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20 September 2013

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

Dear Dr Berry,

DRAFT DECISION ON ORION'S CPP PROPOSAL

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to comment on the Commerce Commission's (**Commission**) Draft Decision on "*Setting the 2014-2019 customised price-quality path for Orion New Zealand Limited*" (**Draft Decision**) published on 14August 2013.

It is important that the Commission acknowledge that the Default/Customised price-quality path regime is a complimentary arrangement. The costs of catastrophic events must either be recovered ex ante through risk mitigation allowances or ex post through cost recovery. Failure to allow for ex ante cost recovery under the Default Price-quality Path (**DPP**) or ex post cost recovery under the Customised Price-quality Path (**CPP**) would result in Electricity Distribution Businesses (**EDB**) being expected to incur the costs of risk mitigation without any compensation. Such an arrangement is contrary to the purpose of Part 4 of the *Commerce Act 1986* to incentivise efficient investment.

The Commission's final decision on Orion New Zealand Limited's (**Orion**) CPP will set the precedent for other EDBs that face catastrophic risk and will therefore have immediate consequences for the risks faced by shareholders of other EDBs and for the target level of network resilience.

WELL's submission covers the following matters:

- Section 2 - Claw-back of costs incurred before a CPP determination takes effect;
- Section 3 - Recovery of uninsurable assets; and
- Section 4 - Expenditure for restoring the resilience of the network.

WELL supports the submission made by the Electricity Networks Association.

2. Claw-back of costs incurred before a CPP determination takes effect

Post-quake restoration costs

WELL supports the Commission's Draft Decision to allow Orion to claw-back the costs incurred in restoring the network following the earthquake. WELL also agrees that an *ex post* review of the prudency of costs incurred would be inappropriate in catastrophic event circumstances.

It is important that EDBs, investors and consumers have a high degree of certainty that the Commission will allow the claw-back of costs incurred during the response period. Responding to a catastrophic event requires urgent high quality decisions that are focused on restoring power to consumers as safely and efficiently as possible. There should be no perceived or real impediments to this occurring because of regulatory uncertainty. Furthermore the regulatory regime is premised on EDBs being compensated for the expenditure required to operate and maintain the network. If this were not the case then investment (including disaster recovery) in electricity networks will be significantly undermined and the purpose of Part 4 of the *Commerce Act 1986* (**Act**) will not be achieved.

Recovery of lost revenue

Significant demand-side reduction following a catastrophic event cannot be compared with the business as usual demand-side risk that EDBs face under a price-cap regime. Residents in Canterbury did not reduce demand in response to high prices or alternative energy solutions; demand was simply unable to be fulfilled due to the extent of damage. Demand-side risk resulting from catastrophic events is asymmetric and cannot be diversified away through alternative investments. There are no equivalent offsetting investments. Insurance is the only ex ante option for managing revenue losses associated with reduced demand following catastrophic events. Therefore, if the Commission's final decision does not allow Orion to recover lost revenue on an ex post basis then it will be essential that the Commission include an ex ante allowance in the DPP to enable EDBs to recover the cost of insuring against the risk of significant revenue losses following catastrophic events.

Notwithstanding, WELL considers that over the long term customers would pay substantially more if EDB's are required to insure against such losses instead of receiving ex post recovery. WELL's insurers have indicated that annual insurance premiums for this type of business interruption cover are likely to be in the order of 10% of the insured limit. Orion has sought to recover $43 million for lost revenue over a three year period. Given the expected frequency of catastrophic events, a 'one-off' ex post clawback would be more cost effective for customers than an annual insurance cost.

The DPP and CPP are two parts of one regime and therefore the Commission must decide which mechanism it considers the most appropriate to provide cost recovery, an ex ante allowance through the DPP or ex post recovery through the CPP. If neither is provided then EDBs are expected to take on a risk that has not been compensated for. This would discourage investment in electricity distribution in New Zealand and would be contrary to the purpose of Part 4 of the *Commerce Act 1986.*

Furthermore, WELL strongly disagrees with the Commission's statement in the Draft Decision that the WACC contains some element of catastrophic risk. This is inconsistent with the Commission's position in the reasons paper for the Final IM Determination, where the Commission explicitly stated that the WACC does not account for type 1 (i.e., catastrophic risk).

3. Recovery of uninsurable assets

WELL supports the Commission's Draft Decision to allow Orion to retain the value of damaged assets in the Regulatory Asset Base (**RAB**) until the end of the life of those assets. It is important that the CPP mechanism enable Orion to recover the cost of uninsured lost assets. It would be uneconomic for EDBs to hold insurance for core network assets, such as overhead lines and underground cables and the insurance premiums (or self-insurance allowances) for these assets would result in consumers paying significantly higher lines charges ex ante. If the CPP mechanism did not provide an assurance that uninsurable assets would be retained in the RAB then the DPP would need to include an allowance for the recovery of the risk premium associated with "self-insuring".

4. Expenditure for restoring the resilience of the network

The benefits of improving the resilience of electricity networks, particularly those in high earthquake prone areas, should not be understated. Network resilience is important for reducing the potential damage to the network that could occur as a result of future catastrophic events. Investment in improved network resilience can enable faster restoration of power supplies and thereby substantially mitigate the risk of significant economic and social damage if a sizeable earthquake occurs in the future.

WELL is surprised and concerned by the Commission's Draft Decision to remove the costs of restoring the resilience of the network from Orion's capex allowance. WELL considers that customers in the Canterbury region have given their support for Orion to undertake resilience capex during the 2014 to 2019 period. The Commission's consultation did not reach as broad a customer base as Orion's consultation and the Commission did not consult on a specific alternative. Furthermore, Orion has a unique opportunity to re-build the network to a high level of resilience in one go, this is likely to be more cost effective in the long term, compared with undertaking a series of ad-hoc resilience improvements to various parts of the network at different points in time in the future.

WELL considers that the Commission has not provided adequate economic or engineering justification for rejecting Orion's proposed resilience capex which is more economically efficient and in the long term interests of consumers compared to the Commission's Draft Decision.

It is important that Orion and other electricity networks in New Zealand learn and adapt from Orion's experience. The Commission should enable Orion to recover sufficient revenue to enable it to restore the Canterbury network to the levels planned prior to the earthquake as endorsed by Orion's customers. Furthermore, the Commission should enable other EDBs, particularly those in earthquake prone areas, to be able to recover the costs of improving the resilience of their network under the DPP, subject to stakeholder consultation.

5. 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 faithfully

Greg Skelton
CHIEF EXECUTIVE OFFICER