MAJOR ELECTRICITY USERS' GROUP

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

Friday, 11 October 2013

Dear John

Orion CPP – Draft Determination – Cross Submissions

INTRODUCTION

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

2 MEUG observes that as with the input methodology("IM") determination process, the submissions of Orion and other regulated suppliers on CPPs endeavour to persuade the Commission away from a model based on a notionally efficient participant in a workably competitive market. In particular:

(i) They seek to cherry-pick the benefits to them of the default price-quality path ("DPP") and a CPP through claw-back and by decoupling CPPs from prevailing DPPs.

(ii) They want and are largely free to create risk-free conditions while still earning premium returns.

(iii) They argue for certainty of return and a guarantee of at least a normal return during every regulatory period. That misconceives the requirements of the legislation, and is inconsistent with what an expected normal return means for a workably competitive market.

(iv) They seek *ex post* compensation for costs, the risks of which have already been compensated for on an *ex ante* basis.

(v) They want unfettered discretion to build.

3 This determination will set a significant precedent. It is important that the Commission not be blindsided by Orion's circumstances and make a soft decision without proper regard to the potential ramifications for all future CPPs. We are particularly concerned that the

Commission is being corralled into making a "split the difference" final decision. Favouring a pragmatic compromise over a more principled approach will only lead to the type of regulatory uncertainty that Part 4 was designed to prevent. It will not appeal-proof the determination. Indeed, any absence of intellectual rigour would make even more vulnerable to challenge.

SUPPLIERS SEEK TO CHERRY-PICK THE BENEFITS OF THE DPP AND A CPP THROUGH CLAW-BACK AND BY DECOUPLING CPPS FROM PREVAILING DPPS

4 Orion, supported by other regulated suppliers, argues that a supplier should not be penalised for the delay in filing a CPP when they were preoccupied responding to a disaster. Under such circumstances, Orion argue, that it has an expectation if not an entitlement, to claw-back.

5 MEUG disagrees and repeats the concerns about claw-back expressed in its primary submissions. Claw-back opens a back-door route for suppliers to recoup losses from consumers on an *ex post* basis. It is also inherently uncertain. Consequently, the Commission's discretion to apply claw-back ought to be reserved for truly exceptional cases. MEUG does not consider that threshold has been met in this case. The amounts involved for Orion in the context of its overall revenues, assets, balance sheet strength and normal capex and opex and maintenance do not take the circumstances into any compelling or extraordinary territory, notwithstanding the initial assumptions that flow from the causal link to an earthquakes that were disastrous for many. Events since the application help put things in perspective. Orion itself has noted that the recent storm in Canterbury was of similar impact on Orion.[1]

6 However, if the Commission does consider applying claw-back, it should guard against allowing suppliers to game the system by cherry picking between DPP and CPPs. The value of the suppliers' CPP option should not be increased more than was intended by the legislation.

7 Orion's submissions confirm its demand to claw-back all costs and lost revenue since the February 2011 earthquake. Other regulated suppliers support it. Vector submits that the proper approach is for the Commission to consider the world as at 23 February 2011 (i.e. the day after the catastrophic event) when Orion would have had full foresight.[2] This is akin to clawing back the CPP's start date. If the Commission is minded to accede, the Commission should reconsider Orion's entire CPP as at that date and not just the selective losses identified by Orion. For example, unlike the resetting of DPPs, the WACC may differ as between a DPP and CPP; here, the WACC applicable to Orion's proposal is significantly lower than the WACC applicable to the DPP and should be substituted in its place. Otherwise the Commission would be allowing Orion to cherry pick all the benefits of a CPP via claw-back without foregoing the higher prices it has received from letting the DPP run as long as possible.

[1] Refer to http://www.stuff.co.nz/national/9182553/Gale-had-quake-like-impact-on-network The article 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.

[2] Refer to Vector's submission at [13]. MEUG does not accept that the risks of natural disasters, including of major earthquakes, are or were unforeseeable, as explained later in this cross submission.

8 Further the CPP should expire at the same time as, or earlier than, the existing DPP to provide the counterfactual yardstick against which to measure the CPP.

SUPPLIERS WANT AND ARE LARGELY FREE TO CREATE RISK-FREE CONDITIONS WHILST STILL EARNING PREMIUM RETURNS

9 Vector submits that because of the very difficult circumstances associated with natural disasters, it would be wrong for the Commission to "second guess" any expenditure incurred in response.[3] It argues that there should be a presumption that all expenditure incurred by Orion and suppliers in similar circumstances before a CPP application is made will be allowed "*unless there is clear evidence otherwise*".

10 MEUG disagrees. There is no parallel indulgence available to firms in workably competitive markets. Vector's suggestion would create a moral hazard. Suppliers need the incentives associated with bearing risk, to ensure that they incur costs prudently. The risk of business failure is the market discipline to which competitive firms are subject. Regulated suppliers must bear at least equivalent cost/risk/return outcomes for the purpose of Part 4 to be satisfied.

11 Further, allowing suppliers to be shielded from the risk of natural disasters is inconsistent with the risk premiums which are already built into their returns, particularly when those returns are calculated at the 75th percentile.

REGULATORY CERTAINTY, NOT CERTAINTY OF RETURN

12 Many suppliers incorrectly interpreted the promotion of "certainty" under Part 4 to mean "certainty of normal return" rather than regulatory certainty.[4] For example:

(a) Auckland Airport said[5]:

> *In general, it is reasonable for regulated suppliers and their investors to bear both the upside and downside risks of ordinary symmetric demand fluctuations. However, the same logic does not apply to the demand risk associated with catastrophic events. Requiring regulated suppliers to bear the demand risks associated with catastrophic events requires that suppliers be appropriately compensated for bearing those risks.*
>
> *In part, the Commission justifies its position by stating that demand risk associated with catastrophic events is largely symmetric, but noting the impact of a catastrophic event on costs is asymmetric. Auckland Airport does not understand the logic of the Commission's distinction, given that lower demand following a catastrophic event is a cost to the supplier.*
>
> *In particular, Auckland Airport disagrees that demand risk associated with catastrophic events is largely symmetric, particularly in the airport sector.*

[3] Refer to Vector submission at [53]

[4] The correct interpretation is referred to in the Supreme Court's discussion of the Commerce Act 2008 amendments in *Vector Ltd v Commerce Commission* [2012] NZSC 99; [2013] 2 NZLR 445 (SCNZ) at [56] (our emphasis):

> *There can be no doubt that the 2008 amendments were intended to address concerns as to regulatory uncertainty and associated concerns about the absence of a right of merits review of Commission decisions.*

[5] Auckland Airport's submission at [15]

> *Events such as terrorism attacks, SARS, bird flu, volcanic eruptions and the Global Financial Crisis have an asymmetric effect on demand for air travel, regardless of geographic location of the event itself. In addition, known events with a positive impact on demand (such as the Rugby World Cup) are likely to be factored into demand forecasts.*

In effect, Auckland Airport seek consumer underwriting of any downside business risk that is extraordinary, expensive or rare in occurrence. This sort of risk sharing is not seen in workably competitive markets. It is not obvious to MEUG how this could promote certainty. For example, how would the Commission draw the line or define extraordinary?

What is effectively consumer underwriting of extraordinary events is not consistent with the Part 4 purpose of promoting outcomes of workably competitive markets. For example, the catastrophic events described, would also impact competitive markets, such as airlines. The fact the particular demand risk is asymmetric, does not mean that it is not a normal demand risk. Regulated suppliers should not be sheltered from the same risks that participants in workably competitive markets face.

(b) Christchurch City Holdings said[6]:

> *The Draft Decision proposes that the major reasons for non-recovery of costs during this period is because of reduced demand. However, the effect is that Orion will have to bear the majority of its quake related costs for that three year period with no other means of recovery.*

As the recent experience of many MEUG members operating in Canterbury has shown, non recovery of costs can be a reality of workably competitive markets. In unique circumstances, such as after a natural disaster, many sensible costs are simply not recoverable. Many are necessary just to minimise loss or enable the business to recover. ANZCO's submission supports this view.

(c) Christchurch City Holdings also said (<u>our emphasis</u>)[7]:

Apart from the significant uncertainty it creates over cost recovery, [Christchurch City Holdings] is very concerned that the Draft Decision does not recognise <u>the right of shareholders</u> to a reasonable rate of return on investment.

In workably competitive markets, there is no such "right to" reasonable rates of return. The industry as a whole may earn reasonable rates of return over time, but no firm within the industry can have any such assurance.

(d) Orion said[8]:

> *The best way to align the interests of regulated suppliers and consumers following a catastrophic event is to give those suppliers confidence that*

[6] Christchurch City Holdings submission, page 4

[7] ibid

[8] Orion submission at [14]

> *they can recover their uninsurable earthquake related costs following that event. Only this certainty can incentivise suppliers to get on with the job of investing to repair and restore the service consumers require.*
>
> Its major shareholder made a similar point[9]:
>
> *Orion has spent significant money on quake repairs and recovery in that three year period, in the expectation that it will recover its costs - the Draft Decision's proposal to decline those costs is retrospective and contrary to incentives to invest in the long term interests of consumers.*
>
> *A rational EDB would spend no money on quake related costs until it first submitted a CPP application and had that CPP approved.*
>
> MUEG pointed out in its primary submissions that many businesses faced business interruption costs as a result of the Canterbury earthquakes.[10] Spending to recover is often rational in workably competitive markets, notwithstanding the non-recoverability of the costs. The spending is often needed to preserve the business overall (its reputation and customers) even if the particular assets involved do no more than restore capacity, without any prospects of additional revenue. The Commission should ensure that regulated suppliers have the same incentives.
>
> MEUG submit that even if the costs are not recovered, except where truly exceptional circumstances exists (for example if the supplier was in financial distress[11]) a rational supplier will still "get on with the job of investing to repair and restore" in order to minimise loss and retain customers.

13 Orion's statements regarding symmetry of demand risk relating to adverse events[12] are irrelevant for the purposes of the CPP decision. MEUG acknowledges that a significant proportion of the decreased demand caused by the Canterbury events are unlikely to have been recouped/offset by providers in other regions. It appears that regulated suppliers are taking advantage of the Commission's framing of demand risk from an earthquake as a "relocation" risk.[13] They purport to rebut the assumption that investors can therefore costlessly insure by diversifying among regulated suppliers. This reframing of the issue is disingenuous. The demand risk (and therefore cost) exists – but diversification minimises the impact of the risk, and means that the Commission should only compensate for the *expected cost on average* across the regulated industry.

14 Whether the demand shifted or could shift to neighbouring EDBs is irrelevant. Asymmetric Type I risks are low for a diversified investor not because there is upside, or balanced gain, but because the chances of the risk maturing for a particular business / investment is so low, that the *average* cost is minimal across a fully diversified portfolio. It is that average amount, faced by a diversified investor that which should be accounted for. MEUG submits that the Commission has already done that.

[9] Christchurch City Holdings submission, page 4

[10] Refer to MEUG's submission [32] [36]

[11] Contrary to Powerco's submission, the Commission would not be expecting a well-managed company to bear more of the costs of a catastrophic event than a poorly run company (and therefore incentivising poor performance) if *ex post* adjustments were reserved as a regulatory last resort.

[12] Refer to Paragraphs 114-129 of Orion submission.

[13] See for example page 2 of Powerco submission

15 For example, in relation to the costs of natural disasters, the Commission calculated that the cost is less than 0.1% of WACC – a small fraction of the generosities to suppliers already built into the cost of capital IM.

Insurability irrelevant – many risks in workably competitive markets are uninsurable

16 Suppliers argue that they should be compensated for uninsurable risk. MEUG is aware of no evidence that such compensation should be *ex post*, or that it was not being compensated for in the *ex ante* permitted returns. The fact that a type of loss is uninsurable does not of itself allow the market participants to recover the amounts from consumers *ex post*.

Self insurance does not require a separate "fund" – shareholders bear risk

17 Orion suggests that because it did not have a specific "self-insurance" fund, it is entitled to rely on consumers to underwrite Type I, asymmetric risks. MEUG disagrees. Many firms, across all market types "self-insure" for risk. Ultimately many risks are carried by an equity capital cushion. Shareholders that have received higher returns in the past, and may in the future, are a form of pooled "self-insurance" fund. The decision of Orion's shareholders to take the earlier dividends is irrelevant to Commission CCP and risk allocation.[14]

ORION IS ALREADY COMPENSATED FOR BEARING THE RISK OF NATURAL CATASTROPHES

18 The regulated suppliers claim that the IMs entitle them, in the event of a natural catastrophe, to *ex post* relief via a CPP.[15] In particular they point out that there is no explicit (or perhaps in their view material) component for Type I asymmetric risk in WACC. They then argue that there was no *ex ante* allowance in operating cash flows used to derive DPP price paths taking into account the risk of natural catastrophes. They argue that with neither relief in WACC nor allowance in an *ex ante* DPP based on forecast capex and opex for natural catastrophes, claw-back under a CPP is the only means of recovering higher-than-expected O&M and lower-than-expected revenues.

19 For example, Unison say[16]:

> *Unison wishes to make very clear its expectation was that, to the extent that risks associated with catastrophic events were not compensated ex ante through specific cash-flows, those risks remained with consumers in exchange for consumers receiving lower prices absent any events. It now seems that we cannot rely on any ex post recovery of foregone revenues following a catastrophe, which is likely to have significant impacts on how we invest, price our services, and contract with our consumers to mitigate the effects of this change in policy.*

20 MEUG disagrees with the claim that the EDBs have not received any *ex ante* allowance for accepting earthquake risk in their DPPs.

[14] Orion at [15] and its major shareholder, Christchurch City Holdings at pages 4 and 5 have attempted to submit that Orion's shareholders are in a special category, as they predominantly consist of Christchurch ratepayers. The Commission's approach must be principled and of general application. The status and individual circumstances of a class of shareholders are clearly not relevant circumstances for the purpose of this determination.

[15] For example see Orion submission [140] - [154]

[16] Unison submissions at [8]

21 Expected opex used for determining DPP was calculated using econometric equations correlating demand forecasts, network scale, partial productivity factors and input factor forecast costs. To the extent historic actual costs for all EDBs used in this exercise included some costs to manage earthquake related costs then opex levels in the generic DPP building blocks incorporate such costs. MEUG is not aware of any reason why provision for earthquake precautionary expenditure would have been excluded.

22 There was also an explicit increase in opex for actual higher insurance costs due to natural disasters[17].

> *To forecast each supplier's opex, we first modelled the impact of changes in the main factors that affect opex, and then made an additional adjustment to reflect increases in insurance costs that are attributable to natural disasters. This adjustment is appropriate as the increase in insurance costs is largely outside the control of all suppliers, is significant, and is not fully captured in our original forecast.*

23 The Commission also relied on asset management plans ("AMPs") to forecast capex. The Commission noted that expected capex for determining DPP was based on the forecasts of each EDB[18]:

> *To model each supplier's network capex, we have relied on the forecasts disclosed by suppliers in their 2009/10 Asset Management Plan (AMP)*

24 The AMPs have consistently taken account of the risk of natural disasters, including major earthquakes.

25 For example the AMPs of Unison have consistently indicated the company has planned for earthquake risk contrary to the quoted statement in paragraph 22 above that *"... risks associated with catastrophic events were not compensated ex ante through specific cash-flows."*

26 The earliest AMP on Unison's website is dated January 2002.[19] Earthquake risk is the first item listed under natural disasters in that AMP:

> ***4.8 Risk Management***
>
> *HBN's network assets can be at risk from:*
> *• Natural disasters - earthquakes, flood, slippage, climatic conditions etc.*
> *• People related - excavations, vandalism, poor workmanship etc.*
> *• Non-supply - non-supply by the transmission company.*
> *• Asset failures - capacity, reliability, structural integrity.*
>
> *There are individual risk management plans for various parts of the HBN businesses, such as a contingency plan which, although developed for Y2K, still covers most of the Company's operational risks. However, the importance has been recognised to have a fully consolidated, Company-*

[17] Commerce Commission, Resetting the 2010-15 Default Price-Quality Paths for 16 Electricity Distributors, 30th November 2012, Attachment C, paragraph C2, page 74

[18] Commerce Commission, Resetting the 2010-15 Default Price-Quality Paths for 16 Electricity Distributors, 30th November 2012, Attachment B, paragraph B6, page 67

[19] http://www.unison.co.nz/AMP

> *wide risk management and contingency plan. This plan is currently being developed for implementation in 2002/2003.*

27 Earthquake risks and how they are to be managed are mentioned in every subsequent AMP by Unison. The consistent view that earthquake risks were ever present is illustrated by the following quote in the latest AMP for 2012-22[20]:

> *Earthquake risk continues to be regarded as the maximum credible natural hazard threat to Unison's network*

28 Similar text was used in Unison's AMP 2011-21[21]; AMP 2010-20[22]; AMP 2009-19[23]; AMP 2007[24]; and AMP 2006[25].[26]

29 Even though Orion is not on the same DPP as other EDBs, Orion's AMPs have also recognised and planned for the risk of earthquakes. There has been no substantial change in the risk assessment of earthquakes both before and after the initial large earthquake in September 2010 as illustrated from the beginning text of the extracts on titled "Impact of natural disasters" in the 2005 AMP and "Impact of natural events" in the 2013 AMP[27].

30 Orion's AMP published in 2005 said:

> ***6.4 Impact of natural disasters***
>
> *Earthquakes and storms are the major natural disaster risks to our network infrastructure. Reviews have been carried out in to the interdependancy of lifelines and the susceptability of Transpower's GXP substations to liquefaction. These reviews show that Addington, Papanui and Bromley GXPs could be subject to differential settlement in the advent of an earthquake and that this may affect our 66kV feeder cable terminations. Although due to differing soil types, settlement should not occur at all three during a single event.*
>
> *Emergency fuel supply storage has become a problem due to a reduction in local private fuel tanks. Also there are fewer commercial fuel stations and all rely on electricity to pump fuel.*

31 Orion's AMP published in 2013 said[28]:

> ***1.5.5 Impact of natural events***
>
> *Earthquakes create the most significant risk of impact on our network, since both likelihood and consequence are currently rated as high and long equipment replacement times are a major consideration. We are having another look at our earthquake risks in the light of what we now know after*

[20] Refer to page 7-17

[21] Refer to page 7-16

[22] Refer to page 7-14

[23] Refer to page 7-8

[24] Refer to page 7-3

[25] Refer to page 7-3

[26] All are identical except for the last AMP where the words "to Unison's network" are omitted.

[27] http://www.oriongroup.co.nz/publications-and-disclosures/asset-management-plan.aspx

[28] Refer to pages 22 - 23

> *the 2010/2011 earthquakes. These recent earthquakes have given us new data that we now need to consider. It will take time to consider this data and consequently any review of our ongoing earthquake risks have not been included in this AMP.*
>
> *We continue to invest significant time and money to ensure we can respond well to natural events such as storms and earthquakes. Orion is a founding member of the steering committee of the Canterbury engineering lifelines group. The purpose of this group is to increase the resilience of Canterbury's infrastructure and to assist lifeline utilities to participate in all phases of civil defence emergency management.*
>
> *During the mid-1990s our network was part of an 'engineering lifelines' study into how natural disasters would affect Christchurch. The study concluded that electricity supply would be essential for almost all service authorities after a natural disaster, with most service authorities' head offices located in the central city area.*
>
> *Since this study we have made the following improvements:*
>
> *• spent $13m to secure power supply to the central city via a second point of supply. This, combined with numerous diesel generators around the city, gives the Christchurch central business district (CBD) a more secure power supply than equivalent CBDs in Auckland and Wellington*
> *• strengthened power supply to the port, airport and main communications sites*
> *• spent $4.5m on earthquake strengthening for bridges, cable supports and buildings. All of our zone substations and all major 33kV and 66kV cables now meet the seismic structural standard*
> *• undertaken regular risk assessment and response studies to ensure we are well prepared for any disaster.*
>
> *We have also reviewed how susceptible Transpower's GXPs are to liquefaction. Our reviews show that Addington, Papanui and Bromley GXPs could be subject to differential settlement in an earthquake – this may affect our 66kV feeder cable terminations. Due to differing soil types, settlement should not occur at all three GXPs during a single event.*

32 The Risk Management sections of the Orion's AMP's have consistently rated earthquakes as the highest risk natural hazard for several asset classes. Extracts from the 2005 AMP and 2013 AMP illustrate how little the text has changed over those nine years are appended.

33 The 2005 AMP included:

> *The need for spares is dominated by two events over and above average failure mode levels. These are earthquakes (65% in the next 50 years) and storm conditions (100% chance in 50 years)*

34 Almost the identical text is in the 2013 AMP. Interestingly the estimate of earthquake risks used for AMP planning is unchanged. The 2013 AMP text is:

> *The need for spares is created by the likelihood of two events over and above average failure mode levels. These are earthquakes (65% in the next 50 years) and storm conditions (100% chance in the next 50 years)*

35 The table below summarises the unchanged pattern of references for the seven AMPs published between 2005 and 2013 referencing the above 2 examples. There was no AMP published in 2011 because of the earthquakes. There was also no AMP published in 2008.

Year published	"Impact of natural events"	Same or similar references in Risk Management section
2005 AMP	Page 17	Pages 147-148
2006 AMP	Page 17	Pages 151-152
2007 AMP	Page 18	Page 179
2008 AMP	No AMP published	
2009 AMP[29]	Pages 22, 23	Page 214
2010 AMP[30]	Pages 22, 23	Page 235
2011 AMP	No AMP published	
2012 AMP	Pages 23	Page 235
2013 AMP	Pages 22, 23	Page 257

36 There was an additional estimation of a magnitude 8 earthquake in the 2012 AMP[31]:

> ***6.7.2 Earthquake***
>
> *Although we have had several significant earthquakes and thousands of aftershocks during 2010/11, there still remains a 1 in 123 chance that an earthquake on the Alpine Fault of magnitude 8 will occur in any year.*

37 This statement was also in the 2013 AMP albeit with a small change in the wording.

38 Finally, MEUG recognise the Orion's statements that[32]:

> *We did invest in risk mitigation, which had significant benefits for our consumers in limiting the damage to our network, and our ability to restore supplies to them. We have a track record of proactive risk management, and consistent with this, our post earthquake planning includes explicit measures and investments which reflect our learning from the earthquakes. We had understood that we would be compensated ex post for those catastrophic risks we were not able to manage or mitigate.*
>
> *We also insured our risks to the maximum extent practicable and fully in line with industry practice for Australasian EDBs.*

[29] Note page reference for 2009 AMP and 2010 AMP refer to the summary document published in those years.

[30] ibid

[31] Page 239

[32] At [102] - [103]

39 Unless Orion was acting against its self interest, MEUG finds it difficult to reconcile Orion's statements on the one hand that it took all practicable steps (at considerable cost) to minimise the risk of earthquakes, but on the other hand, did not consider that the business would bear any of the costs, should an event occur.

40 We consumers have been paying for the earthquake risk, *and* the earthquake precautions, *and now* they ask us to pay again.

NOT ALL INVESTMENT IS GOOD INVESTMENT

41 Orion has taken issue with the Commission's decision to limit the extent to which it reinvests in its asset base following the earthquakes.[33] Chapman Tripp has provided a legal opinion that the Commission lacks the necessary jurisdiction to make this decision.

42 MEUG finds it curious that this is such a 'die-in-the-ditch' issue for Orion. The only reason why someone would ordinarily wish to spend more than a regulatory body objectively thinks necessary, is if the permitted return is materially above their expected actual risk adjusted cost of capital. We consider that the most likely explanation for Orion's push to increase its capital expenditure in the absence of clear demand is the inherent generosity of the Commission's IMs.

43 Chapman Tripp says[34]:

> *… the purpose of a CPP is to enable the particular circumstances of a supplier to be addressed, including to take account of the situation where a supplier has had to apply for a CPP due to a (or several) catastrophic event(s)*

44 MUEG considers this claim to be inconsistent with the Part 4 purpose. CPPs are not intended to convert suppliers back into cost-plus monopolies. This is not all about them. CPPs, like all the regulatory rules and tools under Part 4 are subject to the overriding purpose statement, which should be translated to constrain the CPP. They should be at least as closely focussed on the interests of consumers who may themselves be struggling with the consequences of the events that trigger the application for a CPP. Relevantly here, the purpose is not, as Orion and Chapman Tripp assert, to promote incentives to invest *per se*, but rather, to promote incentives that are consistent with incentives produced in workably competitive markets to innovate and to invest, including in replacement, upgraded, and new assets. The DPP remains the relevant yardstick. A CPP should depart from the DPP which applies to other EDBs only to the extent that it is logically necessary.

45 MEUG supports the approach taken by the Commission in its draft determination in response to Orion's over-ambitious investment plans. Otherwise there is a significant risk of Orion being able to over-invest in or "gold-plate" its asset base contrary to the long term interests of consumers. The price control regulatory scheme could be undermined if on the one hand it went to great lengths to establish a permitted rate of return on capital that reflected implicitly the risks faced by the competitive comparator businesses, but the controlled suppliers were then able to eliminate most of those risks, at consumer expense,

[33] Refer to Orion submission pages 20-23 and 45 onward

[34] Chapman Tripp, Application for a CPP Legal Framework, 27 June 2013, at [12.2]

to deliver de-risked returns still containing the risk premium. Put another way, the returns have been fixed, but the risk has been reduced by being passed to consumers.

46 Alternatively, if the current IMs do not empower the Commission to control the pass-through to consumers 'gold plated' costs or other expenditure that would effectively de-risk the returns, the Commission should urgently review the IMs. They should eliminate perverse incentives which would encourage over-investment or over-insurance or other expenditure that is not in the long term interests of consumers, given that they already pay prices which deliver returns incorporating risk premiums.

Yours sincerely

Ralph Matthes
Executive Director

Appendix 1:

Orion AMP published in 2005 pages 147-148:

6.3 Environmental management

Orion is committed to a policy of environmental sustainability through the application of our environmental sustainability policy. The following topics are covered in this policy: stakeholder consultation, protection of the biosphere, sustainable use of natural resources, reduction and disposal of waste, wise use of energy, risk reduction, restoration of environment, disclosure, commitment of management resources, assessment and annual audit.

Systems are in place to minimise and manage potential oil spills within our network. These include the establishment of ready response kits and regular training by our emergency contractor to control the impact of a spill on the environment. Spills are reported, investigated and appropriate action taken to minimise to risk of reoccurrence.

6.4 Risk analysis

6.4.1 Assessment of risks

Critical assets have had a risk assessment undertaken to clearly establish the impact of asset failure based on expected failure rates for given assets. This work includes the likely impact or consequence and takes into account those physical aspects such as the availability of equipment and the lead times to purchase replacement equipment. This coupled with the impact from the most credible natural events establishes the justifiable spares levels.

Descending order of risk for major assets

	Asset	Main Risk
Cables	11kV U/G cable	Earthquake
	66kV U/G cable	Earthquake
	33kV U/G cable	Earthquake
	400V U/G cable	Earthquake
	Communication cables	Earthquake
Lines	11kV O/H line	Storm
	33kV O/H line	Storm
	400V O/H line	Storm
	66kV O/H line	Storm
Switchgear	Circuit breakers	Earthquake
	All insulated units	Earthquake
	Oil switches	Earthquake
	Outdoor oil switches	Earthquake
Transformers	Ground mounted transformers	Earthquake
	Pole transformers	Lightning
	Auto tapchanger transformers	Earthquake
	Regulators	Earthquake
Ancillary Equipment	Protection	Flooding

The need for spares is dominated by two events over and above average failure mode levels. These are earthquakes (65% chance in the next 50 years) and storm conditions (100% chance in 50 years).

Earthquakes are the most significant risk that would impact on this network since the likelihood is high and the consequence is high with equipment replacement times being a major constraint. It can be seen from the results in the table that earthquake dominates asset exposure.

Consultants were employed to establish our exposure to a seismic event or the impact of asset failure on the environment. The following table is a summary of the outcome of this study.

Possible causes of contaminant dis charge and their relative risks

Cause of discharge	Risk of discharge of contaminant(s)										
	Transformer oil spill				Int/ext OCB oil spill	PCB capacitor leak	Holding tank spill	Transport accident	Portable tank spill	Oil-filled cable leak	Battery electrolyte spill
	District sub	Network sub	Pole sub	Pad or Kiosk							
External/Natural (Note 1)	Low	Low	Mod	Low	Low	Low	Low	Low	Low	Low	Low
Accident	Low	Low	Mod	Low	Low	Low	Low		Low/Mod	Mod	Low
Vandalism	Low	Low	Low	Low/	Low	Low	Low	Low	Low	Low	Low
Fire	Low	Low	Low	Low	Low	Low	Low	Low	Low	Low	Low
Vehicle collision	Low	Low	Mod	Low/	Low	Low	Low	Low/Mod	Low/Mod	Low	Low
Human error	Low	Low	Low	Low	Mod/	Low	Mod	Mod	Mod	Mod	Low/Mod
Design fault	Low	Low	Low/	Low	Low	Low	Low	Low	Low	Low	Low
Plant failure	Low	Low	Low	Low	Low/Mod	Low	Low	Low	Low/Mod	Low/Mod	Low
Probable severity of outcome (Note 2)	High	Mod/ High	Low/ Mod	Low/ Mod	Low	High (Note 2)	Mod/ High	Low/High	Mod/High	High	Low

Note 1 Includes risk of discharge of contaminants occurring as a result of damage caused by earthquake, wind, snow, flood, lightning or other external causes.

Note 2 Severity of outcome with respect to contravention of the Resource Management Act.

Orion AMP published in 2013, page 257:

6.5 Network risk analysis

6.5.1 Assessment of risks

We assess critical assets for risk to clearly establish the impact of asset failure, based on expected failure rates for given assets. This work includes the likely impact or consequence of failure and takes into account aspects such as the availability of equipment and the lead time required to purchase replacement equipment. This, coupled with the impact from the most credible natural events, establishes the justifiable spares levels.

The need for spares is created by the likelihood of two events in addition to average failure mode levels. These additional events are earthquakes (65% chance in the next 50 years) and storm conditions (100% chance in the next 50 years).

Earthquakes create the most significant risk to our network, since both likelihood and consequence is high and long equipment replacement times are a major consideration. We are having another look at our earthquake risk in the light of what we now know after the September 2010 and February 2011 earthquakes. These recent earthquakes have given us new data that we now need to consider. The table below shows that earthquakes dominate our asset exposure.

Primary risk for major assets

Asset	Type	Main risk
Cables	All	Earthquake
Lines	All	Storm
Switchgear	All	Earthquake
Transformers	Ground mounted	Earthquake
	Pole mounted	Lightning
	With auto tap-changer	Earthquake
	Regulator	Earthquake

Possible causes of contaminant discharge and their relative risks

	Risk of discharge of contaminant – (low, moderate, high)										
	Transformer oil spill				Inside/ outside OCB oil	PCB capacitor leak	Holding tank spill	Transport accident	Portable tank spill	Oil filled cable leak	Battery fluid spill
Cause of discharge	Zone substn	Building substn	Pole substn	Pad or kiosk							
External/natural *1	L	L	M	L	L	L	L	L	L	L	L
Accident	L	L	M	L	L	L	L		L/M	M	L
Vandalism	L	L	L	L/M	L	L	L	L	L	L	L
Fire	L	L	L	L	L	L	L	L	L	L	L
Vehicle collision	L	L	M	L/M	L	L	L	L/M	L/M	L	L
Human error	L	L	L	L	M/H	L	M	M	M	M	L/M
Design fault	L	L	L/M	L	L	L	L	L	L	L	L
Plant failure	L	L	L	L	L/M	L	L	L	L/M	L/M	L
Probable severity of outcome *2	H	M/H	L/M	L/M	L	H *2	M/H	L/H	M/H	H	L

Note.*1 Includes discharge of contaminants occurring as a result of damage caused by earthquake, wind, snow, flood, lightning or other causes.

Note.*2 Severity of outcome with respect to contravention of the Resource Management Act.