *Looking at matters ex ante, it is reasonable to anticipate that a regulator will allow for the recovery of efficiently incurred, expected costs (where by expected costs is meant the mathematical expectation or mean of probalistic cost projections). Expected costs caused by catastrophic events are properly included in this calculation.*

[3] Draft Determination, para [C48]

[4] Draft Determination, para [C50]

[5] Draft Determination, para [C85 to C114]

[6] Section 53V(2)(a) and (b) of the Act.

[7] Professor Yarrow "The Orion CPP determination" (30 May 2013), p 4

> *In practice however, ex post outcomes differ from ex ante expectations, and it is an integral part of price or revenue cap regulation that, for the most part, such deviations of outcome from expectations – which can be referred to as outcome risks – are borne by the supplier. Thus, if costs are lower than anticipated, the supplier retains the benefits. By the same token, if costs are higher than anticipated, those unanticipated costs are borne by the suppliers, not by consumers.*
>
> *In the latter case it is true that, if outcomes had been better anticipated, consumers may have been asked to pay more ex ante, but this is an irrelevant consideration when considering claw-back. Expectations are formed on the best information available at the time of decisions, and any reasonable business or regulator will recognise that there will inevitably be risks of deviations of outcomes from anticipations, which will have to be borne by one party or another; and, to repeat, it is a working principle of price or revenue cap regulation that such "outcome risk" lies first with the regulated business.*

14 The Commission's preparedness to allow an exception in this case lacks clear boundaries and risks being exploited. The Commission's definition of "catastrophic event" is sourced from clause 5.6.1 of the IMs. It reads:

> *Catastrophic event means an event-*
>
> *(a) beyond the reasonable control of the **EDB**;*
>
> *(b) in relation to which expenditure-*
>
> *(i) was neither sought in a **CPP proposal**; nor*
>
> *(ii) is explicitly or implicitly provided for in the **DPP** or **CPP**, as the case may be;*
>
> *(c) that could not have been reasonably foreseen at the time the **CPP** or **DPP** was determined; and*
>
> *(d) in respect of which-*
>
> *(i) action required to rectify its adverse consequences cannot be delayed until a future **regulatory period** without quality standards being breached;*
>
> *(ii) remediation requires either or both of **capital expenditure** or **operating expenditure** during the **regulatory period**;*
>
> *(iii) the full remediation costs are not provided for in the **DPP** or **CPP**; and*
>
> *(iv) in respect of an **EDB** subject to a **CPP**, the cost of remediation net of any insurance or compensatory entitlements would have an impact on the price path over the **disclosure years** of the **CPP** remaining on and after the first date at which a remediation cost is proposed to be or has been incurred, by an amount at least equivalent to 1% of the aggregated **allowable notional revenue** for the **disclosure years** of the **CPP** in which the cost was or will be incurred.*

15 This definition appears in the IMs as simply a threshold for re-setting an existing CPP (which does not apply here)[8]. If, as the Commission proposes here, this definition is used as a

[8] Under Part 4, subpart 2 of the IMs applying to EDBs, a "catastrophic event" would not be a ground for resetting a DPP.

trigger for permitting the claw-back of costs on an *ex post* basis, it could lead to the significant transfer of risk from suppliers to consumers. For example, Orion recently incurred substantial damage in a Canterbury winter storm. Press reports indicate that the damage to its network is greater than that inflicted by the Christchurch earthquakes[9]. What is to stop Orion from using the earthquake precedent to claim compensation for an unexpectedly destructive storm?[10] Or for other suppliers to use the Commission's loose definition of "catastrophic event" as a launching pad to seek claw-back of costs for similarly statistically expected but unpredictable events or circumstances? At what point does the Commission's "exception" morph into a new normal, and undermine the incentives-based regulatory scheme?

16 Even if the Commission ultimately resists pressure from suppliers to widen the scope of *ex post* reconsiderations harm will lie in the uncertainty and lack of clarity that persists in the absence of a bright line rule. MEUG also urges against an outcome that could demand representations from consumers on each occasion, because it is not clear what criteria will prove persuasive with the Commission. Consumers can not always be represented and their advocacy is an expensive and unreliable balancing factor.

17 It is imperative that the Commission protect the certainty required for and from Part 4 by minimising the scope of *ex post* reviews as much as possible. Professor Yarrow said[11]:

> *"some ex post adjustment is warranted when things go very badly wrong in ways that require further regulatory intervention if the interests of consumers are to be protected, but that such intervention should be kept to the minimum necessary level to serve this purpose… sometimes unanticipated events can give rise to a situation in which ex ante arrangements become severely sub-optimal, and insistence on rigid adherence to those arrangements becomes harmful.*

18 Professor Yarrow himself would limit a review to "*matters that concern conduct that might be said to be negligent, reckless or egregiously inefficient*"[12] or "*circumstances where the relevant standard of performance is one that is close to recklessness or negligence on the part of the regulated company*"[13] MEUG endorses Professor Yarrow's recommendation that *ex post* adjustments be reserved for only those situations which are truly exceptional (whether due to catastrophic events or otherwise) and which if not addressed immediately, would require some form of regulatory intervention.

19 Alternatively, if the Commission permits the *ex post* claw-back of additional expenditure due to "catastrophic events", it must tighten the definition to give suppliers and consumers sufficient certainty.

20 The term "exceptional" would be best replaced by terms which go directly to the point of the classification of events. That is to provide *ex ante* certainty as to which party will bear

[9] http://www.stuff.co.nz/national/9182553/Gale-had-quake-like-impact-on-network

[10] The article above quotes Orion Chief Executive as saying "*This is the largest storm that has hit Canterbury since 1975. In terms of network damage, it is significantly larger than all other storms we have had since 1975 and only the February 2011 earthquake has had a bigger impact on Orion.*" The comparison with the Christchurch earthquakes suggests that Orion is already positioning itself to make this very argument.

[11] Professor Yarrow "The Orion CPP determination" (30 May 2013), at p 21

[12] Professor Yarrow (as above), at p 12

[13] Professor Yarrow (as above), at p 3

the primary cost of the events, and which party will have the primary responsibility for mitigating those costs. Ideally they will be the same party. If the Commission makes clear who will take the initial assignment of the risk, Coase Theorem might then be expected to encourage parties to transact to reassign parts which were efficient to reassign. For example, dairy shed operators might agree with Orion, or simply accept, that they should have their own stand-by generators.

21 This suggests that the words "exceptional" etc should be replaced by more functional references to impact or financial cost thresholds. They might be a proportion of Orion's revenue, or its network capacity, or usability or mitigation practicality measures.

22 In any case, MEUG would expect the Commission to compare the efficiencies of bailing-out a supplier through claw-back with any other available options, for example the appointment of a receiver.

23 Such scenarios are hypothetical here as Orion's circumstances come nowhere near meeting the threshold proposed by Professor Yarrow. The materiality of the situation is illustrated in Table 1.

**Table 1**

**Materiality of Claw-back Draft Decision: "Five-year Trends"**

| | $m | **2009** | **2010** | **2011** | **2012** | **2013** |
|---|---|---|---|---|---|---|
| Equity | | 697 | 706 | 600 | 620 | 637 |
| Net Debt | | 50 | 42 | 36 | 53 | 60 |
| **Debt/Debt+ Equity** | | **7%** | **6%** | **6%** | **8%** | **9%** |
| Claw-back Draft Decision | 28.6 | | | | | |
| less tax at 28% | 8.0 | | | | | |
| after tax cost to Orion | 20.6 | | | | | |
| **A/tax Claw-back/Equity** | | **3%** | **3%** | **3%** | **3%** | **3%** |

Source: 2013 Orion New Zealand Annual Report, page 6

## Suppliers Should Recover Expected, not Actual, Losses

24 The *ex* ante regulatory regime does not attempt (and in MEUG's opinion should not attempt) to allow suppliers to recover actual costs. Fully diversified investors only require compensation for expected, not actual, losses. The IMs for example took a pan-industry approach to regulated suppliers' required costs of capital. . They focus around the hypothetical competitor under workable competition. Preservation of that approach is important conceptually.

25 In setting the cost of capital IM applicable to Orion's CPP, the Commission choose not to make any adjustments to the cost of capital for asymmetric risk.[14] The Commission correctly dismissed the issue, by noting that adjusting the service-wide cost of capital would incorrectly imply that all suppliers of a regulated service are exposed to the same level of asymmetric risk.[15]

26 The Commission noted that the WACC calculation already includes more than sufficient compensation for the average asymmetric Type I risk borne by suppliers. For example the Commission noted in a footnote that[16]:

> *322 Available evidence is that the cost of natural disasters should have a relatively small impact on the observed cost of capital (ie, likely to be less than 0.1% of WACC). For example, the Global Assessment Report on Disaster Risk Reduction estimate the total expected global loss from earthquakes and cyclone wind damage is around US$180 billion per annum. Relative to the market value of capital provided to listed companies, this implies a cost of 0.30% per dollar of capital per annum. However, as some of the cost of loss would be insured, and since the annual global loss from earthquakes and cyclone wind damage would be shared among government, households, and private businesses as well as listed businesses, the impact on the cost of capital from earthquakes and wind damage would be substantially less than 0.30% per annum (and almost certainly much less than 0.1% per annum). By contrast, the 75$^{th}$ percentile estimate of WACC increases the cost of capital by greater than 0.7% per annum.*

27 The current cost of capital IMs provide some ex ante allowance for catastrophic risk. The Commission said that while the IMs which apply to other EDBs are not directly relevant to Orion (which is still subject to a DPP which does not incorporate the IMs), there is still likely to be an implicit allowance for catastrophic events in the WACC which applies to Orion[17].

28 In relation to Orion's CPP it appears the Commission has misdirected itself in trying to match Orion's actual or "prudent" costs from a maturity of risk. That is not the relevant cost for a regime of this type. The fact that an unequal risk (between suppliers) has matured for one particular supplier is no justification for an effective underwriting of that particular asymmetric risk. For example, some EDBs are more vulnerable to severe storm, earthquakes, or volcanic damage. The Commission determined that it is too difficult to vary the compensation for the risks to reflect that. Therefore, compensation for the fruition of those risks should only cover the additional *risk* of a catastrophic event not the cost of the event itself. Otherwise, Orion would effectively receive both an allowance for the Type I asymmetric risks (such as catastrophic events like the Canterbury Earthquakes) and what amounts to underwriting of the costs where the risk matures.

29 In workably competitive markets, firms only receive risk-adjusted compensation for the expected loss of catastrophic events. In other words, the average costs of catastrophes for a fully diversified portfolio.

[14] H12.1 of the December 2010 IM Reasons Paper.

[15] Refer to Paragraph H12.2 of December 2010 Reasons Paper.

[16] Draft determination, paragraph [C148].

[17] Draft determination, paragraphs [C20 and C143 – C146].

30 In the case of Orion that does not equal the actual costs for the event. Any "recovery' in an *ex ante* regulatory regime for costs should be limited to the expected costs of natural disasters. Here that cost is unlikely to be different today as it was 5 years ago. The only difference of course is that a particular catastrophic risk has matured.

31 The logic of the Orion argument [18] that the non recovery of specific or real costs would undermine operations or incentives to invest is difficult to follow. Over the long life of the proposed (or replacement assets) the expected cost of catastrophic events (adjusted to reflect the low likelihood) does not appear to have materially changed.

## Orion seeks an indulgence that is not available to ordinary businesses operating under competitive conditions

32 The Commission's decision would force businesses that have already borne full responsibility for their own uninsurable costs to carry unlimited liability for Orion's costs. This is an unacceptable transfer of risk which has no parallel in workably competitive markets, as empirical evidence from the Christchurch earthquakes demonstrates.

33 MEUG accepts that Orion, as a supplier of essential services, was required by legislation and under its quality standards to incur uninsured costs[19]. However, the necessity of incurring costs alone should not automatically entitle Orion, or any other supplier, to recover these costs on an *ex post* basis. The critical questions should be:

(a) whether, or to what extent, Orion would have elected to incur the costs even without being compelled to do so; and

(b) the likelihood that a firm in a workably competitive market which elected to incur similar costs, would have been able to pass them through to consumers.

34 Orion made a business decision to incur additional costs and stay in business. In the immediate aftermath of the Christchurch earthquakes, Orion faced a competitive threat from EDBs operating outside its geographical market, as displaced consumers (including large businesses) assessed their relocation options. Like other Christchurch businesses, it faced the risk of dramatic loss of demand. It took rational steps and incurred costs designed to retain customers and preserve its $1b asset base. This is consistent with business decisions made by firms in workably competitive markets, where short-term costs will be borne for the long-term benefit.

35 Other firms have not been able to pass through similar costs to consumers. Orion's consumers include businesses which have themselves suffered Operational & Maintenance losses that have not been recoverable from consumers. One of MEUG's Christchurch-based members has said:

> *[Our business] has experienced higher than normal O & M costs, probably in the region of $200K to $400K for repairs, checking equipment and risk management. We also experienced a significant loss of sales which had an impact on financial performance. However, we certainly have not had any prospect over this time of increasing prices to claw this back. Market forces prevail and prices have been under downward pressure!*

[18] Page 25 of Orion application
[19] MEUG has not formed an independent view as to the efficiency of the costs involved.

36 Another Christchurch member confirmed that it had not been able to pass on additional costs and said:

> *Insurance costs have certainly risen directly related to the earthquake, we have lost staff and have found them harder to replace so there has been an impact on labour efficiency and higher temp costs.*

## The Aim of Part 4 is Efficient Management of Risk

37 The Commission asserts that risk sharing between Orion and consumers is consistent with Part 4 of the regulatory regime. [C50]. MEUG disagrees: the purpose of Part 4 is to allocate risks efficiently. Proper management of risk is more important that simply splitting the difference. In any event, MEUG fails to see any evidence of risk "sharing" when it is proposed that 100% of all net additional costs be allocated to consumers.

38 The following questions should be relevant to any inquiry into proper allocation of risk:

(a) Are earthquakes or other natural disasters unusual in New Zealand?

Answer: No

(b) Who is best able to manage these types of risks from a power supply point of view?

Answer: Orion chiefly, but in some cases (eg remote customers for whom outages is a part of life) then cheaper for those end customers to have their own back-up capabilities.

(c) Does Orion (or any other EDB) have an incentive or risk to plan efficiently for such events and once they occur, to manage the restoration efficiently?

Answer: under a DPP then yes they have an incentive because the longer power is cut off, the business will receive less income. Under the proposed CPP with claw-back that incentive is weakened. Worse, the integrity of the regime based on *ex ante* "set-and-forget" approach, is undermined.

(d) Was the event so catastrophic that from a cash flow point of view, Orion could not do basic O&M in order to re-start services and therefore earn income until the new CPP revenue levels started?

Answer: no. Orion's balance sheet is very strong. Even if Orion had a weak balance sheet, before automatically deciding to bail-out Orion with a future promised claw-back, the Commission should first consider whether, for instance, a receiver could step in and run the business or make a quick fire sale in order to restore supply to affected customers more efficiently and at lower cost.

39 The Commission's decision would fail to allocate risks efficiently and risks creating a moral hazard where suppliers fail to manage risks prudently. Suppliers who can claw-back costs once a risk matures lose the incentive to manage that risk on an ongoing basis. For example, when preparing asset management plans and deciding how best to manage natural disasters, suppliers may sub-optimally underspend on Operations and Maintenance in the belief that they can claw-back additional costs Consumers who do not trust the ability of

suppliers to provide a service in times of crisis may pay twice, once through prices and again through self-insurance (eg back-up generators).

40 The illogicality of the Commission's allocation of risk can be seen when taken to the extreme of far more devastating loss. The transfer of costs from suppliers to customers in such a case could render the service unviable for any customers.

### The Same Reasons for Declining Claw-back for Demand Shock Also Apply to Cost Shock

41 MEUG does not accept that suppliers and consumers necessarily face asymmetric risks for cost shocks generally[20]. Risks and opportunities are on a spectrum. The Commission should not look at natural hazards in isolation from any other unforeseen events. For example, a major resource management change midway through a regulatory period could present major risks or opportunities for suppliers.

42 There are internal inconsistencies between the Commission's more principled preliminary decision not to allow Orion to recover lower-than-forecast revenues and its preliminary decision to allow the claw-back of all additional net costs incurred in response to a catastrophic event:

(a) The Commission acknowledges that allowing Orion to recover claw-back for additional costs and lower than forecast revenues, even for a catastrophic event, runs contrary to the regulatory regime[21].

(b) The Commission accepts that in workably competitive markets, risks tend to be allocated to the party best placed to manage them and in regulated suppliers' situations, by internal actions and investors by portfolio diversification[22].

(c) The Commission accepts that a moral hazard would be created if consumers were to bear all the risks and costs as proposed by Orion[23].

43 These inconsistencies are not reconciled to justify the draft determination.

## AMENDMENTS TO INPUT METHODOLOGIES

44 In the December 2010 Decisions Paper the CC signalled a review of CPP IM after experience of the first application was supported (paragraph 9.2.8):

> *The Commission also notes that some suppliers support a review of the CPP requirements once the Commission has processed the first CPP applications. The Commission supports the suggestion of an early review of the CPP IMs in principle, as it has been a challenge to set CPP requirements prior to their first practical application. There will likely be a need for refinements to the requirements as experience with the CPP process grows. As the Act provides for a review of IMs at any time under s 52Y (but no later than seven years after they are set), the Commission does not consider that a requirement to this effect is necessary in the IM itself.*

[20] Draft Determination, paragraphs [C85 to C114]

[21] Draft Determination, paragraph[C50]

[22] Draft Determination, paragraphs [C52-53]

[23] Draft Determinations, paragraphs [C56], [C57] and [C63]

45 MEUG believes the Orion CPP application process has uncovered aspects of the CPP IM and other IMs that might need adjusting otherwise outcomes will be sub-optimal to those that could be achieved with amendments.

46 MEUG urges that the draft determination be carefully reviewed by the Commission to minimise all aspects that would exacerbate sub-optimality of the existing IMs and which could increase inconsistencies between updated IMs and the CPP.

47 There are at least three aspects that should be reviewed. MEUG accepts that it is not necessarily certain that subsequent amendments will be made. There is though sufficient doubt on how they might be currently applied and integrated within the Part 4 regulatory matrix so as to create uncertainty. Hence a review is needed. Those issues are:

(a) The risk of a supplier during a CPP regulatory period over-investing in new capital works relative to an efficient level; but at the conclusion of the CPP regulatory period able to automatically include that over-build into the opening RAB for the new DPP path.

(b) The poor incentives on EDB to ensure investments do not have a stranding risk due to lower demand than expected. This issue has been highlighted in the extreme stranding case were totally damaged assets, while economically and technically of no value at all, remain in the regulated asset base and customers pay a return on and for those assets.

(c) The CPP IM deliberately has an asymmetric design whereby regulated suppliers can seek a CPP but customers cannot. The experience of the Orion CPP application has made us ask why that limitation should apply. A review would help customers better understand and gain confidence in the IMs.

48 The IMs which apply to Orion should be consistent with the IMs for other EDBs. If the Commission proposes to amend any IMs before the next DPP reset in 2015, then the amendments should also apply to any CPP which operates in place of that DPP. This would include Orion's CPP. On this point, we refer the Commission back to the jurisdictional issues discussed in the Franks & Ogilvie letter which accompanies this submission.

Yours sincerely

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