15 March

Ben Woodham
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Commerce Commission
Wellington

Dear Ben

Submission to the Commerce Commission on Financeability issues paper

Electricity Networks Aotearoa (ENA) appreciates the opportunity to submit to the Commerce Commission (Commission) on its issues paper on the financeability of distribution services.

ENA is the industry membership body that represents the 27 electricity distribution businesses (EDBs) that take power from the national grid and deliver it to homes and businesses across the motu. ENA harnesses members' collective expertise to promote safe, reliable, and affordable power for our members' customers.

The issues paper assumes that networks operating in a steady state will have depreciation expenses that broadly match their reinvestment requirements, it also suggests that decarbonisation-related demand growth will be the driver of material expenditure increases for EDBs.

The view that a rise in decarbonisation expenditure is the sole driver of increased EDB expenditure and consequently financeability concerns ignores the critical role played by sector-wide input price growth, the jump in the cost of new assets (due to the disconnect between CPI and asset costs), and the need for EDBs to replace a significant volume of assets installed during 1960-1970, the last major push to electrify New Zealand, which has been fully depreciated but remained in service.

The proposed approach grants the Commission inappropriate regulatory discretion

ENA is concerned the Commission is considering granting itself carte blanche to decide how it will assess financeability without clear metrics or documented benchmarks.

ENA views the inclusion of a financeability "sense check" into the DPP process as a bare minimum. Its use as a "support tool for decision-making" without the prior establishment of a clear process and detail on the make-up and the use of this "sense check" would grant the Commission unfettered and inappropriate discretion.

In its Input Methodologies (IM) submissions, ENA provided clear and practical recommendations as to what the regime's assessment of financeability should look like[1]. ENA called for the Commission to adopt the clear, quantitative metrics used by rating agencies to assess the cash flows resulting from the DPP determination.

[1] ENA, 2023, Submission on rate of return issues

The Commission states that it does not intend to assess or assign a credit rating or a formal financeability assessment or test by which to assess against nor prescribe thresholds and responses. This neglects the fact that the cornerstone of the IM WACC regime is the assumption that in a workably competitive market, suppliers would maintain a BBB+ credit rating.

Price quality determination cashflows and the notional efficient entity should be the basis of the financeability assessment

ENA is of the view that financeability in the context of the DPP, must solely be assessed on the regulated electricity lines service prescribed by the DPP.

Consistency between the DPP cashflows (post smoothing) and the IM's WACC determination prescribed BBB+ credit rating is not optional and must form part of any financeability assessment. That is cashflows determined by the Commission under the DPP must – for all non-exempt EDBs – be sufficient to maintain the IM-prescribed BBB+ credit rating.

The issues paper's views on the use of notional and actual financeability are contradictory

The Commission notes that Part 4's purpose is not to protect a supplier from the consequences of its ownership structure or financial challenges in a way that would not occur in a workable competitive market.

In paragraph 2.7, the Commission suggests that EDB's financeability concerns relate to the whole firm, for example, its credit rating, ownership structure, or ability of the firm to service debt. ENA and its members do not expect that the Commission, in its regulatory determinations, would consider anything other than the revenues and cashflows determined as part of price-quality determinations in isolation from all other business activities.

A firm's actual financial position, including ownership structure, is irrelevant to the DPP determination as it is not a determinant of the revenues/cashflows allowed under the DPP. Any financeability assessment must, therefore, be based on the Commission's determined regulatory cashflows with reference to a notional firm operating in a workably competitive market. Of most relevance to the notional firm are the Commission's determined WACC parameters for including debt tenor, the 'on-the-day' determined cost of debt, and the gearing ratio.

Supplier financial hardship is not the only consequence of financeability issues

ENA notes while under Part 4, there is no formal obligation for the Commission to protect the financial sustainability of a given supplier, the financial collapse of a supplier or the failure of a supplier to adequately invest because of financeability constraints is not in the long-term interest of consumers. The ENA welcomes the Commission's acknowledgement of this in paragraph 2.12.2 of the issues paper.

The Commission has focused on supplier financial hardship as the sole outcome relevant to the assessment of financeability. The Commission must recognise that, in a workably competitive market, financeability has consequences beyond financial hardship for suppliers. In a workably competitive market, if a supplier has insufficient cashflows, it would have its credit rating downgraded. The result of this would be an increase in the suppliers' cost of debt, which would consequently flow through to a higher WACC and higher prices for consumers.

This sequence of events would create a direct conflict between the BBB+ credit rating prescribed in the IMs, and the cashflows outputted from the DPP determination.

The financeability test should be conducted subsequent to revenue smoothing

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.

ENA is supportive of the Commission's emerging view that any smoothing limits be set in real terms. The recent high inflationary environment has highlighted the risks associated with setting revenue caps in nominal terms.

ENA also agrees that any smoothing limits should only bind in more extreme cases and not capture ordinary variation in wash-up balances, IRIS or incentive payments.

ENA welcomes the Commission's recognition that equity raising is not costless

ENA welcomes the recognition by the Commission that equity raising is not a costless process. The Commission's IM WACC determination was the best vehicle for the issue of equity-raising costs to be addressed. As a result of the failure to include the provision of an equity raising allowance in the IMs, the Commission now finds itself grappling with which second-best solution to apply.

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 Commission's financial model[2].

ENA's view remains that the equity allowance is best incorporated within the return on capital component of the DPP determination (and the DPP model) rather than an opex allowance, as the inclusion of an opex allowance would give rise to IRIS implications and unnecessary complexity.

Financeability should not require a CPP to be addressed

ENA is concerned by the Commission's view that financeability issues are best addressed by a CPP. This ignores the fact that the DPP's financeability is intrinsically tied to the cash flows determined by the Commission. Whereas a CPP is tied to the specific circumstances of the EDB. It is not suitable for issues stemming from the WACC IM and the resultant cashflows of a notional entity in a workably competitive market would need to be addressed via a resource and time-intensive CPP process.

Yours sincerely

[redacted]

Keith Hutchinson
Regulatory Manager

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[2] ENA, 2023, Submission on rate of return issues