



# Regulatory financeability



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# 1 Executive summary

1. Frontier Economics has been engaged by Vector Limited to provide advice on the approach to 'financeability' taken in the Commission's Draft 2023 IMs Decision.<sup>1</sup>

2. Our primary conclusions in this report are summarised below.

**Very significant investment is required – for the long-term benefit of consumers and to support New Zealand's net-zero commitments.**

3. Section 2 provides a brief summary of the scale of the investment task that is required to support New Zealand's decarbonisation commitments. These commitments will be impossible to achieve without very substantial network investment during the forthcoming IM period.

4. That section also surveys some of the modelling that forecasts substantial net financial benefits to consumers from this new investment. There is widespread agreement that substantial new investment over the coming decade will be needed to promote the long-term benefit of consumers. Consequently, it is essential to ensure that there are no regulatory roadblocks to this investment.

**Deficiencies in the regulatory framework should not block or delay efficient investment.**

5. Section 3 considers this new decarbonisation investment in the context of the Part 4 purpose. The key conclusions are that:

- a The *long-term* benefit of consumers must have primacy over any short-run pricing effects. No net benefit accrues to any consumer from a project that is never built;
- b Regulation should promote the outcomes that occur in competitive markets. The focus is on outcomes that *do* occur in real-world competitive markets and not on conjecture about what investors in a regulated firm *could* or *should* do;
- c No investment can be reasonably expected in the absence of ex-ante FCM;<sup>2</sup> and
- d Because investment over forthcoming years is particularly important (as it is essential for achieving national decarbonisation commitments and because it has been modelled as providing very significant net long-term benefits to consumers), there is a greater asymmetry in the consequences of over investment versus under investment.

**'Financeability' requires that the annual regulatory allowance supports the Commission's benchmark financing parameters.**

6. Section 4 sets out our view is that, in the regulatory context, a project or firm is 'financeable' if the annual regulatory allowance is sufficient to support the benchmark financing parameters (leverage and credit rating) that the Commission has adopted in setting that regulatory allowance.

7. It logically follows that:

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<sup>1</sup> Commerce Commission, October 2022, *Part 4 Input Methodologies Review 2023: Framework Paper*.

<sup>2</sup> Financial Capital Maintenance – the concept that the investor is made whole over the life of the asset by recovering their investment plus a fair return on capital.



- a If the Commission's benchmark financing parameters produce an allowed return that best reflects just that level of return that investors require to finance efficient investment; and
- b The annual regulatory allowance is insufficient to support the Commission's benchmark financing parameters; the result would be that
- c Investors would be unwilling to provide the finance that would be required to support efficient investment.

If regulation is the cause of a financeability problem, it must also be the solution.

- 8. Section 4 proposes that a financeability problem should be addressed by accelerating the annual regulatory allowance (in an NPV-neutral way) to the point where it is able to support the Commission's benchmark financing parameters.
- 9. It is not a viable solution for a supplier to:
  - a Accept a credit rating downgrade and consequential increase in its cost of debt without any compensation for this additional cost; or to
  - b Replace debt with more expensive equity, again without any compensation for this additional cost.
- 10. Those proposed 'solutions' generate a shortfall between incurred costs and the regulatory allowance that can never be recovered and are consequently inconsistent with the ex-ante FCM principle.

A clear statement in the IMs is required.

- 11. Section 5 reviews the Australian 'financeability' process where service providers have rejected an approach under which the regulator applies judgment at the time of each determination.
- 12. In that setting, the regulator would exercise judgment at the last step of the project approval process. However, by that stage of the project, the proponent has already incurred very substantial costs and is reputationally, and for all practical purposes, committed to the project. There is no real option of abandoning the project at the point where the regulator's decision becomes known.
- 13. Service providers have submitted that investors cannot be asked to effectively commit to a project without knowing anything about how the regulator would determine whether there is a financeability problem, or how such a problem would be addressed. They have instead proposed an approach that *requires* the regulator to set the annual regulatory allowance to be sufficient to support the regulator's benchmark credit rating at the regulator's benchmark level of leverage.
- 14. Even in the event that the Commission decides not to establish a Financeability IM, we consider that there would be real value in the Final Decision setting out the Commission's views about how it would determine whether a financeability problem exists and about how it would remedy any such problem. Without such clarity, investors will not have the certainty and confidence that the regulatory framework would address genuine financeability problems if/when they arise. This, in turn, could act as an unnecessary roadblock to the significant investment in regulated networks that New Zealand requires.

An IMs solution to financeability is required.

- 15. Section 6 considers potential solutions to the financeability issue. That section first establishes that:



- a Very significant decarbonisation expenditure is required over the tenure of the 2023 IMs – for the long-term benefit of consumers;
  - b Capital expenditure is only made in real-world competitive markets for projects that are commercially viable; and
  - c Commercial viability requires an acceleration of cash flows or government subsidy.
16. The regulatory solution to a financeability issue is to accelerate the allowed cash flows in an NPV-neutral manner. The Draft Decision discusses a number of approaches that can be used to accelerate the allowed cash flows in an NPV-neutral manner:
- a Removing indexation of the RAB;
  - b Removing indexation of the debt component of the RAB; and
  - c Accelerating depreciation allowances.
17. Removing RAB indexation (either for the entire RAB or the debt component) could be easily accommodated in the IMs.
18. To the extent that service providers are able to indicate that the removal of indexation (full or partial) would be sufficient to provide investors with the certainty that is required to support the type of investment that is required, this would be a simple solution.
19. Accelerating depreciation is unlikely to be a viable solution for the same reasons it has been rejected by Australian service providers. It simply does not provide investors with sufficient certainty about how financeability problems might be identified and remedied by the regulator.





## 2 The investment context for the 2023 IMs

### 2.1 The investment task that lies ahead

20. Electrification is at the core of New Zealand's decarbonisation strategy and this will require extensive investment in transmission and distribution networks over a short period of time. Indeed, it will be impossible for New Zealand to meet its decarbonisation commitments without this extensive network investment.
21. In our report of February 2023,<sup>3</sup> we noted that Boston Consulting Group (BCG) estimates that \$30 billion will need to be invested in the 2020s to upgrade transmission and distribution infrastructure. BCG expects that an additional \$35 billion will be required in both the 2030s and 2040s.<sup>4</sup>
22. Investment of this scale is unprecedented. As of 2021, the regulated asset base of New Zealand's Electricity Distribution Businesses (EDBs) totalled \$13.5 billion, with capital expenditure (capex) in that year of \$1.1 billion. Thus, the required capital expenditure is orders of magnitude higher than current levels. And this high level of expenditure is required year after year for decades in order for New Zealand to meet its current decarbonisation commitments. It is difficult to see how New Zealand could meet its net-zero commitments without this investment being delivered.
23. Our February 2023 report also notes that the *Climate Change Response (Zero Carbon) Amendment Act* of 2019 and the *Nationally Determined Contribution* (NDC1) set out three main emissions reduction targets for New Zealand:
  - a 50 per cent reduction of net emissions below gross 2005 levels by 2030;
  - b Net zero emissions of all greenhouse gases excluding biogenic methane by 2050; and
  - c 24 to 47 per cent reduction below 2017 biogenic methane emissions by 2050, including 10 per cent reduction below 2017 biogenic methane emissions by 2030.
24. The Climate Change Commission recognises that electrifying transport and process heat will require significant expansion in electricity generation capacity. It also recognises that increased demand and generation must be accompanied by expanding infrastructure for transmission and distribution.<sup>5</sup>
25. Transpower estimates that an additional 70 per cent of renewable generation is required to electrify process heat and transport, to decarbonise the New Zealand economy.<sup>6</sup>

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<sup>3</sup> Frontier Economics, February 2023, *Efficient investment in a decarbonising economy*.

<sup>4</sup> Boston Consulting Group, *Climate Change in New Zealand: The Future is Electric*, 25 October 2022.

<sup>5</sup> Climate Change Commission, *Inaia tonu nei: a Low Emissions Future for Aotearoa*, 31 May 2021.

<sup>6</sup> Transpower, *A Roadmap for Electrification: Decarbonising transport and process heat*, 10 February 2021.



26. Transpower's submission to the Climate Change Commission stated that New Zealand's electricity sector will need to build and deliver "as much new electricity generation in the next 15 years as it has in the last 40 years".<sup>7</sup>
27. Transpower also estimates that 60 to 70 new grid scale connections will be required before 2035 to meet the increased electricity demand.<sup>8</sup>
28. BCG's 2022 report into New Zealand's decarbonisation roadmap estimates that an investment of \$42 billion across generation, transmission and distribution will be required before the end of the decade. This amount includes:
  - a \$10.2 billion in new utility-scale renewable generation capacity;
  - b \$1.9 billion in new flexible generation and demand resources;
  - c \$8.2 billion in transmission infrastructure; and
  - d \$22 billion in distribution infrastructure.<sup>9</sup>
29. The magnitude of the investment task is similar in other jurisdictions. For example, Frank Calabria, CEO of Origin Energy in Australia, recently observed that:

*It is a truly staggering task to achieve those 2030 targets, and we must act with more urgency, as each month that passes makes the challenge harder with the propensity for adding costs.<sup>10</sup>*

and that:

*All of this will be occurring concurrently, representing a magnitude of investment and construction akin to the wartime reconstruction effort.*

*That \$76 billion in investment to deliver the transition ... needs to be paid for.*

## 2.2 Consumer benefits from network expenditure

30. Our February 2023 report also identified the material net benefits to consumers that have been forecast from this material capital expenditure program. Recent modelling demonstrates that network investment over the next decade will benefit consumers in a number of ways, including:
  - a Significant decarbonisation is impossible without electrification, which in turn requires material investment in networks;
  - b Enhanced network infrastructure facilitates more competition in the generation market, supporting a reduction in wholesale energy costs; and
  - c Augmentation of networks is required to enable customers to extract full value from their investment behind the meter, including rooftop solar, electric vehicles, and electric appliances.

<sup>7</sup> Transpower, *Transpower submission on Climate Change Commission first draft advice to Government*, p.8, March 2021.

<sup>8</sup> Transpower, *Submission to the Infrastructure Commission on the Commission's strategy consultation document - Infrastructure for a Better Future*, p.7, 2 July 2021.

<sup>9</sup> Boston Consulting Group, *Climate Change in New Zealand: The Future is Electric*, 25 October 2022.

<sup>10</sup> <https://www.afr.com/companies/energy/deep-pockets-of-global-capital-keen-to-fund-transition-origin-ceo-20221121-p5bzvj>, emphasis added.





31. A recent detailed assessment of the net benefits to consumers has been conducted by the Australian Energy Market Operator (AEMO) in its Integrated System Plan (ISP). AEMO has computed that every dollar of approved transmission network expenditure is expected to generate \$2.20 in customer benefits.
32. That is, the previously considered trade-off between customer prices on one hand and service quality and reliability on the other is now redundant. It is no longer the case that consumer benefits come at the expense of higher prices. Even disregarding any benefits to consumers associated with decarbonisation itself, recent modelling shows that targeted network expenditure can simultaneously:
- a Create tangible benefits for consumers; and
  - b Lower the total price paid by consumers.
33. In this regard, AEMO has identified:
- the three intrinsic benefits from investment in renewables: to reduce the cost of energy, to increase energy security, and to reduce emissions.*<sup>11</sup>
34. As part of its ISP, AEMO conducted an extensive cost benefit analysis in relation to a series of major transmission projects that formed the *Optimal Development Plan* (ODP). AEMO concluded that:
- The transmission projects within the ODP are forecast to deliver scenario-weighted net market benefits of \$28 billion, returning around 2.2 times their cost of approximately \$12.7 billion<sup>4</sup>. They represent just 7% of the total investment in NEM generation, storage, and network to 2050; optimise benefits for all who produce, consume and transport electricity in the market; and provide both investment certainty and the flexibility to reduce emissions faster if needed.*
- All of the transmission projects in the ODP are needed. They will cost-effectively serve the needs of consumers, support Australia's transition to net zero emissions, and support regional employment and economic growth.*<sup>12</sup>
35. AEMO further identified that its Optimal Development Plan would produce the following benefits:
- The primary benefits of the ODP are that it would:*
- *provide a reliable and secure power supply,*
  - *deliver \$28 billion in net market benefits by saving costs elsewhere,*
  - *retain flexibility to decarbonise the NEM at least as fast as current government, corporate and societal ambitions, and*
  - *be resilient to events that can adversely impact future costs to consumers, and relatively insensitive to changes in input assumptions.*<sup>13</sup>
36. And that:
- These benefits highlight the value of the transmission network in an efficient power system transformation. The network would allow NEM consumers to secure the full benefit of zero-emission VRE [variable renewable energy] generation, which will become even more cost-efficient*

<sup>11</sup> Australian Energy Market Operator, June 2022, *Integrated System Plan*, p. 27.

<sup>12</sup> Australian Energy Market Operator, June 2022, *Integrated System Plan*, p. 15.

<sup>13</sup> Australian Energy Market Operator, June 2022, *Integrated System Plan*, p. 63.



*over the ISP time horizon. Without that transmission, the NEM would require more expensive generation capacity nearer to load centres – either offshore wind, or gas-fired generation with carbon capture and storage (CCS) to manage its cumulative emissions. These technologies have higher capital costs than land-based VRE with, in the case of gas, higher fuel costs.<sup>14</sup>*

37. AEMO estimated that:

*Of the total benefits, 50% are from deferring or avoiding the capital cost of generation and storage projects, and 40% from fuel cost savings.<sup>15</sup>*

38. In particular, but for these network projects, the stated decarbonisation objectives could only be achieved by building more expensive generation facilities closer to existing grid connections and by building gas generation for firming purposes.

39. Importantly, the AEMO assessment of customer benefits does not include any additional benefit that consumers might obtain from their own behind-the-meter investment (e.g., rooftop solar, batteries, etc.).

40. An obvious, but very important, point is that no consumer receives any of the above net benefits from a decarbonisation project that is not pursued.

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<sup>14</sup> Australian Energy Market Operator, June 2022, *Integrated System Plan*, p. 64.

<sup>15</sup> Australian Energy Market Operator, June 2022, *Integrated System Plan*, p. 65. See also Table 4, p. 64 and Figure 30, p. 66.



### 3 Decarbonisation investment in the context of the Part 4 purpose

41. The IMs are produced under Part 4 of the *Commerce Act* (1986), which relates to the regulation of goods and services. The primary purpose of this part of the Act is set out in section 52A as follows:

*52A Purpose of Part*

*(1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services –*

*(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*

*(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*

*(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*

*(d) are limited in their ability to extract excessive profits.*

42. There are a number of aspects of this ‘purpose’ section that would seem to have particular relevance to the very significant investment task that is required to support New Zealand’s decarbonisation commitments:

- a It is the *long-term* benefit of consumers that must be promoted.

The investments in electricity network assets (which tend to have very long lives) must be assessed in terms of the benefits that will accrue to consumers over the *long term*. In cases where consumer benefits might accrue differentially over time, it is the *long-term* benefit that must be considered. For example, many of the consumer benefits identified in the previous section do not accrue immediately, but over the long term. It is this long-term benefit that is relevant to an assessment under Part 4;

- b Regulation should promote the outcomes that occur in competitive markets.

Thus, the focus is on outcomes that *do* occur in real-world competitive markets and not on conjecture about what investors in a regulated firm *could* or *should* do. For example, if investors in real-world competitive markets decline to commit funds to projects that result in a deterioration in the firm’s credit rating, or projects that involve equity capital receiving a return on debt allowance, that would be a relevant consideration; and

- c Regulation should promote the incentive to invest.

This requires that investors are provided with the sort of return that they expect to obtain from a similar investment in competitive markets. It is balanced by the requirement to limit the ability to extract excessive profits.

43. Part 4 of the Act also identifies regulatory certainty and the promotion of incentives in relation to energy efficiency as considerations, as follows:



### 52R Purpose of input methodologies

*The purpose of input methodologies is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part.*

### 54Q Energy efficiency

*The Commission must promote incentives, and must avoid imposing disincentives, for suppliers of electricity lines services to invest in energy efficiency and demand side management, and to reduce energy losses, when applying this Part in relation to electricity lines services.*

44. In its *Framework Paper*, the Commission explained the primacy of the section 52A purpose and identified the three key economic principles that support that purpose:

***Ex-ante real financial capital maintenance (FCM):*** we provide regulated suppliers the ex-ante expectation of earning their risk-adjusted cost of capital (ie, a 'normal return'), and of maintaining their financial capital in real terms over timeframes longer than a single regulatory period. This maintains incentives to invest in line with section 52A(1)(a) of the Act. However, PQ regulation does not guarantee a normal return over the lifetimes of a regulated supplier's assets. Suppliers' exposure to various risks will also differ depending on the applicable IMs and price-quality path settings, thereby affecting ex-post returns;

***Allocation of risk:*** ideally, we allocate risks to suppliers or consumers depending on who is best placed to manage the risk, unless doing so would be inconsistent with section 52A. In line with section 52A(1)(a) and (b), appropriate risk allocation and, where relevant, appropriate compensation for the risks carried, maintains incentives to invest and promotes efficient behaviour; and

***Asymmetric consequences of over-/under-investment:*** we apply FCM recognising any asymmetric consequences to consumers of regulated services, over the long term, of under-investment versus over-investment. This maintains incentives to invest in the service quality that consumers demand, in line with section 52A(1)(a) and (b).<sup>16</sup>

45. These principles have particular relevance and importance to potential financeability issues associated with the major new investment that is required to support decarbonisation. In particular:
- a It is essential that ex-ante FCM is preserved for these decarbonisation projects. This requires that investors in these projects must expect to receive a fair return in line with the risk of their investment; and
  - b Because investment over forthcoming years is particularly important (because it is essential for achieving national decarbonisation commitments and because it has been modelled as providing very significant net long-term benefits to consumers), there is a greater asymmetry in the consequences of over vs. under investment.
46. In the subsequent section of this report, we consider 'financeability' in the context of the Part 4 purpose and these economic principles that the Commission has identified as best supporting that purpose.

<sup>16</sup> Commerce Commission, October 2022, *Part 4 Input Methodologies Review 2023: Framework Paper*, paragraph X24.



## 4 Alternative interpretations of 'financeability'

### 4.1 Our interpretation of 'financeability' – would the project proceed in real-world competitive markets?

47. Our interpretation is that a project is 'financeable' if it is commercially viable and capable of receiving investment approval. We explain below that we do not consider a project to be commercially viable if:
  - a Proceeding with that project would cause a deterioration in the relevant firm's credit rating with no corresponding increase in allowed return; or
  - b The project would require the relevant firm to raise equity capital where that equity is provided with a return on debt allowance.
48. Investors in real-world competitive markets do not invest in circumstances such as those outlined above. Consequently, in real-world competitive markets, projects with those features would not proceed. Thus, projects are not 'financeable' in such circumstances.
49. In our view, the appropriate test relates to the observed practice of investors in real-world competitive markets. Conjecture about whether projects *could* or *should* proceed in such circumstances is not relevant.
50. We contrast our interpretation of 'financeability' with other definitions that tend to be much narrower. For example, financeability might be considered in terms of whether a particular project might lead to insolvency or bankruptcy of the relevant firm. Or it might be interpreted in terms of whether a project *could* be financed if investors *were* willing to accept a less-than-commercial rate of return on it.
51. In our view, these alternative definitions are too narrow and inappropriate for application in a regulatory context. Ultimately, what is important is whether a particular project goes ahead or not. If a particular project would not go ahead in a real-world competitive firm (which is the relevant standard under s 52A) it is not 'financeable' for the purposes of Part 4.

### 4.2 Assessment of 'financeability'

52. When determining the allowed return on capital, the Commission has regard to all of the relevant considerations set out in Part 4, using its framework of key economic principles as set out above. The outcome of this process is a set of regulatory Weighted Average Cost of Capital (WACC) parameters that the Commission considers best meets the requirements of Part 4. That is, the Commission considers that its set of parameters:
  - a Best reflects the outcomes produced in competitive markets;
  - b Provides the appropriate incentive for efficient investment;
  - c Is consistent with ex-ante FCM such that investors would expect to be made whole over the life of their investment; and



- d Balances appropriately any asymmetric consequence of under investment versus over investment.
53. It is also important to note that the Commission (quite appropriately) follows regulatory best practice in its consideration of the *benchmark* firm. For example:
- a The Commission sets allowed returns on the basis of its estimate of the leverage that would be adopted by a prudent and efficient firm, not on the basis of the actual leverage that a particular regulated firm might elect to use from time to time; and
  - b The Commission considers the regulated assets and does not have regard to unregulated assets that might also be owned by a particular firm.
54. Thus, the Commission's approach is to adopt a set of parameters to provide investors in the benchmark firm with the return that it considers best achieves the Part 4 purpose and best meets the other requirements of Part 4. In particular, the Commission sets the allowed return at a level that is just sufficient to support and incentivise the efficient level of investment, but no higher.
55. In this regulatory context, our view is that a project or firm is 'financeable' if the annual regulatory revenue allowance is sufficient to support the benchmark financing parameters (leverage and credit rating) that the Commission has adopted in setting that regulatory allowance.
56. It logically follows that:
- a If the Commission's benchmark financing parameters produce an allowed return that best reflects just that level of return that investors require to finance efficient investment; and
  - b The annual regulatory revenue allowance is insufficient to support the Commission's benchmark financing parameters; the result would be that
  - c Investors would be unwilling to provide the finance that would be required to support efficient investment.
57. For example, it is not enough that a proposed project is considered to be NPV=0, so that it eventually provides investors with the required return over its life. Financeability also requires that the project can be financed in the way that the Commission has assumed in setting the allowed return. This, in turn, requires a cash flow allowance each year that is sufficient to maintain the benchmark credit rating at the benchmark level of leverage throughout the life of the project.
58. Thus, our proposed test of 'financeability' is a simple test of internal consistency. Our view is that the annual regulatory revenue allowance should be sufficient to support the benchmark financing parameters (specifically, leverage and credit rating) that the Commission has adopted as the basis for setting that annual regulatory revenue allowance.

### 4.3 Interpretation of 'financeability' in the Draft Decision

#### Draft Decision definition

59. The Draft Decision defines financeability as follows:





*‘Financeability’ refers to the ability of regulated suppliers to, under certain assumptions and conditions, raise and repay capital in financial markets readily and on reasonable terms.<sup>17</sup>*

60. The approach that we have set out above is consistent with that definition in the case where “reasonable terms” is interpreted as being the Commission’s benchmark financing parameters. Our view is that the annual regulatory allowance should be sufficient to enable the regulated supplier to raise capital in line with the benchmark financing parameters.

#### Relevant Australian context

61. The Draft Decision appears to adopt an interpretation of ‘financeability’ wherein “reasonable terms” is taken to mean something other than the Commission’s own benchmark financing parameters. In doing so, it draws heavily on the process relating to ‘financeability’ that is currently running in Australia.
62. In the Australian setting, network firms have indicated that new projects that are essential to support decarbonisation commitments are not financeable because the annual regulatory allowance is insufficient to support the benchmark financing parameters on which that allowance is based. In particular, the AER considers that the benchmark efficient firm would issue 60% debt at a BBB+ credit rating. However, the annual regulatory allowance is not sufficient to support those parameters.
63. Consequently, the benchmark firm would either have to:
- a Issue debt at 60% leverage and accept a rating downgrade and the consequential increase in interest costs beyond the regulatory allowance; or
  - b Maintain the rating at BBB+ by adopting less than 60% leverage, which requires additional equity to be issued – for which the regulatory allowance would be the allowed return on debt.
64. That is, the annual revenue allowance always assumes that the regulator’s benchmark financing parameters will be achieved. In the Australian setting, that is a BBB+ credit rating at 60% leverage. But for any year in which that cannot be achieved, the regulatory allowance will be insufficient to cover the costs incurred by the benchmark firm. Either debt will be issued at a lower rating or some debt finance will be replaced by equity. In either case, the required return is higher than the BBB+ return on debt allowance provided by the regulator.
65. Moreover, any such shortfall is permanent and can never be recovered. There is no possibility of a symmetrical future scenario. By its very definition, the benchmark firm never issues more than the benchmark leverage or achieves more than the benchmark credit rating.
66. In the Australian setting, this internal inconsistency has already resulted in several major decarbonisation transmission projects failing to gain investment approval from shareholders without the provision of some form of government support (e.g., through concessional debt financing arrangements).
67. In our view, the Commission’s above definition of financeability is only appropriate if “reasonable terms” is taken to mean the Commission’s benchmark financing parameters. That is, the annual regulatory allowance should be sufficient to enable the benchmark firm to raise capital in line with the benchmark financing parameters.

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<sup>17</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.290.



68. However, in a number of places, the Draft Decision implies that something falling short of support of the benchmark financing parameters might be acceptable. We review various aspects of the Commission's approach to financeability in the remainder of this section.

#### Agreement that financeability relates to the benchmark firm

69. The Draft Decision is clear about the fact that financeability (however that term might be defined) should be assessed in relation to the benchmark efficient firm and not in relation to the circumstances of the actual firm providing the regulated service, which may have deviated from the benchmark assumptions and/or may also own unregulated assets:

*We note that 'ability' to invest is not the same as 'incentive' to invest. The potential inability to invest can be caused by a range of factors, which may result in the supplier operating in a way that is inconsistent with the benchmark operating assumptions. Examples include poor performance of unregulated business units, or financial management decisions such as excessive dividend payments (over which the supplier has control), or excessive leverage.<sup>18</sup>*

70. We agree that financeability must only be assessed from the perspective of the benchmark firm.
71. It would be inappropriate to suggest that the regulator should take action to address a financeability issue caused by poor performance of an unregulated business unit. Symmetrically, it would be equally inappropriate to rely on strong performance of an unregulated business unit as a reason for not addressing a financeability issue caused by the regulatory framework.
72. Similarly, it would be inappropriate to suggest that the regulator should take action to address a financeability issue caused by a firm adopting excessive leverage beyond the efficient benchmark. Regulated suppliers should, under the Commission's system of incentive regulation, be free to depart from the benchmark level of leverage determined by the Commission. However, the consequences of doing so (both on the upside and the downside) should fall squarely on shareholders, not consumers. Symmetrically, it would be equally inappropriate to suggest that a financeability issue caused by the regulatory framework could be addressed by adopting leverage below the efficient benchmark, or by equity investors taking action (e.g., by foregoing dividends or injecting additional equity that does not attract the full cost of equity allowance).

#### NPV=0 is not enough

73. Financeability problems arise in the Australian setting even though the regulatory model for the benchmark firm is consistent with NPV=0. Like the New Zealand setting, the Australian framework produces a combination of annual cash allowances and RAB indexation that achieves NPV=0 by definition.
74. The problem arises because the regulatory model assumes, without ever checking, that the annual regulatory allowance is sufficient to support the benchmark financing parameters every year. Where the allowance is insufficient to support the benchmark financing parameters, there is a shortfall that can never be recovered – as set out above.
75. In this situation, the regulatory allowance is less than the costs incurred by the benchmark firm and the NPV=0 principle, and consequently ex ante FCM, fails.

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<sup>18</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.293.



76. This is not apparent in the regulatory model because that model assumes away the possibility of such a problem. The purpose of a regulatory financeability test is to assess whether such an assumption is correct.

77. In this regard, the Draft Decision suggests that NPV=0 implies financeability:

*An efficient supplier operating under our benchmark assumptions is unlikely to face financeability issues, given the way our regulatory accounting is consistent with real NPV=0 over the expected life of the assets.*<sup>19</sup>

78. For the reasons set out above, our view is that it does not follow that NPV=0 in a regulatory model is sufficient to ensure that every efficient project would gain investment approval.

#### The responsibility of suppliers?

79. The Draft Decision indicates that financeability issues should be addressed by the regulated firm rather than by the regulatory process. For example:

*However, in general, we do not consider that depreciation should be used to address financeability concerns. We consider that financing the preferred recovery of investment (the one that best promotes the Part 4 purpose) under the price path is primarily the responsibility of suppliers. They have a range of tools for doing so, including reducing dividend payments, or raising debt and/or equity.*<sup>20</sup>

80. The Draft Decision also states that:

*We note that, assuming Transpower operates according to our benchmark assumptions, Transpower's capital expenditure plans would likely require the suspension or reduction of dividends and equity injections,*<sup>21</sup>

and that the changes proposed in the Draft Decision:

*would imply a need for greater equity injection and a longer suspension of dividends compared to continuing the status quo,*<sup>22</sup>

but that:

*Our modelling at this point indicates indexation may not lead to a financeability problem.*<sup>23</sup>

81. In our view, financeability cannot be achieved by ceasing dividend payments and issuing additional equity, while still receiving the same allowed return. We have already seen several examples (such as the PEC example below) where projects in that circumstance were unable to obtain investment approval.

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<sup>19</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.27.1 and 3.292.

<sup>20</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.27.1 and 3.292.

<sup>21</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.97

<sup>22</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.97.

<sup>23</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.97.



### Is government support the appropriate solution?

82. The Draft Decision discusses the example of Project EnergyConnect (PEC) in Australia. For that project, the annual regulatory allowance was insufficient to support the benchmark financing parameters and the relevant regulators refused to make any modification to the standard allowance. Consequently, the project was unable to obtain investment approval from its proponent firms and their investors.
83. PEC was able to proceed only after a government agency, the Clean Energy Finance Corporation, provided \$295 million of concessional finance.
84. In relation to this example, the Draft Decision states that:

*the government had to provide additional finance to support the project going ahead. We consider that raising additional finance (equity and/or debt) is appropriate to support investment.<sup>24</sup>*

85. In our view, reliance on government support is not the appropriate solution to a financeability issue. Such arrangements are wasteful and crowd out more efficient, welfare-enhancing investments that government could be undertaking. Such government intervention is a second-best solution and is necessary only because the regulatory framework has failed to address an investment problem that (a) it created, and (b) it really ought to fix.
86. Rather, in our view, the appropriate solution is simply to ensure that the annual regulatory allowance is sufficient to support the regulator's own benchmark financing parameters.
87. If a project that has obtained regulatory approval is unable to obtain investment approval under the annual regulatory allowance, there is a problem with the annual regulatory allowance – not with the lack of taxpayer support.

### Inter-generational equity

88. The context for any consideration of efficiency and inter-generational equity is that the decarbonisation of the economy will require very significant transmission and distribution network expenditure. This, in turn, requires very significant and permanent increases in network charges. Although the modelling discussed above indicates that:
- a There is no prospect of achieving decarbonisation objectives without this significant expenditure; and
  - b The additional network expenditure is expected to provide a net financial benefit to consumers;

it remains the case that the very significant network augmentation comes at a very significant cost that must be recovered.

89. This raises the questions of how and when these network augmentation costs are recovered. The current Australian financeability processes have demonstrated that investment will not occur if it results in a deterioration of the credit rating or in the need to raise equity finance that is compensated with a return on debt allowance. That is, the cash flows must be sufficient to support the benchmark investment grade credit rating at the benchmark level of leverage. Otherwise, the

<sup>24</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.93.2.



project will not proceed and no consumers will derive any benefit from it – financial or environmental.

90. An issue then arises in the case where current consumers are unable or unwilling to bear the increase in network charges that would be required to maintain the benchmark credit rating at the benchmark level of leverage. Simply ‘pushing back’ recovery to future consumers in an NPV-neutral manner is not a solution. Any project that would result in a deterioration of the credit rating or the need to raise equity finance that is compensated with a return on debt allowance will simply not proceed – even if it is NPV=0 over its 50- or 100-year life.
91. In this situation, there would seem to be three alternatives:
  - a Network charges increase to the level required to support the benchmark credit rating at the benchmark level of leverage; or
  - b Some form of government subsidy is provided to enable the firm to maintain the benchmark credit rating at the benchmark level of leverage; or
  - c The project does not proceed.
92. In our view, the Australian evidence has shown that any project that would result in a deterioration of the credit rating or the need to raise equity finance that is compensated with a return on debt allowance cannot be expected to proceed. Thus, the Commission should either:
  - a Set the annual regulatory revenue allowance to the level required to support the benchmark credit rating at the benchmark level of leverage; or
  - b Explain clearly that its allowed revenues have been set on the basis that some form of government subsidy is required to support the benchmark credit rating at the benchmark level of leverage for some period of time; or
  - c Accept very significant delays to essential network investment, such as that which has been observed for actionable ISP projects in Australia.

#### 4.4 Clarity in the Final Decision

93. We agree that financeability requires that finance can be raised on reasonable terms. The allowed return on capital is the Commission’s assessment of what constitutes reasonable terms. Thus, our view is that financeability requires that the annual regulatory allowance should be sufficient to enable the regulated supplier to raise capital in line with the Commission’s benchmark financing parameters.
94. As discussed in the next section, we think there is a compelling case for a Financeability IM in which the Commission sets out clearly in advance an objective, predictable and replicable process for:
  - a Assessing whether suppliers would face a financeability problem under a regulatory determination; and
  - b Addressing any financeability problem that is identified.
95. This would give investors (and consumers) greater certainty over how the Commission intends to deal with potential financeability issues if and when they arise. This would be preferable to the current arrangements, whereby no stakeholder can be sure whether/how the Commission would deal with financeability concerns in future. Such certainty would provide investors with the



confidence they require in order to commit scarce capital (which could easily be invested elsewhere globally) to projects that would support New Zealand's energy transition.

96. At a minimum, a Financeability IM would provide a clear statement for stakeholders about whether the Commission agrees with the principle that the annual regulatory allowance should be sufficient to support the Commission's benchmark financing parameters and, if not, how any alternative definition is consistent with ex ante FCM and the provision of incentives for efficient investment.





# 5 Should financeability be addressed in the IMs?

## 5.1 Why a transparent approach to financeability is important

97. The Draft Decision concludes that:

*We do not consider adopting a financeability test in the Part4 IMs would achieve our IM Review overarching objectives. This is because we do not need a test in the IMs to consider financeability, so it is unnecessary. We can already consider, and indeed have previously considered, financeability where relevant and not inconsistent with promoting the Part 4 purpose.<sup>25</sup>*

98. By contrast, our view is that there is some real value in setting out the Commission's views about what would constitute a financeability issue and what remedial action would be taken.

99. In the Australian setting, the Australian Energy Market Commission (AEMC) has proposed a model in which the AER would have discretion to accelerate regulatory cash flows in an NPV-neutral manner in order to address a financeability problem. However, in its June 2023 Rule Change Request, Energy Networks Australia has rejected that approach on the basis that it will have no impact at all on any actionable ISP project.<sup>26</sup>

100. The key problem that has been identified is that the AER's judgment will be exercised in the last step of the approval process where the AER issues a special regulatory determination for the project. By that stage of the project, the proponent has already incurred very substantial costs and is reputationally, and for all practical purposes, committed to the project. There is no real option of abandoning the project at the point where the AER's decision becomes known.

101. Thus, investors are being asked to effectively commit to the project without knowing:

- a How the AER would determine whether or not there is a financeability problem; or
- b How such a problem would be addressed.

102. Faced with this uncertainty, rational investors participating in global capital markets that offer attractive investment opportunities elsewhere may simply decline to finance energy transition projects because they may find themselves in a situation where, a number of years later (when they have effectively committed to the project) that the regulator decides to not act to address a financeability problem created by a failure of the regulatory framework.

103. In our view, a model whereby investors are asked to effectively commit to a project before knowing how the regulator will determine whether a financeability problem exists, or how any such problem would be addressed, will be insufficient to support efficient investment.

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<sup>25</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.288.

<sup>26</sup> <https://www.aemc.gov.au/rule-changes/ensuring-financeability-actionable-isp-projects>.



104. For this reason, we consider that there would be some real value in the Final Decision setting out the Commission's views about how it would determine whether a financeability problem exists and about how it would remedy any such problem.
105. In this regard, we note that there is regulatory precedent for such structured and transparent approaches to financeability.
106. Energy Networks Australia has proposed a fully-transparent formulaic approach. This approach sets out a formula that would be used to determine whether or not the annual regulatory allowance would be sufficient to support the regulator's benchmark credit rating at the regulator's benchmark level of leverage. The formula is a combination of various ratios that credit ratings agencies adopt in their ratings process. Any shortfall would be remedied by accelerating allowed revenues (via depreciation) by the minimum extent required to just support those benchmark financing parameters.<sup>27</sup>
107. An alternative to this approach would be the adoption of the principle that the annual regulatory allowance should be sufficient to support the benchmark financing parameters – without the specification of a precise formula by which that is determined.

## 5.2 IPART approach

108. IPART also applies a financeability test based on various credit metrics.<sup>28</sup> A key component of the IPART process is that IPART seeks to identify the cause of any financeability issue before determining the appropriate remedy. In this regard, IPART applies its financeability test to the benchmark firm as well as to the actual firm providing the regulated service.
109. In the event that the benchmark firm fails the test, the only cause can be an insufficient regulatory allowance – in which case IPART will further investigate what it is about the regulatory allowance that causes the test to fail.
110. In the event that the actual firm fails the test, but the benchmark firm does not, it must be something about the unregulated part of the business, or departures from regulatory benchmarks (e.g., higher leverage) that has caused the problem. In this case, it would not be incumbent upon the regulator to address the problem.

## 5.3 Ofgem approach

111. The UK *Electricity Act* (1989) requires Ofgem, among other things, to have regard to the need for service providers to be able to finance their activities.
112. Ofgem considers a range of key financial ratios that ratings agencies use to inform their credit ratings. These ratios are applied at the benchmark firm level. To the extent that a particular firm elects to depart from the regulatory benchmark, that would be the responsibility of that firm and the costs or benefits of any such departure would remain with shareholders and not consumers.<sup>29</sup>

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<sup>27</sup> <https://www.aemc.gov.au/rule-changes/ensuring-financeability-actionable-isp-projects>.

<sup>28</sup> <https://www.ipart.nsw.gov.au/sites/default/files/documents/final-report-review-of-our-financeability-test-november-2018.pdf>.

<sup>29</sup> <https://www.ofgem.gov.uk/publications/financeability-assessment-riio-2-further-information>.



113. Ofgem is transparent about the financial ratios that it examines. Service providers are required to submit data on the various financial ratios on a pro-forma basis and to provide Board assurance as to financeability based on expected regulatory allowances.<sup>30</sup>
114. In our view, there are advantages to a process that is established and understood by all stakeholders in advance – relative to an approach where discretion is applied by the regulator ‘after the event’ with little guidance provided.
115. Ofgem notes that a potential remedy for financeability problems is the acceleration of depreciation or the adjustment of the benchmark leverage parameter (if warranted by the evidence). In our view, these are potentially appropriate responses – any financeability problem relating to the benchmark firm arises as a result of the annual regulatory allowance being insufficient to support the benchmark financing parameters, in which case the solution must be to increase the annual regulatory allowance in some way.
116. However, there are two aspects of the Ofgem approach that have been identified as problematic in light of the recent Australian financeability processes:
  - a Ofgem maintains discretion about how it would determine when a financeability issue required a regulatory remedy and what the nature of that remedy would be. The recent Australian experience has demonstrated that investors require more regulatory certainty before committing to major decarbonisation projects. A particular hurdle arises when investors are effectively required to commit to a project without knowing how a financeability problem will be addressed if one should arise; and
  - b Ofgem raises the possibility that financeability might be dealt with by restricting dividends or via an equity injection. Whereas this might be appropriate for a financeability problem caused by a departure from the benchmark parameters (e.g., the firm adopting higher than benchmark leverage), it is not a solution to a financeability problem identified for the benchmark firm – where the problem arises, by definition, from the benchmark regulatory allowance.
117. In this regard, we note that the Ofgem financeability framework was developed in the context of marginal business-as-usual capital investment and not in the context of the transformational levels of expenditure that are now required to support national decarbonisation commitments.

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<sup>30</sup> <https://www.ofgem.gov.uk/publications/financeability-assessment-riio-2-further-information>.



# 6 Summary and potential solutions to financeability problems

## 6.1 Financeability in context

Very significant decarbonisation expenditure is required over the tenure of the 2023 IMs – for the long-term benefit of consumers

118. The 2023 IMs will cover the period over which New Zealand plans to fundamentally transform its energy system to achieve decarbonisation targets. The earlier sections of this report highlight the enormity of the task wherein very significant new investment is required during the period covered by the 2023 IMs. Indeed, we have noted above that the investment task has been likened to post-war reconstruction efforts.
119. We have also noted above that:
  - a There is no prospect of achieving decarbonisation objectives without this very significant network expenditure; and
  - b The additional network expenditure is expected to provide a net financial benefit to consumers.
120. Thus, there is a strong imperative for this decarbonisation investment being made.

Capital expenditure is only made in real-world competitive markets for projects that are commercially viable
121. The Australian experience in relation to the major new projects that are required in order to support decarbonisation is that capital investment will not be made unless it is commercially viable, or unless the Government is willing to step in with very significant financial support. The key factor affecting the commercial viability of major decarbonisation investments in energy networks in Australia is the speed of the allowed cash flows.
122. In this regard, new decarbonisation investment differs from business-as-usual replacement and augmentation capex in a number of ways, including:
  - a The investment required to support decarbonisation over the tenure of the 2023 IMs is orders of magnitude greater than business-as-usual capex;
  - b New decarbonisation projects tend to be more substantial and longer-lived before being fully commissioned; and
  - c New decarbonisation projects are discretionary in the sense that they can be delayed without materially impacting safety and reliability standards.
123. Whereas business-as-usual capex can be accommodated within the prevailing regulatory framework (because it is smaller in magnitude and quicker to be incorporated into the RAB), new decarbonisation investment has been more closely scrutinised by network owners and their investors. The Australian experience has been that major new decarbonisation investment cannot



be accommodated within the prevailing regulatory framework – because of its effects on credit ratings and/or the requirement to issue additional equity without a commensurate allowed return.

#### Commercial viability requires an acceleration of cash flows or government subsidy

124. As we have explained above, logically, there are only three options available when such a financeability issue arises:
- a The regulator can set the annual regulatory revenue allowance to the level required to support the regulator’s benchmark credit rating at the regulator’s benchmark level of leverage; or
  - b A government subsidy can be provided to support the benchmark credit rating at the benchmark level of leverage; or
  - c Accept very significant delays to essential network investment, such as that which has been observed for actionable ISP projects in Australia.
125. In this regard, regulatory statements about how investors could, or should, finance these decarbonisation projects, or modelling showing that the projects might be NPV=0 over their 50- or 100-year lives, is insufficient in real-world competitive markets.

## 6.2 Regulatory approaches to accelerating cash flows

126. The regulatory solution to a financeability issue is to accelerate the allowed cash flows in an NPV-neutral manner. Under this approach, consumers pay the same amount in NPV terms, but the allowed cash flows are accelerated by reversing some of the ‘back-loading’ of cost recovery that occurs within the prevailing regulatory model.
127. The Draft Decision discusses a number of approaches that can be used to accelerate the allowed cash flows in an NPV-neutral manner:
- a Removing indexation of the RAB;
  - b Removing indexation of the debt component of the RAB; and
  - c Accelerating depreciation allowances.

#### Removing RAB indexation

128. Under the prevailing regulatory model for EDBs and gas businesses, the RAB is indexed to inflation. Under this approach, the cash flow allowance is only sufficient to provide the real return on capital. The inflation component of the allowed return is then recovered over the remaining life of the assets via the indexed RAB.
129. Transpower currently operates with an unindexed RAB<sup>31</sup> as a means of facilitating the significant capital expenditure program over the duration of the 2010 and 2016 IMs.
130. The experience with Transpower is that the removal of RAB indexation has been sufficient to ensure that there have been no financeability issues in relation to its substantial capex program over the tenure of the current and previous IMs.

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<sup>31</sup> Although the Draft Decision proposes to apply RAB indexation in the 2023 IMs.



131. This approach is also straightforward to implement and has already been applied to Transpower since 2010.
132. Thus, one approach open to the Commission for ensuring that there is no regulatory obstacle to the very significant investment that is required to enable decarbonisation would be to consult with service providers about removing RAB indexation under the 2023 IMs. This could be applied as a temporary measure to enable the transformational investment that is required during the tenure of the 2023 IMs.
133. To the extent that service providers are able to indicate that non-indexation of the RAB would be sufficient to provide investors with the certainty that is required to support the type of investment that is required, this would be a simple and implementable solution that is based on existing Commission practice for Transpower.

#### Removing indexation of the debt component of the RAB

134. A 'hybrid' approach would be to remove indexation of the debt component of the RAB. This would have the effect of accelerating some cash flows, but obviously less than if indexation of the entire RAB were removed.
135. The rationale for non-indexation of the debt component of the RAB is that the benchmark service provider issues debt in nominal terms, such that lenders require payment of the full nominal interest bill in cash every year. Under RAB indexation, however, the allowed revenue each year only includes sufficient cash flow to pay the real component of the interest bill, leaving a shortfall.
136. That is, removing indexation from the debt component of the RAB would simply result in the allowed revenue each year including a return on debt allowance that is just sufficient to cover the nominal interest payment that the benchmark firm is contractually required to make.
137. We note that the Draft Decision does recognise that the benchmark service provider issues debt in nominal terms. The Draft Decision then proposes a wash-up/adjustment mechanism to ensure that the *quantum* of the allowed return on debt matches the nominal interest that would be incurred by the benchmark firm.
138. However, the wash-up mechanism proposed in the Draft Decision does not match the *timing* of the benchmark interest payments. Whereas the real component of the allowed return on debt is provided in cash via allowed revenue, the inflation component is provided via RAB indexation. Thus, the *timing* problem remains, even under the approach proposed in the Draft Decision.
139. As for the entire removal of RAB indexation above, the Commission could consult with service providers about removing RAB indexation for the debt component of the RAB. Again, to the extent that service providers are able to indicate that this approach would be sufficient to provide investors with the certainty that is required to support the type of investment that is required, this would be a simple solution to implement. It would be written into the IMs and obviate the need for service providers to pursue CPPs to address financeability problems that may arise during the course of undertaking major decarbonisation investments.

#### Accelerated depreciation

140. The Draft Decision proposes that service providers are able to pursue customised acceleration of depreciation allowances – just sufficient to address any financeability problem – via a CPP.
141. This is analogous to the approach recently proposed by the AEMC in Australia. The AEMC has proposed that financeability concerns could be addressed, project by project, with the AER tailoring depreciation allowances in a way that is just sufficient to address the financeability problem.





142. However, this approach has been rejected by the Australian service providers as being no solution at all. The key reason for this rejection is that it provides no certainty at all about how the AER would go about determining whether a financeability problem existed, and, if so, how it would be addressed. Moreover, the AER's judgment would be exercised at a time in the process where the service provider is already effectively committed to the project. Because service providers would not know whether/how the regulator would address a financeability problem until it was too late to withdraw from the project (if the regulator's solution proves inadequate), service providers have indicated that their investors would be less inclined to commit funds to such projects in the first instance. This may jeopardise the major network investments that would be required to achieve Australia's net-zero objectives.
143. This has led Australian service providers, via their industry association, to propose a solution that *does* provide the certainty that investors require about the identification and remediation of financeability problems.<sup>32</sup> The key observation from this submission is that the service providers consider regulatory discretion about accelerated depreciation to be no solution to financeability issues at all.
144. Moreover, accelerating depreciation via a CPP process involves considerably more complexity than an IMs solution to this issue.

### 6.3 Potential conflict with a 10% cap to price increases

145. We note that there is a potential conflict between:
- A 10% cap on price increases; and
  - The increase in prices that would be required to produce the allowed revenues that are sufficient to support the required degree of investment in decarbonisation projects.
146. In the event that the 10% price cap is triggered, the allowed revenues are (by definition) insufficient to cover the efficient costs of the benchmark service provider. In our companion report, we observe that:
- In any year in which the limit binds, an EDB will not earn sufficient revenue to cover its prudent and efficient costs (and the costs that it has been permitted to pass through because they are entirely exogenous) for that year and will not receive the full value of incentive payments for past efficiency gains that it is entitled to receive in that year.*<sup>33</sup>
147. Clearly, any such constraint on allowed revenues would exacerbate the cash flow financeability problems described above and rule out any regulatory solution that involved any mechanism to accelerate allowed cash flows.

### 6.4 Is it possible to ever establish a financeability problem?

148. The Commission has published some modelling for Transpower in conjunction with its Draft Decision.<sup>34</sup> That modelling contains a scenario in which Transpower would be required to suspend

<sup>32</sup> <https://www.aemc.gov.au/sites/default/files/2023-07/ENA%20rule%20change%20request%20-%209%20June%202023.pdf>.

<sup>33</sup> Frontier Economics, July 2023, *A review of the limit on EDB price increases*, p. 1.

<sup>34</sup> [https://comcom.govt.nz/\\_data/assets/excel\\_doc/0028/318466/Part-4-IM-Review-2023-Risks-and-incentives-topic-paper-Demonstration-model-Financial-impacts-of-indexation-of-Transpowers-RAB-June-2023.xlsm](https://comcom.govt.nz/_data/assets/excel_doc/0028/318466/Part-4-IM-Review-2023-Risks-and-incentives-topic-paper-Demonstration-model-Financial-impacts-of-indexation-of-Transpowers-RAB-June-2023.xlsm).



dividends for the best part of a decade and raise material amounts of new equity. However, the Commission concludes that such a scenario is not indicative of a financeability problem:

*Transpower's capital expenditure plans would likely require the suspension or reduction of dividends and equity injections under either indexation or non-indexation. The lower revenue from RAB indexation would imply a need for greater equity injection and a longer suspension of dividends compared to continuing the status quo. We welcome comments on whether Transpower's (benchmark) cash flows would create concerns for its (benchmark) credit rating position. Our modelling at this point indicates indexation may not lead to a financeability problem.*<sup>35</sup>

149. The statement above fails to identify correctly why a supplier such as Transpower may need to suspend dividends and seek additional equity injections. The Commission suggests in the quote above that these actions may need to be taken due to "Transpower's capital expenditure plans." This is incorrect. The reason a supplier such as Transpower may be compelled to take such actions is because the regulated cash flows have been set too low to support the benchmark credit rating at the benchmark level of leverage. In other words, the source of the problem is a failure in the way regulatory allowances have been set—not the supplier's investment program.
150. The core of the Part 4 purpose is the promotion of "outcomes that are consistent with outcomes produced in competitive markets."<sup>36</sup>
151. Moreover, section 53P(8)(a) permits alternative prices to be charged "if, in the Commission's opinion, this is necessary or desirable to minimise any undue financial hardship to the supplier or to minimise price shock to consumers." That is, minimising hardship to suppliers is given equal weight to minimising price shocks to consumers.
152. This raises the question of whether a regulatory allowance that has the effect of:
  - a Suspending dividend payments over the course of the following decade; and
  - b Requiring significant equity capital raising
 can reasonably be considered to be "reflective of outcomes and practices in competitive markets," or whether it is more indicative of "hardship to suppliers."
153. Moreover, if it is the case that a decade-long suspension of dividends is not indicative of a financeability issue, it is not clear how a financeability issue could ever be established.
154. Consequently, an approach whereby:
  - a Financeability is not addressed in the IMs; but where
  - b Service providers who consider that financeability is an issue are permitted to seek accommodation via a CPP

is unlikely to provide the type of investment certainty that investors (in competitive capital markets) actually require.

<sup>35</sup> Commerce Commission, June 2023, *Financing and incentivising efficient expenditure during the energy transition topic paper*, paragraph 3.97.

<sup>36</sup> *Commerce Act* (1986), s. 52A(1).



## 6.5 Recommendation

155. In our view, the approach proposed in the Draft Decision is unlikely to provide investors with the certainty they require in order to commit the significant levels of capital that is required in order to deliver the network investments required in order to support the achievement of New Zealand's net-zero commitments.
156. Relying on a CPP process would be too cumbersome and leave too much uncertainty over whether and how the Commission might address financeability problems that suppliers might face when undertaking these major investments.
157. We therefore think that the Commission should either:
  - a Consult on whether a full or partial suspension of RAB indexation for the tenure of the 2023 IMs would be sufficient to provide investors with the certainty required to support the transformational investment that is required over the next decade; or
  - b Develop an IM that specifies clearly how the Commission proposes to:
    - i Assess whether a supplier faces a financeability problem; and
    - ii Address any financeability problem identifiedwhen it sets DPP allowances.
158. Any financeability test codified within the IMs should:
  - a. Indicate that the financeability of a benchmark efficient supplier would be assessed by checking whether the regulated annual cash flows available to such a supplier would be sufficient to support the benchmark credit rating at the benchmark leverage level determined by the Commission in the cost of capital IM;
  - b. Recognise that any financeability problem caused by regulated cash flows being set too low should be fixed by setting regulated cash flows at a more appropriate level – not by suggesting that equity investors could step in;
  - c. Seek to address any financeability problem identified by accelerating the regulated cash flows (in an NPV-neutral manner) to the extent necessary to support the benchmark credit rating at the benchmark level of leverage; and
  - d. Be entirely formulaic (in the same way as the cost of capital IM is formulaic) so that the outcomes of the test can be anticipated by any informed party (including regulated suppliers and their investors). Any scope for regulatory discretion about how the results of the test would be interpreted by the Commission, or how any financeability problem that is identified may be addressed, would not provide investors with the upfront certainty and predictability needed to commit funds to decarbonisation investments.

## Frontier Economics

Brisbane | Melbourne | Singapore | Sydney

Frontier Economics Pty Ltd  
395 Collins Street Melbourne Victoria 3000

Tel: + [REDACTED]

<https://www.frontier-economics.com.au>

ACN: 087 553 124 ABN: 13 087 553 124