Vector Limited
110 Carlton Gore Road
PO Box 99882
Newmarket
Auckland 1149
/ vector.co.nz

28 March 2024

Ben Woodham
Electricity Distribution Manager
Commerce Commission
44 The Terrace
Wellington 6140
By email: infrastructure.regulation@comcom.govt.nz

Vector cross-submission on DPP4 Financeability Paper

1. This is Vector's ('our,' 'we,' 'us') cross-submission on the Commerce Commission's (Commission) Financeability Paper for the default price-quality path (DPP) reset. No part of this submission is confidential, and it can be published on the Commission's website. All quotations, unless referenced, are from responses to the DPP4 Issues Paper.

2. The Commission's paper has ignited a good discussion on financeability with varied acceptance of the Commission's proposed approach.

3. Vector reiterates that financeability (financial viability) and investability (attractiveness to investors), which involves having sufficient cash flow to support the necessary debt and equity capital for infrastructure investment, must be central considerations in the decision-making process for the DPP reset. Without adequate cash flows to sustain increasing investments and attract new capital, Electricity Distribution Businesses (EDBs) will be compelled to underinvest, thereby slowing New Zealand's electrification efforts. This would result in New Zealand falling behind other nations in the electrification of its energy system, jeopardising the goal of achieving net-zero emissions by 2050.

4. We view it as a significant missed opportunity that the Commission did not include financeability testing in its recent review of the Input Methodologies (IMs). However, there is still an opportunity for the Commission to incorporate these tests into its decision-making processes for resetting of the DPP. It is crucial to the Part 4 Purpose statement, that the Commission promotes incentives to invest, which includes suppliers' ability to undertake and finance that investment.

5. PowerNet explains that some of the borrowing pressures have led to shareholders to exit or explore exiting their investments:

> *"It is in the long-term interest of consumers and investors that there is an appropriate balance from operating cash flows between investment in the network, debt levels and returns to shareholders. DPP3 has seen this balance tip away from the shareholder due to cost increases, delayed CPI revenue adjustments and interest rate increases. EDB's are borrowing to meet capital investments to maintain quality standards. This has led to some shareholders exiting or consulting on exiting their EDB investments. The lack of balance in DPP3 will in part lead to the revenue increases we will see in DPP4."*

6. Clearly this is not a position the Commission wants to be in. Investors need certainty and unfortunately their financeability paper has not provided that. Instead, its approach to financeability:

   - is out of step with other jurisdictions;
   - has proposed undefined thresholds and metrics;
   - leaves full discretion for the Commission to make judgement calls on financeability settings; and
   - does not instil confidence to debt and equity holders in the return of their investments.

7. Without this certainty suppliers could be left without the ability to attract capital which in turn threatens New Zealand's path towards decarbonisation and risks leaving consumers without the services they require.

8. Since the Commission's paper was released, the Australian Energy Market Commission (AEMC) published a final determination and final rule to address challenges Transmission Network Service Providers (TNSPs) may have in raising finance to proceed with actionable Integrated System Plan (ISP) projects.

9. Their final decision on 21 March 2024[1], was made on in the context of the broad consensus that transmission is a critical enabler for the transition to net zero. The AEMC states that:

> *"[…] this transition will require an unprecedented level of investment in, and build of, transmission infrastructure to deliver power from renewable generation and energy storage to consumers, and to deliver infrastructure quickly. The scale of transmission investment required, coupled with the speed of the energy transition, presents challenges for the existing regulatory framework."*

10. Their final rule amends the National Electricity Rules (NER) by improving the ability of TNSPs to efficiently access finance, where needed, to deliver actionable ISP projects in a timely and efficient way. The AEMC considers that this is in the long-term interests of consumers.

[1] https://www.aemc.gov.au/rule-changes/accommodating-financeability-regulatory-framework

11. More precisely the rule change facilitates the following:

> *"If a TNSP's financial position is at or below a financeability threshold then the final rule will address financeability challenges by preventing a TNSP's financeability position from worsening as a result of an ISP project, based on a TNSP's regulated business and determined using the benchmark gearing ratio in the applicable rate of return instrument (RORI), or as adjusted in accordance with any concessional finance agreements.*
>
> *If a TNSP has a financeability issue, the final rule requires the Australian Energy Regulator (AER) to bring forward the TNSP's cash flows related to an actionable ISP project through a combination of one or more of as incurred depreciation, varying the depreciation profile of assets, and revenue smoothing within a regulatory control period. This, in turn, will improve a TNSP's financial metrics and consequently, its ability to efficiently raise finance, facilitating timely investment in and delivery of actionable ISP projects."*

12. The Commission must follow suit and provide the sector with a more robust financeability testing regime for the DPP instead of a mere 'sense check'. A view also shared by credit rating companies[2].

Cost pressures

13. There is a misrepresentation in certain submissions that EDBs are using financeability as a means to receive higher revenues, which in turn would impact consumers' prices.

14. Fonterra has raised their concerns by saying:

> *"Electricity users are facing significant pricing pressure from both the sustained high cost of electricity via wholesale electricity market prices and increased transmission and distribution costs from the proposed Transpower RCP4 and the EDB DPP4, without any real ability to avoid these costs or, in the case of exporters of internationally traded products, the ability to pass the costs on to customers. Allowing further costs to be passed onto electricity users will create more pressure and impact New Zealand's international competitiveness, which is crucial for a small island nation at the end of global supply chains."*

15. PowerCo have rightfully explained that:

---

[2] Fitch Ratings, 28 February 2024, [Ofgem's Credit-Enhancing Mechanisms Unlikely to Benefit Ratings (fitchratings.com)](): Fitch advocates for strong financeability settings (i.e. a credit rating test should be in line with an investment grade rating (BBB+) not a lower grade (BBB). They state that if a regulator applies low testing thresholds (not investment grade thresholds) it would put pressure on EDBs' credit profiles.

"The primary driver of the increase in revenue for the upcoming DPP period will be the updated WACC, increasing from abnormally low levels in DPP3, primarily due to the risk-free rate and the way the current IMs calculate the cost of debt."

16. Indeed, factors outside of suppliers' control, including inflation and rising interest rates throughout DPP3, will result in a direct and significant uplift in the value of EDBs' regulated asset bases and the weighted average cost of capital (WACC) used for DPP4. Even in the absence of the need for EDBs to invest to facilitate decarbonisation and fortify their networks to withstand the increase in extreme weather events, revenue allowances for DPP4 will exceed those set in DPP3.

17. Consumer Advocacy Council (CAC) has proposed a solution to reduce EDBs' need to raise capital:

"As noted in our previous submission on this price-quality path reset, demand-side management and energy efficiency initiatives also have the potential to defer or avoid investment that would otherwise be required, hence reducing the need for EDBs to raise capital and reducing overall costs to consumers."

18. Whilst we agree that demand side management and energy efficiency are great tools to defer investment in the long run (Vector supported CAC's position on this topic in our cross-submission to the DPP4 Issues Paper), the amount of savings related to these activities in DPP4 will be minimal. In fact, in order to have demand side management systems, people and processes in place, EDBs are more likely to invest in, rather than save from demand side management in DPP4, followed by saving in subsequent DPPs.

19. We must also dismiss CAC's position below:

"We also consider EDBs' concerns about financeability may be overstated. In general, we agree with the commission that investment in regulated monopoly companies "involves 'patient capital' and attracts investors that have long horizons for recouping their investment (generally over the expected physical lives of the long-lived assets)."
To the extent that EDBs recognise and respond to growing demand for ethical or responsible investment opportunities, we note they have the potential to attract new sources of funding. Money in ethical investment funds has been growing and this pattern is expected to continue (albeit there are varying definitions of what qualifies as 'ethical' investment)."

20. The CAC appears to be suggesting that providers of "ethical funding" would be prepared to accept different levels of returns and timings of cashflows than other investors providing capital to a BBB+ entity. If this is the case, we would suggest that CAC provide evidence that this is the case.

21. Vector's financeability modelling has stress tested all foreseeable scenarios with a set up robust assumptions and had our model reviewed by an expert consultancy in this field. We shared the

vector

results confidentially to the Commission with our original submission to demonstrate that we certainly are not 'overstating' our concerns.

22. Indeed, Oxera conclude concisely and poignantly that:

    "Estimating an appropriate cost of capital allowance bottom-up may not be sufficient to incentivise investors to invest—a financeability test is required to see if the network is able to raise financing on the terms assumed by the regulator when setting cost of capital allowances."

Notional company

23. The Commission must consider the notional firm when assessing financeability. This is important because it provides a theoretical benchmark for assessing the financial performance and viability of the regulated utility. The notional firm represents an idealised entity that operates efficiently and effectively within the regulatory framework. Some elements of the actual firm such as forecasted expenditures and wash-up account balances are needed as inputs into the notional firm financeability assessment. However other elements of the actual firm such as gearing, unregulated earnings etc. should not be considered in the notional firm financeability assessment. If the notional firm is not financeable then the regulator needs to adjust regulatory settings to resolve this. If the notional firm is financeable but the actual firm is not it is still incumbent on the regulator to consider the implications of the firm failing. Such failures could lead to lost confidence by investors in the sector and undesirable consequences for consumers.
    .

24. ENA explains this further:

    "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."

25. For the reasons above we believe that CAC has misrepresented the role of a financeability assessment:

    "We further note that financeability can be affected by factors outside the regulator's control, such as poor management by the company or decisions regarding dividend payments.

Consumers should not be expected to bear the costs of problems caused by an EDB's bad business decisions."

26. CAC is incorrect because financeability testing should be done on the notional firm basis - "poor management" and "decisions regarding dividend payments" are not considerations for a notional firm financeability assessment.

27. MEUG also advises the Commission on this point:

"In the context of the DPP4 reset, MEUG agrees with the Commission's definition of "financeability" and that this issue must only be considered in the context of Part 4 – the long-term benefit of consumers. We strongly support the focus on solely the provision of the regulated service [emphasis added]. The Commission is only responsible for the regulation of electricity transmission and distribution businesses because they are natural monopolies. The Commission is not responsible for the oversight of an EDB's wider business, which may include other related/unrelated, competitive services."

28. But it is Oxera's explanation below which Vector endorses on this matter:

"We agree that the NZCC needs to be mindful of the financeability of the actual company, as it is the actual company that in reality delivers the service to consumers. We further discuss how important it is that the actual company maintains its financial resilience and provides an uninterrupted service in the next sub-section. However, we disagree with the NZCC that it can disregard notional company financeability issues if the actual company does not experience them, as we explain below. We consider that regulatory allowances need to be workable for the notional (i.e., the efficient and prudent) supplier, and ensuring this would be consistent with the Part 4 purpose to incentivise (and avoid disincentives to) investment. Otherwise, investor confidence in the regime may be undermined and/or financing on reasonable terms may be at risk."

CPPs and reopeners are not the right solutions

29. MEUG agrees with the Commission that CPPs are available to EDBs should they come across financial hardship.

"EDBs can also seek a Customised Price-Quality Path (CPP), where it would better suit the needs of a regulated EDB and its consumers. The Commission itself notes that "since financeability issues are likely to be specific to individual suppliers, CPPs are our preferred mechanism for suppliers facing business-specific issues that are not catered for in the DPP." We encourage the Commission to ensure that it is adequately resourced to deal with any increase in re-opener applications or CPP applications. It is important that these are dealt with in a timely manner, with a robust and repeatable process."

30. Alpine Energy explains why a CPP is not the right solution:

"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."

31. ENA expands on this:

    "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."

32. And PowerCo elaborates:

    "It is inconsistent that the Commission's view is that financeability is better addressed with a CPP, however, go on to mention that financeability issues would not be grounds on their own for a CPP application. This supports addressing financeability within the DPP. Financeability is a concern for all EDBs and should be addressed by providing sufficient cashflows in the DPP to support the allowed expenditure and maintain the assumed BBB+ credit rating throughout the DPP."

33. As we described in our submission to the financeability paper, CPPs are not the right solution. Instead, the Commission should look at establishing the right settings now on financeability to avoid CPPs being the last resort.

34. MEUG also believes that reopeners could help:

    "MEUG believes that any specific issues with financeability should be dealt with outside of the DPP framework. EDBs now have a number of re-opener provisions available to them, to address a range of uncertainties facing the sector. Considerable time has been spent discussing and refining these options, to support EDBs through the energy transition."

35. Vector is perplexed that the Commission and other stakeholders advocate for setting a DPP that is not financeable and then suggest a supplier applies for relief by applying for a CPP or reopeners. Such an approach cannot be sound regulatory practice. The Commission is obligated to set a DPP that is workable in all aspects including that the DPP is financeable. It is deeply concerning that such an approach by a regulator would be supported by stakeholders as surely the regulator in the first instance should set a DPP that it considers is most likely to be workable. Not doing so is in direct conflict with the long-term interests of consumers. If a supplier was minded undertaking expenditures set in a DPP that was not financeable there would be a likelihood it would fail. It is hard to see how this would be in consumers' interests.

vector

Revenue caps/ smoothing

36. The Commission's financeability paper was silent on providing emerging views on any revenue smoothing limits to both the first year of the regulatory period and the intra-period. We consider it a lost opportunity that how these smoothing limits are set by the Commission were not addressed in the IM review. This has led to significant uncertainty going into the next DPP especially when these limits will be set after the 90-day period EDBs are supposed to, under the Commission's model, to have hedged their debt. Without knowing the limits in advance of the DPP how suppliers can consider the levels of debt and hedging that will be required for the DPP.

37. Vector agrees with Alpine Energy:

> *"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."*

38. We reiterate that revenue smoothing limits could lead to the deferral of cashflows which could substantiate perceived regulatory risks for investors. Oxera explains this:

> *"Indeed, revenue deferral, especially if done at the DPP reset, can substantially increase the perceived risk of investment recovery, prompting investors to seek higher returns. Cash flow deferrals can also potentially affect investments if networks then choose to defer their investments, which has the potential to, in turn, harm consumers in the long term."*

39. Vector supports revenue smoothing limits set in real terms. We agree with Oxera's rationale:

> *"While we note that any moves towards a nominal basis of revenue setting (e.g. a nominal WACC allowance combined with non-indexation of the RAB) can be a means of accelerating cash flows in an NPV-neutral way if appropriately estimated, we agree with the NZCC's view that it is reasonable to specify revenue smoothing limits for EDBs in real terms. This is because specifying the limit in nominal terms would introduce additional inflation risk into the regime that would be difficult (or costly) for companies to hedge."*

40. Vector also supports any recovery of revenue caused by smoothing limits to be returned to suppliers within the regulatory period. Oxera highlights that:

> *"[…] such a cap needs to be set with consideration of its effects on financeability and potential cash flow deferral beyond the regulatory period […]."*

Equity raising costs

41. ENA and PowerCo support the inclusion of additional allowances for equity issuance costs. Vector agrees with them that equity raising, if required, is not a costless exercise, and the regime must provide a method to recover these costs. ENA (and PowerCo) suggests that the Commission adopts the Australian Energy Regulator's (AER) approach to equity issuance costs.

> *"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. 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."*

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

43. Oxera explains that:

> *"[…] we have seen that recent market and academic evidence supports a higher transaction cost allowance (than the 5% allowed by Ofgem), such that it will be important to undertake further analysis on both the direct and indirect costs of equity issuance as part of the DPP4 financeability testing."*

44. In Vector's original submission to the financeability paper, we confidentially provided some valuations of equity transaction costs. If the Commission requires further evidence, there is plenty available from other jurisdictions including Australia and the UK where these costs are accounted for within their respective regulatory frameworks.

Exempt vs non-exempt

45. PowerNet and Unison raised interesting points around the constraints of non-exempt EDBs in juxtaposition to exempt EDBs.

46. PowerNet explains in relation to New Zealand's decarbonisation challenge:

> *"It is explicitly clear to us that the settings for exempt EDBs are more conducive to meeting the needs of customers and the goals of decarbonising and electrifying the New Zealand economy. We are of the view that the current regulatory settings for non-exempt EDBs are inhibiting this transition, which in our view has unfortunately not been efficiently and effectively addressed in the Input Methodology review. It would be disappointing to see this*

continue by comparing costs and financeability to a DPP period where activity was different."

47. While Unison elaborates more specifically around financeability:

> *"The lack of certainty the Commission has provided about what a financeability 'sense check' will measure and achieve, including its relevance to a CPP application does not promote outcomes consistent with s 52A, and embeds further uncertainty contrary to s 52R. There is also an inequity between the circumstances of a non-exempt and exempt EDB in the electricity lines market, given the financing constraints may be substantially reduced where the regulation is not constraining an EDBs potential revenue."*

48. Vector also considered this inconsistency when it comes to opex allowance setting, in particular, in relation to opex step changes. Exempt EDBs do not have to get opex step changes approved by providing robustly verifiable evidence to the Commission. This puts them in an advantageous position when it comes to investing in opex solutions (for example smart meter data, SaaS, Cyber Security, flexibility services) which drive efficiency, investment deferral and resilience in the long run. Non-exempt EDBs could therefore be penalised through the non-acceptance of step changes (none were accepted at the DPP3 reset). The Commission must factor in these inconsistencies when it sets out its DPP4 draft decisions for non-exempt EDBs.

Dividend yields vs buybacks

49. Vector has commissioned Oxera Consulting LLP to undertake additional analysis[3] of the importance of dividend payments for utilities. Their report was sent alongside our submission.

50. In their original submission to the DPP4 financeability paper, Oxera highlighted the following:

    a. The Modigliani-Miller dividend irrelevance theorem—which suggests that investors are indifferent between receiving a dividend as a cash flow or reinvesting it in the business—is based on assumptions that may not hold in the real world. Therefore, in practice, investors do not tend to be indifferent between receiving a dividend and reinvesting in the company.

    b. There is a catering theory of dividend policy that supports that investors in utilities may have a specific preference for stable and high dividends due to institutional, clientele and behavioural explanations, and therefore a reduction in dividends may cause investors to reduce their holdings in utilities.

    c. Finally, they found that, across geographies, dividend yields for utilities are generally higher than those for the broader stock market indices.

---

[3] Oxera Consulting LLP, *DPP4 financeability consultation cross-submission—dividend yields*, 28 March 2024

51. Oxera's additional analysis supports the view that investors may choose to invest in utilities to receive those stable and high dividend flows. They conclude:

> *"Overall, the analysis in this report confirms the robustness of our conclusion in the response to the NZCC's financeability consultation, in which we showed that it is important for the NZCC to enable networks to pay out stable levels of dividends to avoid disincentivising investments."*

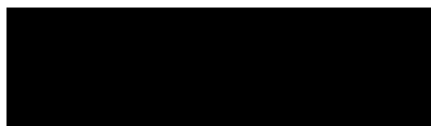
52. Vector supports this view and advocates that the Commission takes on board the importance of dividends for the utility sector when making its draft decisions on EDBs' financeability settings in particular:

    a. The financeability testing should include the ability to pay dividends as well as pay interest (i.e., both funders not just one); and

    b. Shareholders have an expectation of regular dividend payments (not long-term capital gains).

53. As always, if there are any elements of our submission that you would like to discuss please feel free to get in touch.

Yours sincerely



Richard Sharp
GM Economic Regulation and Pricing