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Keston Ruxton
Manager, IM Review
Regulation Branch
Commerce Commission
Wellington

by email: im.review@comcom.govt.nz

SUBMISSION ON EMERGING VIEWS ON FORM OF CONTROL AND COST OF CAPITAL

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the Commerce Commission's (the **Commission**) consultation paper "Input methodologies review, Emerging views on form of control" (the **Form of Control Paper**) and the expert report by Dr Martin Lally, "Review of WACC Issues" (the **WACC Report**). It also comments where necessary on the "Input methodologies review, Process update paper" (the **Process Paper**). All of these consultation papers were released on 29 February 2016.

2 We have reviewed and support the submission by the Electricity Networks Association (the **ENA**) on these consultation papers.

Summary of submission

3 We agree with Dr Lally that Black's 'simple discount rule' would be prohibitively difficult to implement in practice. We also agree that there is no empirical evidence of a difference in beta between firms subject to price caps and revenue caps.

4 We support a pure revenue cap for EDBs from the next reset. We expect that a pure revenue cap would be implemented in such a way that the effect of revenue shocks during a regulatory period would be washed up in subsequent years if necessary and provide the affected EDBs with greater certainty than the current methodology.

5 We support an incentive to carry out new connections that were not forecast when the price path was set. Otherwise EDBs would not be able to recover the costs of supplying unexpected connection growth.

- 6 We are unsure what the Commission means by an “incentive on suppliers to plan for catastrophic events”. We have made such investments for many years as part of the normal course of our business, and we do not think that any changes to the form of control will affect our decisions to plan and invest for catastrophic events. Investment for network resilience should continue to be able to be recovered in the same way as other expenditure.

Cost of capital

- 7 Dr Lally’s expert view, as stated in the WACC Report, is that there is very likely a difference in beta between firms subject to price caps and revenue caps, although of an unknown magnitude, as a result of additional sources of risk in price cap frameworks. However, his view is also that there is no empirical study that provides a clear conclusion of the magnitude of this effect.
- 8 We agree that there is no empirical evidence to support a conclusion that there is a difference in beta between firms subject to price caps and revenue caps. Without any empirical evidence, we therefore remain unconvinced regarding Dr Lally’s view that there is very likely a difference in beta between these firms.
- 9 As we stated in our previous submission on WACC, we consider that it has not been demonstrated that that an adjustment should be made to the average beta of the Commission’s current sample comparator firms.
- 10 We also agree with Dr Lally’s view that Black’s ‘simple discount rule’ would be prohibitively difficult to implement in practice. This approach has never been used in a regulatory setting, and it is difficult to see how it could be robust.
- 11 We therefore consider that there should be no change to the method for estimating asset beta, if the form of control is changed to a revenue cap. We also consider that Black’s simple discount rule should not be used to an element of the cost of capital or wider price-setting framework.

Timing of next Lally report

- 12 We found it useful to review the WACC Report at this stage in the process and provide feedback to the Commission on it in advance of the draft decision. We note from the Process Paper that Dr Lally’s next expert advice (on the cost of debt, RAB indexation and inflation risk) will be released in May 2016. We would like to be able to read and comment on this advice before the draft decision, which on the Commission’s current timetable will not be possible. We ask the Commission to consider releasing this paper early so stakeholders can submit on it before the draft decision is published.

Form of control

Asset beta implications of the form of control

- 13 In the Form of Control Paper the Commission states:¹

Our emerging view... is to implement a pure revenue cap for EDBs.

Our reasons supporting our current view are that:

it removes the quantity forecasting risk;

it removes potential disincentives for suppliers to restructure tariffs; and

it removes any potential disincentive on suppliers to pursue energy efficiency and DSM initiatives.

- 14 Based on the WACC Report and the Commission's emerging view that a change in the form of control will not lead to a change in the regulatory WACC (discussed above), Orion supports a pure revenue cap being applied to EDBs from the next reset. We agree that the benefits identified by the Commission would be delivered by a pure revenue cap.
- 15 We also note the Commission's conclusion that the benefits of resolving the "quantity forecasting risk" (i.e. the risk the Commission's demand forecasts will be inaccurate) outweigh any concerns that moving to a pure revenue cap will shift the "demand uncertainty risk" (the inherent uncertainty in future demand for services) towards consumers.²
- 16 We interpret this to mean that under a pure revenue cap any revenue shocks (such as those caused by catastrophic events) on a network would be accommodated such that revenue surpluses or shortfalls would be washed up in subsequent years. We believe this would be appropriate.

Additional mechanisms to support a revenue cap

- 17 The Form of Control Paper also discusses potential disadvantages of revenue caps and mechanisms that could resolve those issues:³

We could include a smoothing mechanism to minimise the intra-period average price volatility, and include a mechanism to limit the ability to flow under recovery into future investment periods.

¹ Form of Control Paper, paragraphs 23 and 24.

² Form of Control Paper, paragraph 28.

³ Form of Control Paper, paragraph 30.

We could implement an incentive for connections service. This could be similar to the connections incentive scheme that has been implemented in the UK

We could introduce an incentive on suppliers to plan for catastrophic events.

- 18 Some of these suggestions imply that what the Commission is proposing to implement is not a pure revenue cap. If we are not able to carry over under-recoveries into subsequent regulatory periods then we will not be earning our full allowable revenues. That is not consistent with a pure revenue cap.⁴
- 19 In principle we are comfortable with mechanisms to smooth price shocks for consumers, although we would need to understand how these mechanisms would work before reaching a final view.
- 20 As the Commission has identified, one issue associated with revenue caps is that unexpected growth or new large connections on a network can be problematic. This is because the costs of these connections will not have been provided for in the expenditure forecasts used to set the price path. We support a mechanism that gives us an incentive to carry out new connections even when those costs were not included in the price path forecasts. This would be in the long-term interest of consumers as it would promote new connections and ensure cost recovery.
- 21 We are unsure what the Commission means by an “incentive on suppliers to plan for catastrophic events”. As outlined in our CPP application, Orion had invested in network resilience and related projects since at least 1990. We did this because we are a responsible network services provider, not due to any particular incentive. These investments were made across several changes to regulatory regimes. We acknowledge that it is critical for distributors to plan appropriately for catastrophic events. However we do not think that changes to the form of control are likely to materially affect our decisions to plan and invest for catastrophic events.
- 22 Further, as any expenditure in relation to planning for catastrophic events would be recovered in the same way as other expenditure, there are already sufficient incentives within the regulatory regime to make such investments. In addition, we have strong incentives from our customers, our shareholders and our status as a good corporate citizen to plan for catastrophic events.
- 23 We are also concerned that any incentive in this area may undermine the effect of a pure revenue cap if it prevents the recovery of costs associated with responding to a catastrophic event.

⁴ However, if the intention is simply to set revenue cap balances to zero when EDBs consistently choose to earn less than their MAR (as some community-owned EDBs choose to do) then we would accept that provided the mechanism could only be applied in such circumstances.

Concluding remarks

- 24 Thank you for the opportunity to make this submission. We do not consider that any part of this submission is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Rob Jamieson', written in a cursive style.

Rob Jamieson
Chief Executive