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Dr Mark Berry
Chair
Commerce Commission
P.O. Box 2351
WELLINGTON, 6140
NEW ZEALAND

Dear Dr Berry

Invitation to comment on Yarrow and Aon reports

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to comment on:

- a report from Professor George Yarrow regarding claw-back of the costs of repairing damaged assets and foregone revenues resulting from the Canterbury earthquakes (**the Yarrow report**); and
- a report from Aon New Zealand on insurance aspects of Orion's CPP proposal (**the Aon report**).

The Yarrow and Aon reports have been commissioned by the Commission to inform its assessment of Orion's customised price-quality path (**CPP**) proposal, and in particular to inform its assessment of Orion's CPP claw-back proposal. WELL considers that the Commission's decision on Orion's CPP claw-back proposal will be critically important for confidence in the Part 4 regime. Further, this decision has significant implications for investors and their assessment of investment risk in New Zealand.

2. The Yarrow report

The Electricity Networks Association submission on the Yarrow report[1] (**the ENA submission**) expresses concern that the Commission is re-visiting the issue of clawback when the issue was settled in the development of the input methodologies (**IMs**). The ENA report clearly demonstrates that:

- The IMs provide certainty that a supplier can recover the prudent costs of supplying regulated services, including rectifying for catastrophic events;
- The claw-back provision under s53V(2)(b) of the Commerce Act may be applied in response to a catastrophic event to allow for recovery of prudent additional costs incurred in responding to the event prior to the CPP taking effect; and
- The IM WACC does not provide compensation the risk of a catastrophic event.

[1] Electricity Networks Association, Submission on the Yarrow Report in Relation to Orion's CPP Application, 26 June 2013.

The ENA submission concludes that the purpose of part 4 of the Commerce Act is not able to be achieved under the existing DPP or CPP without the application of claw-back for Orion. If the Commission wishes to re-visit the way in which catastrophic risk and regulatory delay is handled in the future, under a DPP or a CPP, it should initiate a review of the relevant IMs but any change should not apply to Orion's application.

WELL fully supports the ENA submission which is consistent with the points WELL made in its previous submission on Orion's CPP proposal.[2]

If the Commission prefers to take a different approach in the future and alter the current balance between ex-ante and ex-post recovery, it must consult with EDB's first. It is vitally important that any adjustment to the 'rules' are carefully considered so that EDB's can consult on the interpretation and impact a change will have on businesses and the position (commercial and financial) each has taken to prepare, respond and recover for a major event. If businesses are allocated a larger share of the risk then they should be compensated for taking on a higher level of exposure. This should be clearly supported through the prices paid by the ultimate beneficiary, the consumer, to ensure the purpose of Part 4 and the concept of a price / quality trade-off is maintained.

One way the Commission could review a change in the allocation of risk between customers and shareholders, would be to revisit the WACC calculation. The Commission must take into account that a tremendous amount of infrastructure investment is likely to be required in the near future, both in New Zealand and internationally, all of which will be competing for a limited pool of capital.. The decision to invest is based on returns and risk appetite as for example seen in the recent changes in coverage from insurance markets.

Reallocating natural disaster risks to investors will mean that they require a higher risk premium to invest in New Zealand compared with other countries. With uncertainty around claw-back, businesses operating in Canterbury, Wellington and Hawkes Bay will need to reassess whether current risk premiums are appropriately priced should they be required to carry the burden of the cost for post-event recovery.

Additionally, Orion has shown that preventative investment can form part of an efficient solution. The $6m spent by Orion on seismic strengthening over the 15 years prior to the earthquakes proved invaluable in preventing more extensive damage to the network and ensured that electricity supply was able to be restored more quickly. The resilience of Orion's network prior to the earthquake avoided even greater social and economic impacts on the Canterbury community. This provides further evidence that Orion's management of seismic risk was prudent.

3. The Aon report

The Aon report clearly identifies the prohibitive cost of insuring overhead and underground transmission and distribution assets. The premium costs of up to 10% of the loss limit and the level of deductibles show that it is simply uneconomic for consumers and businesses to consider this level of insurance cover. It should be noted that it remains unclear what impact earthquake risk will have on the premium costs quoted in the Aon report. It is not unreasonable to assume that this could result in higher costs again.

Any re-allocation of risk between customers and EDB's will result in a re-assessment of the optimal level of insurance cover the businesses require and will result in an increase in insurance cover. If the allocation of risk (and reward) causes any doubt, WELL will be left

[2] WELL, Letter to the Commerce Commission on Orion's CPP proposal, 24 May 2013.

with no choice but to seek insurance cover for as much of its network assets as possible and require an allowance for any remaining self insured portion (including the significant deductible portion). The subsequent massive increase in insurance costs will be borne by customers and as the Aon report highlights, the cost requires a catastrophe to occur once every 10 years to justify the cost. Based on the likely premium cost, WELL's insurance premiums will increase by an extraordinary magnitude. An initial estimate is that the increase could be in excess of fifty times the current premium.

It should also be noted that insurance on its own will not help restore power to customers post a catastrophic event. Preventative investment in network resilience will assist in quicker power restoration and can assist in reducing insurance costs. Preventative investment can help preserve the functioning of key equipment (long lead-time assets) to be available for restoring power more quickly and reduce the subsequent cost. There should be a simple recovery mechanism for this expenditure under the DPP framework.

4. Closing

WELL would welcome the opportunity to discuss with the Commission any of the matters raised in this submission. Please do not hesitate to contact Megan Willcox, Senior Analyst Regulation, on (04) 915 6126 or mwillcox@welectricity.co.nz if you have any questions.

Yours sincerely

G Skelton

Greg Skelton
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