

5 June 2013

Orion's customised price-quality path proposal: Release of expert reports for public consultation

Purpose

1. We invite submissions on two expert reports we have commissioned to inform our assessment of Orion's customised price-quality path (CPP) proposal. These two expert reports are:
 - 1.1 a report from Professor George Yarrow regarding claw-back of the costs of repairing damaged assets and foregone revenues resulting from the Canterbury earthquakes;¹ and
 - 1.2 a report from Aon New Zealand on insurance aspects of Orion's CPP proposal.²
2. The expert reports from Professor Yarrow and Aon New Zealand can be found on our website at www.comcom.govt.nz/orion-cpp.³ The terms of reference for these expert reports are included as Attachment 1 and Attachment 2 of this document.

Our expert reports respond to issues raised by Orion's advisors

3. The reports from Professor Yarrow and Aon New Zealand address issues related to claw-back and allocation of risk in relation to catastrophic events, which were included with the CPP proposal. Orion's CPP proposal included the following reports from Orion's experts on these issues:
 - 3.1 PricewaterhouseCoopers (PwC) prepared a report regarding the long-term incidence of cost recovery following a catastrophic event;⁴
 - 3.2 NERA Economic Consulting peer reviewed the PwC report on cost recovery following a catastrophic event;⁵ and

¹ Professor George Yarrow, *The Orion CPP determination*, 30 May 2013.

² Aon New Zealand, *Commerce Commission Orion CPP proposal – Insurance review: Aon expert opinion*, May 2013.

³ Orion's proposal, including additional information provided by Orion at our request after submission of the proposal, can also be found on this page of our website.

⁴ PwC, *Long-term incidence of cost recovery following a catastrophic event*, 17 December 2012. See Appendix 1 of Orion's CPP proposal.

⁵ NERA, *Peer review of PwC report on cost recovery following a catastrophic event*, 6 February 2013. See Appendix 2 of Orion's CPP proposal.

- 3.3 Marsh Limited prepared a report regarding Orion's network catastrophe insurance.⁶
4. Copies of Orion's expert reports are also available on the Orion CPP page of our website (www.comcom.govt.nz/orion-cpp).
 5. We sought advice from Professor Yarrow on claw-back and the allocation of risk between consumers and Orion (and its shareholder) under the Part 4 regulatory regime. The Aon New Zealand report is a peer review of the recommendations contained in the report prepared for Orion by Marsh Limited.
 6. These reports were requested in advance of the receipt of submissions on the Commission's Issues Paper, and therefore do not take into consideration any submissions that have been provided by parties.

We want to hear and consider your views

7. We are releasing the expert reports from Professor Yarrow and Aon New Zealand now to allow you to provide your views before we reach our draft decision. We will take into account any submissions that are received on these reports when forming our views on maximum average prices and required quality standards for Orion.
8. Submissions on the expert reports from Professor Yarrow and Aon New Zealand are due by **5pm on Thursday 27 June 2013**.
9. Please email your submission to regulation.branch@comcom.govt.nz, with 'Orion CPP proposal' in the subject line of your email. All submissions will be published on our website.

You will also have an opportunity to provide submissions after we issue our draft decision

10. We will release our draft decision after we have completed our evaluation of Orion's proposal and we have reviewed submissions on these expert reports. You will have an opportunity to submit on our draft decision after that time. We currently expect to issue our draft decision on 9 August 2013 and propose allowing six weeks to submit on our draft decision.

Please contact us with any questions

11. Please contact John Groot, Orion CPP Project Manager, if you have any questions.

Email: regulation.branch@comcom.govt.nz, attention: John Groot

Phone: (04) 924 3671

⁶ Marsh Limited, *Orion's network catastrophe insurance*, 8 October 2012. See Appendix 11 of Orion's CPP proposal.

Attachment 1: Terms of reference for Professor Yarrow's report

The terms of reference for the expert report from Professor George Yarrow are set out below.

“Focus of your advice

- A1. Your advice should be focussed on the three main questions set out below.
- A1.1 In principle, would businesses or consumers bear the costs (and risks) of a catastrophic event, such as an earthquake, in a workably competitive market characterised by long-lived specialised assets?
- A1.2 Taking into account specific features of the New Zealand regulatory regime, should Orion be allowed to claw-back: (i) the costs associated with repairing and replacing assets that were damaged by the earthquakes; and (ii) foregone revenues resulting from decreased electricity consumption after the earthquakes?
- A1.3 If, in your view, claw-back should be applied, how should recovery of the costs of the earthquakes be allocated between consumers and Orion's shareholders?

Relevant issues when preparing your advice

- A2. Your advice should consider whether allowing claw-back is consistent with the Part 4 purpose set out in section 52A of the Act. Section 52A(1) states:

52A Purpose of Part

- (1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
- (d) are limited in their ability to extract excessive profits.
- A3. You should also consider the following questions when forming your view on whether allowing claw-back is consistent with section 52A(1), and the extent of any such claw-back.
- A3.1 What role does insurance (and self-insurance) play in determining whether claw-back should be applied?

- A3.2 To what extent should regulated suppliers be exposed to demand risk associated with catastrophic events?
- A3.3 Should the costs of repairing and/or replacing damaged assets and foregone revenues be treated separately when considering claw-back?
- A3.4 Are investors already compensated for the risks of catastrophic events through the market risk premium and debt premium in WACC?
- A3.4.1 Given that investors diversify widely, to what extent do they require compensation for (i) additional costs incurred; and (ii) revenues foregone due to lower electricity volumes; as a result of Orion's exposure to a catastrophic event?
- A3.4.2 Given the Commission's long-standing use of an estimate of WACC which is above the mid-point (to ensure there are incentives to invest given the uncertainty of estimating the true WACC and to reflect the asymmetric consequences of underinvestment) to what extent is there a need to compensate explicitly for the costs attributable to catastrophic events?
- A3.5 What influence (if any) should specific features of the New Zealand regulatory regime have on the decision regarding claw-back for Orion? For example:
- A3.5.1 the interplay between the DPP and CPP;
- A3.5.2 the transitional nature of the regime;⁷ and
- A3.5.3 other circumstances in which claw-back has been applied.
- A3.6 Is the form of ownership of Orion relevant to whether claw-back should be applied?⁸
- A3.7 How might the decision on claw-back for Orion affect future incentives for *all* regulated suppliers subject to price-quality regulation, having regard to the factors listed in section 52A(1)(a)-(d)?
- A3.8 Given the statutory purpose in New Zealand and the factual circumstances regarding Orion, are you aware of any obvious examples of how similar catastrophic events been addressed in other jurisdictions? If so, what lessons do these examples provide (if any) in the context of Orion's claw-back proposal?

⁷ The Orion CPP determination will set the first input methodologies compliant price-quality path that Orion will be subject to. Orion's current price path was not set to reflect forecast efficient costs and would have been reset along with others regulated suppliers subject to a DPP, but Orion was excluded from the initial DPP.

⁸ Orion is owned by a holding company of the Christchurch City Council (89.275%) and Selwyn District Council (SDC) (10.725%).

- A4. Your advice should also consider, and respond to, any additional relevant issues raised in expert reports on claw-back prepared for Orion. To date, Orion has commissioned three expert reports which are relevant to claw-back:
- A4.1 PricewaterhouseCoopers (PwC) prepared a report regarding the long-term incidence of cost recovery following a catastrophic event;⁹
 - A4.2 NERA Economic Consulting peer reviewed the PwC report on cost recovery following a catastrophic event,¹⁰ and
 - A4.3 Marsh Limited prepared a report regarding Orion's network catastrophe insurance.¹¹

⁹ PwC, *Long-term incidence of cost recovery following a catastrophic event*, 17 December 2012.

¹⁰ NERA, *Peer review of PwC report on cost recovery following a catastrophic event*, 6 February 2013.

¹¹ Marsh Limited, *Orion's network catastrophe insurance*, 8 October 2012.

Attachment 2: Terms of reference for Aon New Zealand's report

The terms of reference for the expert report from Aon New Zealand are set out below.

- “B1. Peer review of the analysis and conclusions in the Marsh report in Appendix 11 of the Orion CPP proposal;
- B2. Comment on whether the conclusions reached by Marsh and Orion regarding insurance coverage, policy excesses, and pricing (both material damage to network assets and business interruption cover) can be directly linked to earthquakes as being the dominant driver;
- B3. If not the dominant driver, comment on the estimated extent to which earthquake risk is likely to be affecting the conclusions of Marsh and Orion on the availability and pricing of material damage and business interruption cover;
- B4. Comment on the types of reasonable earthquake-mitigating actions Aon would have expected Orion to have taken from an insurance point of view pre-earthquakes in the absence of available coverage for network material damage and for business interruption on commercially-reasonable terms, including taking into account the knowledge of the risks inherent in Orion's participation in the Christchurch Engineering Lifelines Group;
- B5. With the benefit of the information now available after the earthquakes, comment on the types of future mitigating actions Aon would expect Orion to take from an insurance point of view in the absence of available coverage for network material damage and for business interruption on commercially-reasonable terms;
- B6. Comment on whether in the case of Orion's circumstances it would be possible to calculate hypothetical self-insurance covers, excesses and self-insurance premiums for network material damage cover and for business interruption cover in the absence of commercially-available insurance coverage on commercially-reasonable terms relating to cover, excesses and pricing.”