Attachment G Financeability

Purpose of the attachment

G1 This attachment explains the rationale for decisions related to financeability. It also provides background analysis to those decisions and responds to stakeholder submissions on this topic area.

G2 This attachment focuses on our use of a financeability 'sense check' including details of our methodology. We refer to this as a sense check or assessment. It is a decision support tool, not a financeability test as applied in some other jurisdictions with prescribed responses in the event of 'failing' the test.

G3 The results of this sense check have informed decisions related to revenue-setting discussed in **Attachment F**.

Financeability at the DPP4 reset

G4 We proposed our approach to considering financeability at the DPP4 reset in the DPP4 Financeability issues paper, published 22 February 2024.[1] That paper was published after the overall DPP4 Issues paper[2] so that it could incorporate aspects of the final decisions from the 2023 IM Review published December 2024.[3,4]

G5 Unlike some other jurisdictions, New Zealand's Part 4 regime does not set any express statutory duty or direction requiring the Commission to consider financeability in our decision making. We may take financeability into account where relevant to our decisions, but only to the extent doing so would assist in promoting the Part 4 purpose.

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1 Commerce Commission "DPP4 reset – Financeability of electricity distribution services in the default price-quality path – Issues paper" (22 February 2024)

2 Commerce Commission "Default price-quality paths for electricity distribution businesses from 1 April 2025 – Issues paper" (2 November 2023)

3 Commerce Commission "Report on the IM Review 2023: Part 4 Input Methodologies Review 2023 – Final decision" (13 December 2023)

4 Relevant IM decisions included not to adopt a financeability test in the IMs. They also included changes to revenue setting likely beneficial to EDBs, including treatment of CPI in the revenue path, minimising delays in cashflow through wash-ups where inflation is higher than forecast; increasing EDB's flexibility to make early drawdowns of any accrued wash-up balances; reclassifying transmission-related charges to pass-through costs, so their recovery is not deferred for revenue smoothing purposes; and greater flexibility in how the 'revenue smoothing limit' within a DPP is specified. See our DPP4 Financeability issues paper (reference 1 in this Attachment) above for discussion.

G6 In the DPP4 Financeability issues paper we acknowledged the financeability context for DPP4, and that we are alive to financeability issues associated with the regulated profile of cashflows in the DPP4 reset. Equally, we were clear that financing significant new capacity and new investment is the responsibility of regulated businesses through normal, efficient capital raising and management.

G7 Our decisions under Part 4 are intended to provide the expectation of a normal return for investors, and it is primarily the responsibility of the supplier to manage timing differences between revenues and costs and to finance new investment. Within this approach there are certain conditions where the timing of cash flows, and the impact of that on financeability, may be relevant to the promotion of the Part 4 purpose.

G8 As discussed in **Attachment F**, we have applied notional financeability sense checks, the results of which have informed our choices about what best promotes the Part 4 purpose when making revenue path decisions related to cash flow timing.

Submissions on the Financeability issues paper informed our approach

G9 Financeability has been a very high-interest topic for some stakeholders, especially prior to the draft DPP4 decisions. We received 12 submissions on the DPP4 Financeability issues paper from a range of stakeholders including a report from Oxera prepared for the 'Big Six' EDBs. [5] We received cross submissions from four parties.

G10 At a high level, submissions focussed on three themes:

G10.1 Support for a notional financeability sense check, with calls for more details to increase certainty on how financeability would be assessed for DPP4;

G10.2 Concerns that smoothing DPP4 revenue paths would result in revenue deferrals of significant amounts with strong, adverse short-term impact on cashflows; and

[5] Oxera "Response to the New Zealand Commerce Commission consultation on the financeability of electricity distribution services in the fourth default price-quality path (DPP4)" report prepared for the 'Big Six' EDBs (15 March 2024)

G10.3 Longer term concerns about financeability and investability with respect to high investment needs (through and after DPP4) to support an electrification transition.

G11 The development of our approach to financeability for the DPP4 reset has been informed by these submissions and cross submissions. We refer to them below where relevant to our decisions.

G12 Our approach has also been informed by reports previously submitted in the IM Review process in 2023. In particular the report by NERA Economic Consulting for ENA has been valuable in informing the details of our financeability sense check.[6]

G13 In keeping with the low-cost nature of the DPP regime, we have sought to appropriately size our approach to financeability assessments to the likely size and prevalence of financeability issues for DPP4.

Submissions supported our draft decisions on financeability for DPP4

G14 There were seven submissions on our draft DPP4 decisions with comments on our draft financeability sense check. Alpine Energy, Entrust, ENA, Powerco, PowerNet, Vector and Wellington Electricity all expressed support for our draft approach. [7]

G15 ENA, Vector and Wellington Electricity provided the most substantive feedback. ENA supported the use and form of our draft approach to financeability: [8]

> ENA is encouraged to see that the Commission has listened and has proposed to implement a financeability sense check that is practical, transparent and uses credit metrics that rating agencies apply across the globe.
>
> The use of outputs from the DPP4 financial model and the BBB+ credit rating for the sense check is supported by ENA.

G16 ENA went on to say that “the draft DPP4 decision largely ameliorates EDB concerns over the changes' impact on cashflows and financeability.”[9]

[6] NERA “Financeability considerations under the DPP: Appendix D -Submission on IM Review CEPA report on cost of capital” prepared for Electricity Networks Association (16 January 2023)

[7] Submissions by Alpine Energy, Entrust, ENA, Powerco, PowerNet, Vector and Wellington Electricity on the Commerce Commission “EDB DPP4 draft decision" (12 July 2024).

[8] Electricity Networks Aotearoa (ENA) “Submission on EDB DPP4 draft decisions” (12 July 2024), p. 6.

[9] Electricity Networks Aotearoa (ENA) “Submission on EDB DPP4 draft decisions” (12 July 2024), p. 8.

G17 Vector supported the draft approach: [10]

> In terms of the Commission's approach to the financeability "sense check" we support the Commission's approach of using a notional firm based on Standard & Poor's ratios.

G18 Vector also called for a financeability test to be included in the IMs, considered that an allowance for equity issuance costs should also have been included in the test, and recommended that the Commission reapply, as a matter of course, the financeability sense check when considering re-opener applications. [11]

G19 The decision not to include a financability test at the recent IM Review, is discussed in our financability issues paper, along with other decisions about the IMs that may be relevant to financeability.[12]

G20 Vector noted concerns around the price path impacts of potential changes to capital contributions arising from the Electricity Authority's open work on distribution connection pricing reform.[13] Vector submitted that the Commission "re-considers the financeability sense check for the amended price path"[14]

G21 The Commission is keeping abreast of the Authority's work on this topic and may consider the impacts of any of their decisions on the DPP4 reset once they are published. We discuss this more below, near the end of this Attachment.

G22 Wellington Electricity supported our approach: [15]

> We support and commend the Commission for developing a financeability check. Coupled with the starting position of setting prices with the expectation that an EDB will recover all of the revenue within a regulatory period, it will help ensure a network's debt costs are aligned with WACC's cost of debt.
>
> We also support the financeability check itself. We think it is practical and transparent, and should correctly capture whether regulatory cashflows will support a BBB+ credit rating.

[10] Vector "Submission on EDB DPP4 draft decisions" (12 July 2024), p. 6.

[11] Vector "Submission on EDB DPP4 draft decisions" (12 July 2024), p. 3.

[12] Commerce Commission "DPP4 reset – Financeability of electricity distribution services in the default price-quality path – Issues paper" (22 February 2024), p. 10.

[13] Electricity Authority webpage, https://www.ea.govt.nz/projects/all/distribution-connection-pricing-reform/

[14] Vector "Submission on EDB DPP4 draft decisions" (12 July 2024) p. 6.

[15] Wellington Electricity "Submission on EDB DPP4 draft decisions" (12 July 2024), p. 49.

G23 Wellington Electricity also acknowledged our approach as a sense check rather than a test:[16]

> We understand that it's a sense check rather than a test, such as those applied in other judications. While we would have preferred a 'test' because it provides more confidence that the price path will support a network's debt funding. The transparency provided with the Draft Decision will quickly highlight financeability issues that can then be raised with the Commission (assuming the Commission hasn't already addressed them).

G24 Our consideration of financeability was also acknowledged by Aurora and Unison. Aurora "appreciate[d] the Commission's progress in addressing the issue of financeability and we think the sense check is a step in the right direction."[17] While Unison noted the "financeability 'sense check' confirms the importance of restoring EDBs' cashflows in DPP4, particularly in the first few years."[18]

Financeability outlook and DPP4 final decisions

G25 In our DPP4 final decisions, we have made no changes to our approach to financeability from our draft decisions.

G26 We have applied our notional financeability sense check before and during the setting of staring price adjustments and alternate X factors to derive final DPP4 revenue paths. Financeability results on the DPP4 revenue path (after starting price adjustments and alternate X-factors have been applied) include the effects of the final DPP4 WACC and cost of debt which are lower than their values in the draft decisions, as well as updated financial model outputs. They do not indicate a widespread financeability problem for DPP4.

G27 The overall financeability outlook for DPP4 has benefitted from several aspects of our regulatory regime and the consequence of changes in economic conditions under it:

G27.1 the increase in WACC to 7.10% from 4.57% in DPP3;

[16] Wellington Electricity "Submission on EDB DPP4 draft decisions" (12 July 2024) , p. 49.

[17] Aurora Energy "Submission on EDB DPP4 draft decisions" (12 July 2024), p. 5.

[18] Unison Networks "Submission on EDB DPP4 draft decisions" (12 July 2024), p. 20.

G27.2 the impact of inflation:

G27.2.1 inflation wash-ups on the RAB and the price paths feeding through to allowed revenues, making EDBs whole for past inflation; and

G27.2.2 decrease in forecast inflation, which means forecast RAB revaluations, when treated as income, should not have an otherwise potentially material impact on allowed revenues.

G27.3 IM changes to revenue settings, including flexibility in the way revenue smoothing limits are applied, transmission costs deemed pass-through costs and therefore not subject to such smoothing, and changes to enable faster recovery of wash-up balances.

G28 Notional financeability assessments have informed our final decisions on capping initial 'price shocks' and setting alternate X-factors for each EDB. (See **Attachment F** for more details).

Financeability sense check

Nature of the decision

G29 The key new proposal in our DPP4 Financeability issues paper was to apply a financeability 'sense check' to assist us in understanding the extent to which financeability issues may be relevant to this reset, and to inform how we might take financeability into account in our DPP4 decision making.

G30 This is the first time we have published a financeability assessment of this nature, considering all non-exempt EDBs, at a DPP reset.

G31 Submissions on the DPP4 Financeability issues paper supported a financeability sense check and called for more details to improve certainty.

G32 Submissions on the Draft DPP4 decision widely supported our proposed financeability sense checks, in particular the notional approach, the use of the existing Standard & Poor's methodology, and our choice of reference levels.

Decision P5: Assess notional financeability drawing on metrics from the S&P methodology

G33 Final **decision P5** is to apply a financeability sense check to assess notional financeability drawing on metrics form the Standard & Poor's (S&P) methodology. We focus on the core S&P ratios FFO/Debt and Debt/EBITDA[19] with reference levels consistent with a BBB+ credit rating, and also consider leverage and FFO interest cover ratio. We considered allowing a greater initial level of revenue uplift where we were satisfied that doing so would better promote the Part 4 purpose.[20]

G34 We outline below various details of this sense check. We have published the results of this sense check with our financial modelling suite for the DPP4 final decision.[21]

G35 Our financeability sense check is a support tool for decision making. This assessment is not a 'financeability test' in the sense used in some jurisdictions where there may be prescribed responses or outcomes to address the test result(s) of a supplier not meeting defined thresholds.

G36 How we considered the results of our financeability sense check in making decisions on the revenue path is discussed in **Attachment F**.

Details of our financeability sense check

G37 For the DPP4 final decision, we have retained the same financeability sense check approach and methodology as in the DPP4 draft decision, which we developed from the approach proposed in the DPP4 Financeability issues paper.[22]

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[19] FFO is funds from operations, and EBITDA is Earnings Before Interest Tax Depreciation and Amortisation. See the 'Financeability Metrics' section below for details on how these ratios are calculated in our case.

[20] As discussed in **Attachment F** in regard to alternative rates of change and revenue smoothing, we have not ultimately made any adjustments on financeability grounds.

[21] Commerce Commission "Financeability model – EDB DPP4 final determination – 20 November 2024

[22] Commerce Commission "DPP4 reset – Financeability of electricity distribution services in the default price-quality path – Issues paper" (22 February 2024)

G38 We have considered various approaches to financeability assessments and tests in other jurisdictions, including in Australia (IPART (NSW),[23] ESC (Victoria),[24] AEMC/AER for approved transmission network projects [25,26]) and the UK (Ofgem[27] and Ofwat[28]).

G39 Useful summaries and comparisons of financeability assessments across jurisdictions can be found in the IPART final report on its financeability test[29] and the NERA submission on the recent IM Review.[30]

G40 Our approach is based on the S&P Methodology[31] considered in relation to regulated electric and gas networks by NERA[32] and overviewed by IPART[33]. The use of an S&P framework, rather than one based on other ratings agencies, is supported by S&P being the rating agency most relevant to the NZ distribution businesses and was supported in submissions on the draft DPP4 decision.[34]

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[23] IPART (Independent Pricing and Regulatory Tribunal, NSW) "Review of our financeability test" (November 2018)

[24] Essential Services Commission, Victoria (ESC) "Assessing the Financial Viability of Victorian Water Businesses – Summary of Views and proposed new indicators" (June 2014)

[25] AEMC (Australian Energy Markets Commission) "National Electricity Amendment (Accommodating financeability in the regulatory framework) Rule 2024" (March 2024)

[26] Under the AEMC Rule change above, AER (Australian Energy Regulator) must develop Financeability Guidelines specifying its financeability test, but this has not been published to date.

[27] Ofgem (Office of Gas and Electricity Markets, UK) "Financeability Assessment for RIIO-2" (26 March 2019)

[28] Ofwat (Office of Water, UK) "PR19 final determination, Aligning risk and return technical appendix" (December 2019, updated 30 April 2020)

[29] IPART (Independent Pricing and Regulatory Tribunal, NSW) "Review of our financeability test" (November 2018)

[30] NERA "Financeability considerations under the DPP: Appendix D -Submission on IM Review CEPA report on cost of capital" (report prepared for Electricity Networks Association 16 January 2023)

[31] S&P Global "General: Corporate Methodology" (19 November 2013, updated 2019)

[32] NERA "Financeability considerations under the DPP: Appendix D -Submission on IM Review CEPA report on cost of capital" (report prepared for Electricity Networks Association, 16 January 2023)

[33] IPART (Independent Pricing and Regulatory Tribunal, NSW) "Review of our financeability test" (November 2018)

[34] Explicit support for use of S&P approach in submissions by Alpine Energy, Vector, ENA, Powerco and Wellington Electricity on the Commerce Commission "EDB DPP4 draft decision" (12 July 2024), supporting the use of a BBB+ credit rating to set reference levels.

G41 Within this approach we have calculated core S&P metrics and compared them against reference levels derived below from their methodology. We consider these to be 'reference levels' rather than thresholds, to again emphasize that we are applying a sense check, not a test with prescriptive responses.

G42 The key features of our final decision approach, expanded on below, are:

G42.1 a notional assessment, using notional cost of debt;

G42.2 leverage is initially the notional level and allowed to vary dynamically;

G42.3 the only actual inputs are indicative IRIS and wash-up amounts from DPP3, recovered over DPP4;

G42.4 we do not specify an allowed dividend level;

G42.5 we have assessed several S&P metrics, primarily the core ratios FFO/Debt, and Debt / EBITDA, and others including FFO interest cover ratio;

G42.6 we compare results for these metrics with reference levels indicative of a 'strong' business maintaining a bbb+ anchor credit rating, which together are consistent with an overall BBB+ issuer credit rating; and

G42.7 to inform price decisions on revenue path smoothing we have considered results of this notional financeability sense check before and after the application of starting price adjustments and alternate X-factors.

Notional analysis

G43 In our Financeability issues paper we proposed for DPP4 an approach where we would start with a notional analysis, and if a financeability issue arose under the notional analysis, we would then assess if there was in fact likely to be a financeability issue for the particular supplier.

G44 Out notional analysis is described below. We have not found it necessary to assess the actual circumstances of any suppliers in this sense for DPP4 final decisions.

G45 The notional cost of debt for DPP4 final decisions is 5.74%.

G46 Leverage is initially the notional leverage 41% and allowed to vary dynamically under our notional analysis as follows. These are intended as reasonable modelling assumptions, required to model leverage dynamically, not expectations for how EDBs would actually manage such circumstances.

G47 This approach works as follows:

G47.1 we start with a notional leverage of 41%;

G47.2 we calculate cashflow available to equity by including the additional borrowing capacity from increased RAB at a level to maintain the notional leverage;

G47.3 in years where this results in a negative cashflow available to equity, we assume additional borrowing at the level to provide zero cashflow available to equity, ie, increasing leverage above 41%; and

G47.4 in years where, as a result of the above additional borrowing, leverage is above 41% and there is a positive cashflow available to equity, then repayments are made to reduce leverage. The repayment amount is the lesser of cashflow available to equity and the amount required to restore leverage to 41%.

G48 Our one use of actual amounts is to account for revenue balances from DPP3 through indicative IRIS payments and wash-ups. We have applied both these in regulatory years 2026 and 2027, and IRIS amounts for the remainder of the period. We discuss below some cases where these balances have impacted the results of our sense checks.

No specified dividend levels

G49 Our notional assessments do not include a specified dividend yield. We do calculate cash available to equity as an output.

Financeability metrics

G50 Informed by submissions on the IM review and DPP4 Financeability issues paper, and approaches in other jurisdictions, we have evaluated various S&P ratios. The two core S&P metrics we have considered are:

G50.1 funds from operations (FFO) as a percentage of notional debt; and

G50.2 notional debt to EBITDA.[35]

[35] Earnings Before Interest Tax Depreciation and Amortisation, calculated as revenue less opex.

G51 We have also evaluated:

G51.1 FFO interest cover ratio; and

G51.2 notional leverage, based on forecast free cashflows.

G52 FFO / debt is the primary measure for S&P credit ratings, and the most common (or in some cases only) metric mentioned in ratings reports. As such, we place most weight on it.

G53 These metrics have been calculated as below, where notional Interest is notional cost of debt x notional debt, and notional debt is notional leverage x RAB:[36]

G53.1 FFO / Debt = (revenue - opex - tax - notional interest) / (notional debt)

G53.2 Debt / EBITDA = notional debt / (revenue - opex)

G53.3 FFO interest cover ratio (ICR) = (revenue - opex - tax) / (notional interest)

Reference Levels

G54 We have used reference levels for these ratios at the S&P anchor rating of bbb+ which are generally consistent with an issuer credit rating of BBB+:

G54.1 FFO / Debt > 13%;

G54.2 Debt / EBITDA < 4; and

G54.3 FFO ICR > 3.

G55 We show below how these are derived from the S&P Methodology.

G56 In the S&P methodology, the ratios above are used to determine an ‘anchor rating’ expressed in lower case, eg, bbb+. The S&P ‘issuer credit rating’ (eg, BBB+) is derived from the anchor rating by considering modifiers such as diversification, capital structure, financial policy, liquidity, management / governance, and comparable ratings analysis. Evaluating these considerations for all EDBs is beyond the scope of a DPP reset. We have made the simplifying assumption to equate financial metrics supporting a bbb+ anchor rating with an issuer credit rating of BBB+.

[36] S&P refer to FFO ICR as ‘FFO plus interest to interest’ to emphasize the numerator is not the same as in the FFO / debt ratio (otherwise these metrics would be directly proportional in a notional assessment).

G57 The S&P methodology to link the values of these ratios with anchor ratings depends on some other factors: industry and country risk volatility, business risk profile, and financial risk profile.

G58 In 2018 S&P revised upwards the regulatory framework score for New Zealand regulated utilities to 'strong', noting: [37]

> Due to recent regulatory decisions and a consistent track record of regulatory resets, the New Zealand regulatory landscape for the country's electricity and gas networks is now more mature, predictable, and strong, as well as being stable and transparent.
>
> As a result, we are now assigning a higher regulatory advantage score of strong for New Zealand regulated utilities from strong/adequate, the most important factor in assessing a utility's competitive advantage.
>
> With this improved regulatory score, entities can operate with a somewhat lower threshold of financial metrics for a given rating, all else being equal.
>
> We are affirming the ratings on three New Zealand regulated utilities: Transpower New Zealand, Powerco, and Vector Ltd. The rating outlooks remain stable.

G59 Based on this and the IM Review submission on this topic from NERA,[38] who applied a 'low' volatility, we have used 'low' volatility rating and 'strong' business risk profile.

G60 As in Table G1 below, for a business with a 'strong' business risk profile to achieve a bbb+ anchor rating its financial risk profile should lie above the boundary between 3(Intermediate) and 4(Significant):

[37] S&P Global, "Regulatory framework score for New Zealand regulated utilities revised to strong" (22 April 2018) (online access with free registration confirmed October 2024).

[38] NERA "Financeability considerations under the DPP: Appendix D -Submission on IM Review CEPA report on cost of capital" (prepared for Electricity Networks Association, 16 January 2023).

Table G1 S&P Methodology anchor table: combining the business and financial risk profiles to determine the anchor[39]

Business risk profile	--Financial risk profile-- 1 (minimal)	2 (modest)	3 (intermediate)	4 (significant)	5 (aggressive)	6 (highly leveraged)
1 (excellent)	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
2 (strong)	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
3 (satisfactory)	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
4 (fair)	bbb/bbb-	bbb-	bb+	bb	bb-	b
5 (weak)	bb+	bb+	bb	bb-	b+	b/b-
6 (vulnerable)	bb-	bb-	bb-/b+	b+	b	b-

G61 Table G2 below gives the values for this boundary between 'Intermediate' and 'Significant' financial risk profile for 'low' volatility. From this we find reference levels for our financeability sense check notes above: FFO / Debt > 13%, Debt / EBITDA < 4 and FFO ICR > 3.

Table G2 S&P Methodology metric value table: cash flow/ leverage analysis ratios – low volatility[40]

	--Core ratios--		--Supplementary coverage ratios--		--Supplementary payback ratios--		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest (x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	35+	Less than 2	More than 8	More than 13	More than 30	20+	11+
Modest	23-35	2-3	5-8	7-13	20-30	10-20	7-11
Intermediate	13-23	3-4	3-5	4-7	12-20	4-10	3-7
Significant	9-13	4-5	2-3	2.5-4	8-12	0-4	0-3
Aggressive	6-9	5-6	1.5-2	1.5-2.5	5-8	(10)-0	(20)-0
Highly leveraged	Less than 6	Greater than 6	Less than 1.5	Less than 1.5	Less than 5	Less than (10)	Less than (20)

[39] S&P Global "General: Corporate Methodology" (19 November 2013, updated 2019), p. 6.

[40] S&P Global "General: Corporate Methodology" (19 November 2013, updated 2019), p. 34.

Results of our notional sense check

G62 The inputs, calculations, and results of our notional financeability assessment are included in our published final DPP4 financial model suite.[41] Shown below are financeability sense check results for the DPP4 final decision. These are post-smoothing, based on revenue allowances after 'price shock' caps and alternate X-factors have been applied.

G63 Final decisions on our approach to smoothing, in terms of 'price shock' limits and alternate X-factors and secondary smoothing are discussed in **Attachment F**. This included consideration of our notional financeability sense check results before and after any smoothing.

G64 On the whole, all EDBs will be able to fully recover their final DPP4 allowed revenue plus outstanding DPP3 balances within the DPP4 regulatory period. This reflects revenue path **decision P1** which includes no deferral of building blocks allowable revenue into DPP5. Given that we have sought to cap 'price shocks' from the last year of DPP3 to year-one of DPP4 at 20% this has led to us setting alternate X-factors at levels to enable full in-period recovery on a PV-neutral basis.[42]

G65 Table G3 shows results of our financeability sense checks, after year-one 'price shock' limits and alternate X-factors have been applied.

G66 On the whole, financeability metrics improve over the DPP4 period. After the adverse impact from 'price shock' limits at 20% applied in year one,[43] they improve in subsequent years because of the compounding effects of alternate X-factors on the revenue path. Given the tilted nature of the revenue path – to mitigate price shocks while allowing full in-period revenue – a full-period view of financeability is appropriate.

G67 Our full-period view is consistent with the approach of credit rating agencies, who have been willing to 'look through' temporary dips in financial metrics.[44]

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[41] Commerce Commission "Financeability model – EDB DPP4 final determination" (20 November 2024)

[42] For more information, see **Attachment F**. Given wash-ups accrued over the DPP4 period cannot be forecast with any certainty, and drawdowns necessarily operate on at least a two-year lag, there may still be some deferral of DPP4 revenue into DPP5. Additionally, within the undercharging limit, EDBs may choose to defer recovery of some revenue. Price shocks were assessed on a real distribution revenue per ICP basis.

[43] With the exception of Top Energy's starting price step of 24%, see **Attachment F**.

[44] See Commerce Commission "Input methodologies review 2023 - Final decision - Financing and incentivising efficient expenditure during the energy transition topic paper" (13 December 2023), p. 68 and reference.

Table G3 Financeability test results from applying our financeability sense check to post-smoothing final prices over DPP4 as a whole[45]

EDB Reference level	FF0/debt *> 13%*	Debt/EBITDA *< 4.0*	FFO ICR *> 3.0*	Maximum Leverage *41%*
Alpine Energy	15%	4.3	3.7	41.0%
EA Networks	18%	3.7	4.2	41.0%
Electricity Invercargill	18%	3.8	4.1	41.0%
Firstlight	17%	4.4	3.9	41.0%
Horizon Energy	21%	3.2	4.7	41.0%
Nelson Electricity	18%	3.6	4.1	41.0%
Network Tasman	17%	3.9	4.0	41.0%
Orion NZ	16%	4.08	3.8	41.0%
OtagoNet	18%	4.0	4.2	41.0%
Powerco	17%	4.09	3.9	41.0%
The Lines Company	17%	3.9	4.0	41.0%
Top Energy	18%	3.8	4.1	41.0%
Unison Networks	18%	3.8	4.2	41.0%
Vector Lines	17%	3.9	4.0	41.0%
Wellington Electricity	17%	3.9	4.0	41.0%

G68 At this aggregate level, all EDBs meet the BBB+ reference level for our primary metric (FFO/Debt > 13%).

G69 Four EDBs do not meet the BBB+ reference level for Debt/EBITDA < 4.0. These are Alpine (4.3), Firstlight (4.4), Orion (4.08) and Powerco (4.09). From above, these values are well within the BBB range (between 4 and 5) for a 'strong' business.

G70 Alpine is currently under investigation in relation to historical depreciation errors, the outcome of which may impact its notional financeability sense check results.

[45] S&P Global "General: Corporate Methodology" (19 November 2013, updated 2019), p. 34.

G71 In Firstlight's case this impact reflects the effects of both a relatively high negative IRIS balance and a reduction in deprecation after accounting for fully depreciated assets.[46]

G72 In Orion's case this in part reflects a negative IRIS balance.

G73 Powerco's metrics are marginally better than in the draft and includes the effect of correcting an error in their draft wash-up balance as they rolled off their previous CPP onto DPP3.[47]

G74 Considering the additional metrics in Table G3, all EDBs also meet the BBB+ level for FFO ICR > 3, and none exceed 41.0% notional leverage in any years.

G75 As discussed in **Chapter 4** and **Attachment F** we considered these financeability metrics in the process of setting starting prices and alternate X-factors. Adopting an alternative revenue profile would not change the whole-period financeability results, only their profile. With part of the issue being large negative IRIS balances, we do not consider that making additional changes would better promote the Part 4 purpose and we have not made additional adjustments to start prices or alternate X-factors on financeability grounds.

What we heard from stakeholders on the DPP4 Financeability issues paper

G76 Our approach detailed above for the DPP4 final decision is unchanged from that in the DPP4 draft decision, which was widely supported in submissions. This was in turn informed by submissions on our financeability issues paper, referred to below.

Overall support for financeability sense checks and a call for more details

G77 Submissions on our financeability issues paper from a range of parties overall supported our proposal to include a financeability sense check, with calls for more details on our methodology to improve certainty.[48]

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[46] As part of the 2023 IM review, we amended the asset valuation IMs to change the way forecast depreciation on existing assets is calculated. This change was to ensure depreciation attributable to fully depreciated assets was not incorrectly included in depreciation forecasts. See **Attachment I**.

[47] Additionally, because Powerco transitioned to the DPP in 2023 and its revenue allowance was determined based on (higher) forecasts of inflation at that time, it has not accrued the same level of CPI wash-ups as other EDBs who have been on the DPP since 2021.

[48] For example: Electricity Networks Aotearoa (ENA) "Submission to the Commerce Commission on Financeability issues paper" (15 March 2024); Consumer Advocacy Council "Submission to the Commerce Commission on Financeability issues paper " (15 March 2024); Powerco, "Submission to the Commerce Commission on Financeability issues paper " (15 March 2024).

Thresholds

G78 Several submissions on our financeability issues paper (including ENA[49] , Powerco[50], Vector[51] and Oxera for the 'Big Six' EDBs[52]) specifically called for thresholds to be set for financeability ratios at a level corresponding to the BBB+ rating used in setting the WACC.

G79 Whilst not using 'thresholds', with prescriptive responses should they not be met, we have set reference levels for the financial ratios we have considered at the S&P bbb+ anchor rating level. As discussed above, this is generally in line with a BBB+ issuer credit rating.

Dividends

G80 Some submissions on our financeability paper (notably Oxera for the 'Big Six' EDBs[53] and Vector's cross submission) emphasized the importance of stable dividends to infrastructure equity investors. Vector asserted that "financeability testing should include the ability to pay dividends as well as pay interest (ie, both funders not just one)"[54]

G81 The cross submission from Vector included a report from Oxera on this topic, with detailed analysis of the dividend expectations of infrastructure investors.[55]

[49] Electricity Networks Aotearoa (ENA) "Submission to the Commerce Commission on Financeability issues paper" (15 March 2024), p. 3.

[50] Powerco, "Submission to the Commerce Commission on Financeability issues paper" (15 March 2024), p. 3.

[51] Vector "Submission on Financeability in EDB DPP4 reset "(15 March 2024), p. 2.

[52] Oxera "Response to the New Zealand Commerce Commission consultation on the financeability of electricity distribution services in the fourth default price-quality path (DPP4)" prepared for the 'Big Six' EDBs (15 March 2024), p. 41.

[53] Oxera "Response to the New Zealand Commerce Commission consultation on the financeability of electricity distribution services in the fourth default price-quality path (DPP4)" prepared for the 'Big Six' EDBs (15 March 2024), p. 31.

[54] Vector "Cross submission on Financeability in EDB DPP4 reset "(28 March 2024), p. 11.

[55] Oxera "DPP4 financeability consultation cross- submission—dividend yields" report prepared for Vector (28 March 2024).

G82 We accept the general position of the importance of dividends to equity investors. We have considered this and, in reaching our final decision, maintain our position from the 2023 IM Review that it is not efficient for suppliers to pay dividends and then incur costs from raising new equity.[56] We have avoided making strong assumptions about investor behaviour (ie, additional borrowing or dividends) beyond matching to the 41% leverage assumption where possible.

G83 We also note that infrastructure investors in New Zealand have been prepared to forego dividends at times when significant investment has been required, for example Transpower and Chorus.[57] This is consistent with what we observe in workably competitive markets. Ultimately, we consider that, as long as investment continues to occur, maintaining our approach better promotes the Part 4 purpose, rather than frontloading cashflows in order to allow suppliers to pay dividends, at the same time as they state a need to raise new equity to finance investment. We remain open to reconsidering this position in the future, including if we were presented with credible evidence that equity investors are less willing to invest in infrastructure regulated under Part 4 (eg, evidence of suppliers actually trying and failing to raise equity readily and on reasonable terms).

G84 We have not included in DPP4 final decisions any move to indicate support for any specific level of dividend yield for equity holders of EDBs. We have not included a specific dividend level in our financeability sense check.

G85 This approach is in line with the decision of IPART (Independent Pricing and Regulatory Tribunal, NSW Australia) to not include dividends in its financeability test:[58]

[56] Commerce Commission “Input methodologies review 2023 - Final decision - Cost of capital topic paper” (13 December 2023), p. 193.

[57] Commerce Commission “Input methodologies review 2023 - Final decision - Financing and incentivising efficient expenditure during the energy transition topic paper “(13 December 2023) paragraph 3.145 ".. in times in the past where Transpower has faced significant increases in investment, as is likely to be the case again for RCP4 and RCP5, it has suspended dividend payments. Similarly, investors in Chorus in the early years of the fibre rollout forewent some dividends in favour of growth of Chorus's equity value."

[58] IPART “Review of our financeability test” (November 2018)

> The objective of the financeability test is to assess whether there are sufficient cash flows for the regulated business to remain financially sustainable. Whether the regulated business then decides to use the cash flows generated by our pricing decisions to fund dividend payments, pay down debt or build capital reserves, is outside the scope of the financeability test. Furthermore, because most of these ratios are not included by credit ratings agencies in their methodologies, it would be more difficult to establish a target ratio that a BBB rated business would need to meet.

G86 We note that the cashflow available to equity over (opening) RAB for our notional analysis of post-smoothing DPP4 final prices averages 2.3% pa over the DPP4 period, and 3.7% in the last year of the period.

Notional assessment

G87 In our DPP4 Financeability issues paper we proposed an approach including a notional analysis, and that if a financeability issue arose under the notional analysis, we would then assess whether there was in fact likely to be a financeability issue for the particular supplier.

G88 The intention of this approach was to inform our assessment of whether there was likely an actual risk that financeability concerns may disincentivise or otherwise impact investment in a way that would risk actual harm to the long-term benefit of consumers.

G89 All submissions with a view on this topic supported notional assessments, and some argued against actual assessments.

G90 One concern raised was to avoid the outcome of a notional financeability issue being addressed if a real issue also existed, but not if an EDB had arranged its affairs so that no actual issue existed. Oxera for the 'Big Six' EDBs noted:[59]

> ...while we agree that testing financeability of the actual company is important, we do not find it appropriate to not remedy notional financeability issues.

G91 For the DPP4 final decision, we have conducted only notional assessments. Given the results of this notional analysis, (where the drivers of the small number of issues identified above are understood) we have not considered it necessary to engage in any actual financeability assessments or to seek additional information.

[59] Oxera "Response to the New Zealand Commerce Commission consultation on the financeability of electricity distribution services in the fourth default price-quality path (DPP4)" report prepared for the 'Big Six' EDBs (15 March 2024),p. 44.

Consideration of financeability when setting the revenue path

G92 The revenue path related decisions in DPP4 where we noted in our financeability issues paper that financeability may be relevant are:

G92.1 determining an alternate X-factor to change the profile of cash flows during the regulatory period; and

G92.2 how we determine the revenue smoothing limit.[60]

G93 As noted above, one theme of submissions was a concern about the cashflow and financeability impacts of decisions on starting price adjustments and alternate X-factors, and the potential for revenue smoothing limits to result in revenue recovery deferred beyond the DPP4 regulatory period.

G94 ENA expressed this as:[61]

> Cashflows are at the heart of financeability and its assessment. The Commission's decision on revenue smoothing within the regulatory period will be a key determinant of the outcome of all financeability assessments. Therefore, any financeability assessment must be conducted using post-smoothing revenues.

G95 Powerco said:[62]

> The Commission should set revenue smoothing limits, and X-factors in a way that ensures the notional supplier that does not have periods of sustained negative cashflows, to ensure the financeability of the supplier. This will protect the long-term interest of consumers and preserve EDBs incentives to invest. Any Financeability test should be performed post application of X-factors or revenue smoothing.

G96 Following **decision P5** above we have conducted financeability sense checks through the final DPP4 revenue setting process. An overall consideration of financeability has informed our revenue path decisions related to limiting 'price shocks' in starting price adjustments and alternate X-factors (see **Attachment F**). Our financeability results shown above in Table G3 are after application of starting price adjustments and alternate X-factors.

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[60] Our approach to the revenue smoothing limit (including how we have considered financeability) is discussed in **Attachment F**.

[61] Electricity Networks Aotearoa (ENA) "Submission to the Commerce Commission on Financeability issues paper" (15 March 2024), p. 5.

[62] Powerco "Submission on Financeability issues paper" (15 March 2024), p. 3.

Other matters in the financeability issues paper

G97 Beyond the financeability sense check, we here discuss other financeability matters raised in submissions which are relevant to DPP4 final decisions.

Equity issuance costs

G98 In the financeability issues paper we noted that currently no equity issuance costs are provided in the cost of capital IMs. We added that where notional modelling and evidence from an EDB demonstrates that they need to issue new equity to finance investment, and that they are willing and able to do so, there's an argument that providing this allowance better supports ex ante FCM.

G99 Several submissions on this topic supported adoption of the Australian Energy Regulators (AER) approach. Powerco said:[63]

> We support the inclusion of additional allowances for equity issuance costs, equity raising, if required, is not a costless exercise and support the Commission adopting an approach like the AER in the financial model as part of the return on capital BBAR component.

G100 ENA also supported the AER approach:[64]

> ENA in its IM submission, proposed that an equity raising allowance be incorporated into the WACC IM and that the AER approach to the calculation of this equity raising allowance be adopted in the Commissions' financial model. ENA's view remains that the equity allowance is best incorporated within the return on capital component of the DPP determination .. rather than an opex allowance as the inclusion of an opex allowance would give rise to IRIS implications and unnecessary complexity.

G101 Vector in its cross submission generally supported views on this topic expressed by Oxera for the 'Big Six' EDBs,[65] including on the direct and indirect costs of equity issuance. Vector noted it was:[66]

> ..open to considering different approaches but highlighted that both the direct and indirect costs of obtaining new equity injections must be considered in any proposed approach.

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[63] Powerco "Submission on Financeability issues paper" (15 March 2024), p. 3.

[64] Electricity Networks Aotearoa (ENA) "Submission to the Commerce Commission on Financeability issues paper" (15 March 2024), p. 5.

[65] Oxera "Response to the New Zealand Commerce Commission consultation on the financeability of electricity distribution services in the fourth default price-quality path (DPP4)" (prepared for the 'Big Six' EDBs,15 March 2024), p. 47.

[66] Vector "Cross submission on Financeability in EDB DPP4 reset " (28 March 2024), p. 9.

G102 After considering submissions, and the results of our financeability sense check, our final decision is that we see no demonstrated need for providing equity issuance costs in DPP4:

G102.1 Our notional financeability sense check modelling required no EDB to borrow above 41% leverage, accordingly we do not see a need for equity raising in DPP4. (Noting that submissions strongly supported a notional view on financeability.)

G102.2 We received no evidence or indication that any EDB was actually considering issuing new equity in the DPP4 regulatory period.

G102.3 Based on information available to us, equity issuance in the New Zealand EDB sector is relatively uncommon in practise.

G103 We have not provided equity issuance costs for DPP4 in our final decision.

G104 If an EDB sees a genuine need to raise equity associated with expenditure beyond what it accommodated under the default price path, a CPP could include an allowance for the cost of equity issuance.

Capital contributions

G105 Some submissions on our DPP4 Financeability issues paper referred to the potential interaction of financeability and any changes to capital contributions (ie, connection pricing) stemming from the Electricity Authority's work in progress on distribution pricing. In particular, Vector said:[67]

> With the Electricity Authority due to release its emerging views on distribution pricing due in April 2024, we would like assurances from the Commission that they have taken account of the possible outcomes from the Authority's work in their assessment of EDB financeability.

[67] Vector "Submission on Financeability in EDB DPP4 reset"(15 March 2024), p. 13.

G106 Capital contributions were identified by the Electricity Authority as an area of interest in an Issues paper on distribution pricing.[68] Close to publication of our DPP4 final decision, the Authority opened consultation on a draft Code amendment to regulate distribution connection pricing methodologies.[69] Final decisions on proposed Code amendments are expected to be released in the first half of 2025.

G107 In its consultation paper, the Authority notes that changes to capital contributions could impact EDBs' financeability outlook, and that the actual financeability position of an EDB or its owner can differ from the notional approach we have applied at DPP4.

G108 The Authority has engaged with us under Section 54V(1) of the Commerce Act 1986 and we will continue to engage with the Authority on its connection pricing work programme. Section 54V(5) enables us to accommodate Code changes, or decisions made under the Code that relate to, or affect, pricing methodologies if asked to by the Authority.

G109 We wish to assure stakeholders that we will continue to engage with the Authority and wider stakeholders, as appropriate, on implications of the Authority's work on distribution connection pricing on our regulation under Part 4 of the Commerce Act.

Discretionary adjustment of asset lives

G110 In our Financeability issues paper we noted that "the IMs provide for a discretionary shortening of asset lives for existing assets triggered by application from an EDB and the Commission considering that doing so would better promote the Part 4 purpose."[70]

G111 We did not receive any applications by the 29 February 2024 deadline.

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[68] Electricity Authority "Targeted Reform of Distribution Pricing Issues Paper"(5 July 2023)

[69] Electricity Authority "Distribution connection pricing: proposed Code amendment. Consultation paper" (24 October 2024).

[70] Commerce Commission "Electricity Distribution Services Input Methodologies (IM Review 2023) Amendment Determination 2023 [2023] NZCC 35" (13 December 2023), clause 4.2.2(5).

G112 Oxera for the 'Big Six' EDBs disagree with our suggestion that while this adjustment was introduced in the context of mitigating potential economic stranding risk for existing assets, broader application may be an option to consider in the future:[71]

> .. asset life shortening may not be the most appropriate financeability remedy when it introduces a disconnect between the technical and regulatory asset lives. Over time, this may lead to a situation in which the RAB is not reflective of the revenue generating assets owned and operated by the business. The EDBs do not foresee a major risk of asset stranding, and instead, expect the network to expand, requiring cash flows in the future. Therefore, the NZCC should be mindful of the long-term implications of any potential measures in relation to the shortening of the asset lives.

G113 We have not further considered discretionary shortening of asset lives for DPP4.

[71] Oxera "Response to the New Zealand Commerce Commission consultation on the financeability of electricity distribution services in the fourth default price-quality path (DPP4)" prepared for the 'Big Six' EDBs (15 March 2024), p. 49.