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Alpine Energy Limited's submission on the Commerce Commission's issues paper on the financeability of electricity distribution services in the default price-quality path

Overview

1. Alpine Energy Limited (**Alpine Energy, we, our**) would like to thank the Commerce Commission (**the Commission**) for the opportunity to submit on the issues paper regarding the financeability of electricity distribution services (**EDB**) in the default price-quality path (**DPP**), dated 22 February 2024 (**the Issues Paper**).
2. Alpine Energy supports, in general, the Electricity Networks Aotearoa's (**ENA**) submission on this matter.
3. We have highlighted specific areas of additional consideration to Alpine Energy below.
4. None of the information in our submission is confidential (including signatures).
5. We look forward to further engagement with the Commission as it develops its financeability sense check approach as part of the DPP4 reset.

Investment context and financeability for DPP4

6. As a mid-size EDB in the South Canterbury region, Alpine Energy has significant challenges given our regional network and the economic environment we operate in. As mentioned in our previous submissions to the Commission, South Canterbury is uniquely diverse and complex in its electricity needs:
    a. **Diverse land use and economic activities**: Dairy, sheep and beef, and crop farming, significant food processing and other industrial operations, and high tourism activity in the Mackenzie District.
    b. **Diverse energy demand**: Significant industrial process heat requirements combined with seasonal demand driven by irrigation.

c. **Diverse geography and climate**: Stretching from the Alpine village of Aoraki/Mt Cook to the temperate coast at the Waitaki River.
d. **Diverse population spread**: One significant urban centre (Timaru) and many smaller towns and rural settlements throughout the region.
e. **Seven** Grid Exit Points.

7. We have developed our AMP work programmes from the ground up, considering customer requirements and feedback, independent engineering advice, asset health, and resource availability. Alpine Energy is fully committed to providing our customers a secure and reliable electricity supply to both home and business in a cost-efficient manner, whilst balancing future needs and network changes.
8. However, our ability to innovate and deliver on customer requirements over the DPP4 regulatory period greatly depends on the extent to which our AMP forecasts are accepted by the Commission.
9. During the DPP3 regulatory period, we have been exceeding our allowances, not only due to significant cost increases and hard economic times but also due to the changing needs of our customers. The 10% annual cap on the increase in maximum allowable forecast revenue from prices has further contributed to the mismatch between our cash inflows and outflows. Enabling our customers to connect, making our network more resilient, and responding to the changing needs of our consumers has meant that we had to increase our debt levels to fund the required network investment.
10. Our specific challenge is that, if the allowances granted under DPP4 do not allow us to meet debt servicing requirements, it will limit our ability to service the necessary capital. This will inevitably lead to us having to make decisions on where not to invest or face significantly higher costs due to higher debt levels. It will also mean that we will continue to exceed our allowances, resulting in IRIS implications.
11. The Issues Paper highlights the decisions confirmed in the Input Methodologies (**IMs**) that RAB indexation and the regulatory return offered through the weighted average cost of capital are sufficient to attract investment. However, we urge the Commission to consider where such investment will come from. Many EDBs, including Alpine Energy, are owned by local councils, who are facing similar challenges to us with significant infrastructure spend forecast in long-term plans.
12. The uncertainty around how we will finance the investment needed in the next five to ten years if financeability is not appropriately tested and considered in setting allowances for DPP4, is a real concern for us.

Financeability is integral to setting prices for a regulated entity

13. Industry-wide, significant step changes in capex and opex are forecast, making financeability a key issue for many EDBs, including Alpine Energy, as we head into the next regulatory period.
14. If an EDB does not remain financeable, credit ratings will deteriorate below the efficient benchmark set, debt will become more expensive and this will, over time, result in higher prices for consumers.
15. While the regulated entity earns a real rate of return, they have a contractual obligation to pay debt interest in nominal terms. When the regulated real return on debt capital is insufficient to service nominal interest payments, a portion of the regulated return on equity must be used to service nominal debt payments.
16. A reduction in the cash-flow available to service nominal debt payments also puts pressure on the entity's credit rating. All other things being equal, if the credit rating declines, any new debt raising will demand a higher price (due to higher interest rates) and the financeability problem worsens.
17. If an EDB cannot recover its costs from consumers, it increases the risk that it will underinvest and future customers will effectively pay for the higher financing costs or, alternatively, receive a lesser level of service. Underinvestment in maintenance and resilience will further increase network risk and have a detrimental long-term impact on the quality of supply.
18. In the face of financeability issues – and consequent credit rating downgrades – an EDB would find it difficult to raise funds consistent with the notional gearing and credit rating benchmark proposed by the Commission. Subsequently, projects that provide net benefits to consumers may not go ahead.[1]
19. As economic regulation is designed to allow a regulated business to recover its efficient costs, it would be inconsistent if an otherwise efficient regulated business faces a credit rating downgrade, and the consequent increase in financing costs above the efficient level for a business operating in similar circumstances.

Remaining financeable is in the long-term benefit of consumers

20. We acknowledge that the Commission is not statutorily required to consider financeability but that it may take financeability into account in its decision-making where relevant to the Part 4 purpose - to promote the long-term benefit of consumers.
21. We believe it is fundamental to the long-term benefit of consumers for regulated EDBs to remain financeable as this is more likely to have long-term stable pricing outcomes for consumers.

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[1] See for example TransGrid's rule change proposal to AEMC: Australian Energy Market Commission "Participant derogation – financeability of ISP Projects" 8 April 2021.

22. Many EDBs, including Alpine Energy, are facing a bow wave of critical investment, driven by much of the network infrastructure being at or past the end of its design life, the move to electrification/decarbonisation, and the need to invest in resilience in the face of climate hazards. These investments are in the long-term benefit of consumers as they will enhance network reliability and resilience and enable the transition to a low carbon future.

Assessing financeability in the context of DPP4

23. Alpine Energy is encouraged by the Commission's consideration of financeability and agrees with the Commission that financeability checks should be 'ring-fenced' to the regulated portion of the EDB's business operations, given the Commission's lack of mandate to control the EDBs unregulated business activities and broader financial management strategies.

24. We are, however, concerned with the Commission's generalisation of financeability and the simplification of its proposed 'sense check' methodology of assessing financeability.

Levers to address financeability could delay recovery of maximum allowable revenue

25. We note that applying the levers proposed by the Commission (including the alternate x-factor, the revenue smoothing limit, and the timing of drawdowns of the wash-up balances) could potentially result in a delayed recovery of maximum allowable revenue (**MAR**).

26. We are concerned that the curtailment of our capex and opex programmes, to an extent such that we are forced to overspend the DPP allowance to maintain security of supply, will almost certainly result in financeability issues for Alpine Energy. This would be further amplified by the Commission's revenue smoothing limits and delays in the recovery of wash-up balances.

Need for more certainty on how the financeability 'sense check' will be assessed

27. We appreciate the Commission's assurance that it is aware of and willing to consider financeability issues associated with the regulated profile of cash-flows. However, we reiterate the key points raised by stakeholders in previous consultations, particularly the need for certainty on how the Commission will assess and address financeability through a defined test and response levers.

28. The Commission notes that it has flexibility to consider financeability and apply its judgement when appropriate. We urge the Commission to provide a clear and transparent framework that sets out the conditions under which it believes it is appropriate to consider financeability and the factors that will be taken into account in the application of its judgement. This should include a worked example setting out the parameters / thresholds that indicate financeability issues may be considered in the Commission's decision-making process and what other quantitative and qualitative factors may be considered.

29. The Commission has access to a range of financial information from past information disclosures, compliance statements, and publicly available information on calculating and assessing financeability metrics and ratios. Whilst we are not proposing or expecting the Commission to assign formal credit ratings to the regulated portion of our business, we do urge the Commission to clearly compute and demonstrate their methodology in assessing financeability via the DPP4 Model.

30. We welcome the Commission's proposal of a notional supplier in a workably competitive market as part of DPP4. We are comfortable with the Commission's approach to also consider a supplier's actual financeability as important. **Appendix 1** supports the point that it is common for regulatory approaches in other jurisdictions to adopt both a notional financeability test and an actual financeability test.

31. This will allow for consideration of whether DPP4 delivers sufficient cash-flows for the regulated EDB's investment to be, and to remain, financeable as well provide a cross check on the EDB's ability to service nominal debt payments.

Suggestions on the proposed financeability sense check

32. We strongly believe that the Commission's sense check methodology should incorporate a high-level financial statement and ratio calculations that clearly demonstrate how the Commission has assessed financeability as part of its decision-making process.

33. We support the Commission's notion that a financeability assessment is conducted on the basis the notional entity is able to maintain a BBB+ credit rating over the DPP period.

34. At a minimum, we would expect to see the following built in as a separate tab in the DPP4 model:

- The high-level income statement that clearly reflects net lines revenues (post revenue smoothing, wash-up drawdowns and other recoveries), opex, net interest cost and tax expense.
- A pro-forma balance sheet for the ring-fenced regulated business, established at the start of the regulated period with the starting asset base funded to reflect the leverage assumptions in line with the Input Methodologies (**IMs**).
- Subsequently, the income statement and balance sheet should be rolled forward based on the Commission's net capex allowances and opex allowances with capex funded via a mix of operating cash-flows, new debt and retained earnings such that the leverage reflects the IM.
- A sensitivity test of the capex and opex allowance should be incorporated to allow sufficient "headroom". Headroom provides a dual purpose, accounting for any need to marginally overspend, while also countering any uncertainties in the Commission's allowances forecasts.

- The Commission's sense check calculation should also ensure that equity holders are compensated in line with the IM and DPP4 WACC estimates over the 5-year DPP period.
- Debt and interest cost should reflect a BBB+ notional EDB with its ability to maintain BBB+ rating over the 5-year DPP period.
- Furthermore, the Commission should disclose the qualitative aspects it may take into consideration when assessing financeability.

35. We would expect deriving a high-level cash-flow statements and ratio analysis, similar to that of rating agencies, should be relatively straightforward on the back of a high-level income statement and balance sheet. Such an approach would greatly assist us in understanding the Commission's assessment of financeability and the role it plays in the Commission's decision-making process. Alpine Energy is committed to assisting the Commission to the extent it needs further clarifications or specific inputs.
36. We note that other regulators, including IPART, have determined that the benefits of conducting a financeability check are high, relative to the small costs incurred.[2]
37. We broadly support the decision to not assess financeability on a bright line approach, and we understand the Commission's reluctance to determine prescribed responses to issues of financeability. However, we strongly suggest that guidance is built into the financeability analysis model that indicates whether the financeability of the notional regulated entity would be subject to further consideration.
38. The parameters of a notional supplier and the thresholds that indicate a potential financeability issue should take into consideration factors including, for example, the size of the EDB, to account for the different tiers of suppliers, and its ability to access debt markets. For example, Ofgem's approach to defining a notional efficient operator includes a premium on the cost of debt of six basis points for smaller regulated entities, to account for the higher costs of debt infrequent and smaller issuers of debt face in the market.[3]

Use of a CPP to address financeability

39. Alpine Energy agrees with the Commission's notion that financeability issues, on their own, should not be the grounds for a CPP application. In our view, a CPP is an inefficient and unwieldy solution to a challenge we expect will be common to all EDBs. Relative to conducting the proposed high-level financeability sense check and resolving financeability issues by application of the levers available, the CPP process is likely to incur far greater time, cost, and effort for both the Commission and EDBs.

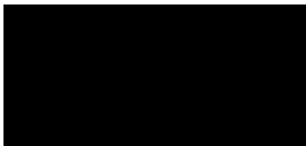
[2] IPART "Review of our financeability test" November 2018, at page 13.
[3] Ofgem "RIIO-ED2 Final Determinations Finance Annex" 30 November 2022, at page 16.

40. We are also concerned that the Commission will not have the capacity to process multiple CPPs in a timely manner, which may result in the benefit of successful applications being delayed.

Conclusion

41. We hope our submission is helpful to the Commission and we are happy to discuss our views with you further or provide any additional information to further support our views.

Yours sincerely,



Marisca MacKenzie
Chief Regulatory Officer

Appendix 1

The table below summarises the approach of selected regulators to assessing financeability. We note that it is common for both a notional and actual financeability test to be modelled, consistent with the proposal by the Commission.

Table 1: Regulatory approaches to notional entities

Regulator	Key item	Approach
Ofgem (UK)	A **notional efficient operator** has totex, allowed return, notional gearing, depreciation, and capitalisation that allows them to generate cash-flows sufficient to meet its financing needs.[4]	Modelling of the notional efficient operator is based on: • A WACC allowance, with notional gearing (weightings) based on Ofgem's assumption tested against supplied financial data, a cost of equity based on geometric average of historical equity returns for the sector adjusted for inflation, and a cost of debt based on a 17-year trailing average plus a calibration (from notional to actual debt costs) adjustment and a cost of borrowing and cost of infrequent issuer premium • Depreciation life based on Ofgem's assessment of economic life • Totex, capitalisation rates, tax costs, and RAV (regulatory asset value) from supplied forecast financials • Index-adjusted debt proportions, dividend yields, and cost of equity issuance from assumptions made by Ofgem
	The **financeability test** takes an 'in-the-round' assessment that targets each **notional company** being broadly of comfortable investment grade credit quality, rather than applying strict thresholds to particular credit metrics that must be met in all circumstances.[5]	As part of this assessment, Ofgem considers whether weakness in one particular credit metric is offset by other factors (below) before concluding whether an assessment is necessary. Those factors include: • Strength in other credit metrics • Forecast future trends in the metric (informing whether the metric is a leading indicator of credit weakness) • The exposure of companies to credit rating downgrades, as a result of plausible downside scenarios • The costs of applying the adjustment
Ofwat (UK)	The **notional company** is one with a **notional capital structure** and which has an efficient level of expenditure	The **notional capital structure** is consistent with the capital structure embedded within the benchmark WACC. The benchmark WACC is informed by research and analysis: • The forward-looking cost of equity was calculated by using a DDM, cost of equity

[4] Ofgem "RIIO-ED2 Final Determinations Finance Annex" 30 November 2022, at page 64.
[5] Ofgem "RIIO-ED2 Final Determinations Finance Annex" 30 November 2022, at page 69.

	including financing costs.[6]	inferred from transaction and trading data, and investor surveys, which informed a CAPM cost of equity • The cost of debt was calculated by analysing historical yields and issuance costs on water bonds
	The financial metrics Ofwat will use to assess **financeability** …comprise debt ratios, equity ratios, and other return metrics. These metrics draw on common approaches used in financial markets and reflect metrics used by the credit rating agencies.[7]	The primary financial ratios Ofwat uses in its assessment are: • Gearing • Interest cover • Adjusted cash interest cover • Funds from operations over net debt • Dividend cover • Retained cash-flow over net debt • Return on capital employed • Return on regulated equity Ofwat will not publish target levels for these metrics. Companies are responsible for submitting a plan that is financeable, and need to provide evidence about the credit rating targeted in their plan and the level of each ratio they consider appropriate. Companies need to provide these ratios under both the notional capital structure and their actual capital structure.
IPART (Australia)	Pricing decisions allow an **efficient (benchmark) business**, that is investment graded, to raise finance and remain financeable during the regulatory period.[8]	The **efficient (benchmark) business** is constructed using: • Building block target revenue • Building block allowances for opex, depreciation, tax expense, and inflation • Interest expense calculated using WACC real cost of debt and gearing • Dividends calculated to maintain a constant benchmark gearing ratio
	IPART will conduct **separate financeability tests**, using the inputs for a benchmark efficient business and the actual business.[9]	IPART adopts the following target ratios in calculating the benchmark and actual test: • A real interest coverage ratio of greater than 2.2 times • An interest coverage ratio of greater than 1.8 times • A real funds from operations over debt ratio greater than 7% • A funds from operations over debt ratio greater than 6%

[6] Ofwat "Delivering Water 2020: Our final methodology for the 2019 price review" December 2017, at page 191.
[7] Ofwat "Delivering Water 2020: Our final methodology for the 2019 price review" December 2017, at page 197.
[8] IPART "Review of our financeability test" November 2018, at page 22.
[9] IPART "Review of our financeability test" November 2018, at page 28.

		• A debt to RAB gearing ratio less than 70% The benchmark debt is conducted assuming the real cost of debt and gearing set in the WACC. The actual test uses the business' actual cost of debt and gearing level.