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DPP4 reset – Financeability of electricity distribution services in the default price-quality path

Issues paper

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Executive summary

Defining financeability and its place in the Part 4 regime

X1 This paper sets out the Commission's view of financeability in the context of setting a default price-quality path (DPP) and seeks feedback on our proposed approach to financeability in the electricity distribution business (EDB) DPP4 reset in advance of our draft decision. It builds on considerations and submissions on this topic during the Part 4 Input Methodologies Review (IM Review)[1] and on our main DPP4 Issues paper.[2]

X2 In a context of significant expenditure on decarbonisation-related demand growth on networks in an environment where there is also expected to be significant revenue lifts from DPP3, and following the recent IM Review decision to not include a financeability test IM, we want to explain how we propose to consider financeability in the context of the DPP4 reset.

X3 We wish to provide assurance that we are very alive to financeability issues associated with the regulated profile of cashflows in the DPP4 reset, but equally, be clear to regulated businesses that financing significant new capacity and new investment is the responsibility of the businesses through normal, efficient capital raising and management.

X4 In the Part 4 context we interpret financeability as the ability of a prudent and efficient notional supplier to raise and repay debt and raise equity in financial markets, readily and on reasonable terms.

X5 Our focus is the financeability of the provision of the regulated service, not the supplier of that service whose overall financial position and outlook may be affected by its management choices and non-regulated activities.

X6 Unlike some other jurisdictions, the Part 4 regime does not set any express statutory duty or direction requiring us to consider financeability in our decision making. We may take financeability into account where relevant to our decisions, but only to the extent doing so would assist in promoting the Part 4 purpose: to promote the long-term benefit of consumers by promoting outcomes consistent with those produced in workably competitive markets.

X7 Our decisions under Part 4 are intended to provide the expectation of a normal return for investors, and it is primarily the responsibility of the supplier to manage timing differences between revenues and costs and to finance new investment.

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[1] Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023).

[2] Commerce Commission, "Default price quality paths for electricity distribution businesses from 1 April 2025 Issues paper (DPP4 Issues Paper)", (2 November 2023).

X8 Within this approach there are certain conditions where the timing of cash flows, and the impact of that on financeability, may be relevant to the promotion of the Part 4 purpose.

Analysing financeability of regulated services

X9 We are proposing for the DPP4 reset to carry out a financeability 'sense check' to assist us to understand the extent to which financeability issues may be relevant to this reset, and to inform how we might take financeability into account in our DPP4 decision making.

X10 The financeability sense check will serve as a support tool for making decisions, not a deterministic test with thresholds and prescriptive responses.

X11 The sense check is likely to involve a notional analysis to be satisfied that a financeability issue would exist for a prudent and efficient supplier under the proposed price path. If a financeability issue arises under the notional analysis, we would then assess whether there was in fact likely to be a financeability issue for the particular supplier.

X12 This assessment of the actual circumstances of the particular supplier, once a notional issue has been identified, is important as it informs our assessment of whether there is a real risk that financeability concerns may disincentivise or otherwise impact investment in a way that would risk actual harm to the long-term benefit of consumers.

X13 Actual financeability analysis may require us to seek additional information on particular suppliers' circumstances. The type of analysis and evidence sought would depend on the decision at hand. As we would first expect suppliers to do what they can themselves to address financeability issues before we considered imposing higher near-term recovery from consumers, this could include invitation for suppliers to identify the capital management steps they have taken already (such as additional borrowing or changes to the repayment profile of debts), and evidence they have about a lack of access to equity.

DPP decisions where we consider financeability

X14 We set out decisions the Commission must make as part of a DPP reset where we consider financeability analysis may inform our choices about what best promotes the Part 4 purpose.

X15 This includes determining alternative X-factors to tilt the profile of cash flows during the regulatory period, effectively weighing up price impacts on consumers and supplier cashflow, and setting the form and level of the secondary revenue smoothing limit.

X16 The latter relates to one of several recent IM amendments to revenue setting which may be relevant to financeability by reducing cashflow risks. Others include updating the treatment of consumer price index (CPI) inflation in the revenue path, minimising delays in cashflow through wash-ups where inflation is higher than forecast; and reclassifying transmission-related charges as pass-through costs, such that their recovery is not deferred by revenue smoothing.

X17 Where financeability issues arise due to a capex programme which is large relative to the existing regulatory asset base (RAB) our view is that a customised price-quality path (CPP) application is likely to be the most appropriate response where the supplier considers this heightened expenditure is a prudent and efficient way to meet consumer demands.

X18 Finally, we note that the EDB IMs do provide for a discretionary shortening of asset lives for existing assets triggered by application from an EDB and the Commission considering that doing so would better promote the Part 4 purpose. Given the imminent deadline for applications, and no submissions on our issues paper expressing an intention to apply, this may not be relevant in DPP4, but could be relevant in future resets or necessitate a targeted process IM amendment if we later consider it necessary for DPP4.

Chapter 1 Introduction

Purpose of this paper

1.1 This paper sets out the Commission's view of financeability in the context of setting a default price-quality path (DPP) and seeks feedback on our proposed approach to financeability in DPP4 in advance of our draft decision. It builds on considerations and submissions on this topic during the Part 4 Input Methodologies Review (IM Review)[3] and on the main DPP4 Issues paper.[4]

1.2 We are addressing this topic separately from the DPP4 Issues paper to allow the present paper to incorporate the IM Review final decision, that addressed financeability in an IM context. We draw on and refer to those papers below.

1.3 Specifically, this paper addresses:

1.3.1 the place of financeability in the Part 4 regulatory regime, in the context of the DPP4 reset;

1.3.2 our proposed approach to analysing the financeability of regulated electricity distribution services; and

1.3.3 the DPP4 decisions where financeability analysis could inform our decision making.

Defining financeability

1.4 Financeability refers to the ability of firms to raise and repay debt and raise equity in financial markets, readily and on reasonable terms, to fund investment needs. In a Part 4 context, we interpret this as the ability of a prudent and efficient notional supplier of a regulated service to access capital on a basis that approximates the assumptions that underpin our estimate of the cost of capital.

1.5 We note there is a difference between the financeability of the provision of the regulated service itself, and the financeability of the supplier of the service. The supplier may be affected by factors like non-regulated business activities or by its ownership structure. As discussed in Chapter 2, our focus is on the financeability of the provision of the service.

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[3] Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023)

[4] Commerce Commission, "Default price quality paths for electricity distribution businesses from 1 April 2025 Issues paper (DPP4 Issues Paper)", (2 November 2023).

Investment context and financeability for DPP4

1.6 Concerns about financeability have been raised throughout the IM Review and submissions on our main DPP4 Issues paper. This follows challenges for Electricity Distribution Businesses (EDBs) during DPP3, including higher than forecast inflation and tight labour market conditions (both of which were in part linked to the COVID pandemic and were unforeseen when DPP3 was set). The change from a period of low, stable inflation to high, less stable inflation has contributed to revenue deferrals from DPP3 into DPP4. On top of this, some suppliers have been exposed to higher costs from extreme storm damage.

1.7 Looking ahead, in their 2023 asset management plans (AMPs) EDBs have forecast significant increases in expenditure. This includes spending to meet anticipated electrification-driven demand growth, network renewal and resilience, and potentially new approaches to meeting and managing this demand.

1.8 As we noted in laying out the context for the reset in our main issues paper, we are alive to these factors.[5] Nevertheless, we remain of the view that investment in regulated infrastructure 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).

1.9 In common with other regulators overseas, and to achieve the purpose of Part 4,[6] we adopt an inflation-indexed regulatory asset base (RAB) approach which results in a smoother profile of prices and revenues over time (compared to a non-indexed approach). A consequence of RAB indexation is that investors face delayed revenue recoveries relative to their cash outgoings (particularly interest costs) in the early years of any given investment. In our recent IM Review decisions, we have reconfirmed that RAB indexation remains an appropriate basis for setting the profile of investment cost recovery for EDBs and have introduced it for Transpower.[7] This is consistent with our view that we promote allocative efficiency (consistent with s 52A(1)(b) by setting a profile of prices/revenue recovery such that prices to consumers match the benefit they receive.

1.10 In cases of well-developed networks operating in a relative steady-state (such that depreciation allowances are relatively closely matched to reinvestment requirements) entities with appropriate capital structures can maintain adequate credit ratings and can sustain investment in their networks. This state has generally prevailed for EDBs in recent times, meaning financeability has not been a prominent issue across past price-quality path resets under the Part 4 regime.

[5] Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), Chapter 2.
[6] Commerce Act 1986, section 52(A).
[7] Commerce Commission, "Part 4 IM Review 2023 Final decision Context & summary paper", (13 December 2023), Chapter 5.

1.11 Prudent businesses undertaking effective capital planning will manage their finances to ensure that over the course of investment cycles there is sufficient capital headroom to meet expenditure needs at any given point in time, while maintaining appropriate credit metrics. Maintaining capital headroom is likely to be particularly important for trust owned EDBs that prefer to maintain trust ownership.

1.12 It is possible for a supplier to make capital structure, dividend, or other investment decisions that ultimately compromise that supplier's ability to finance expenditure on the regulated service. It is not the regulator's role to resolve these issues for the entity through higher prices or faster recovery of the investment to address this problem, rather it is for the owners of that entity to restructure their capital or sell to another owner.

1.13 Nor – in periods of high demand growth – is it the regulator's role to accelerate revenue recovery from existing customers to provide funds for new investments: that funding needs to come from new debt and/or equity. Financing significant new capacity and new investment is the responsibility of the businesses through normal, efficient capital raising and management. As confirmed through the IM Review process, the regulatory return offered though the weighted-average cost of capital (WACC) is sufficient to attract such investment.

1.14 However, as we discuss in Chapter 4, we recognise that in particular circumstances an entity's financial management can be affected by decisions made when setting the regulated revenue path (for example, by revenue smoothing factors to avoid price shocks to consumers).

1.15 We wish to provide assurance that we are alive to financeability issues associated with the regulated profile of cashflows.

Financeability issues in the Part 4 IM Review

1.16 Financeability was a high interest topic through the recent review of the Part 4 IMs. The key points raised by stakeholders in this process were:

1.16.1 the Commission should provide certainty on how it will assess and address financeability problems for suppliers, preferably through a defined test and response approach for accelerating cashflow;

1.16.2 that failure to do so may undermine suppliers' incentives to innovate and invest to meet customer demands; and

1.16.3 the Commission should make financeability assessments to check regulatory consistency.

1.17 Chapter 5 of the IMs Context and Summary paper summarises our consideration and decisions relevant to cashflow, including financeability and inflation.[8]

1.18 Chapter 3 of the IMs Risk and Incentives paper – Financing and incentivising efficient investment – includes financeability (Topic 3f), RAB indexation (Topic 3a), and other cashflow related topics.[9]

1.19 The key conclusions of the IM Review related to financeability were:

1.19.1 Not to adopt a financeability test in the IMs, as it would not better achieve our framework's objectives.

1.19.2 That we can already consider (and have previously considered) financeability where relevant and not inconsistent with promoting the Part 4 purpose.

1.19.3 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.[10]

1.20 While we did not adopt a financeability test as part of the IMs, some decisions about the IMs may be relevant to the financeability of regulated services:

1.20.1 Maintaining indexation to inflation for EDB RABs.[11]

1.20.2 Providing for greater flexibility in how the 'revenue smoothing limit' within a DPP is specified.[12]

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8 Commerce Commission, "Part 4 IM Review 2023 Final decision Context & summary paper", (13 December 2023), Chapter 5.

9 Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), Chapter 3.

10 Commerce Commission, "Part 4 IM Review 2023 Final decision Context & summary paper", (13 December 2023), para. 5.9.

11 Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), Chapter 3. RAB indexation was linked to financeability by some submissions through its impact on cashflow. In the IMs Review we decided to maintain RAB indexation to inflation for EDBs. We consider that the original reasons for indexing EDBs' RABs remain valid in the current context. Our current approach is consistent with providing incentives to invest and supporting a more efficient pricing profile – one that approximates constant average real prices.

12 Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), Attachment D, paras D10 to D86.

1.20.3 Updating the treatment of CPI inflation in the revenue path, such that the most up-to-date information about inflation is incorporated in each year's allowable revenue, minimising delays in cashflow through wash-ups where inflation is higher than forecast.[13]

1.20.4 Increasing EDBs' flexibility to make early drawdowns of any accrued wash-up balances, provided this does not cause price shocks (ie. complies with any 'revenue smoothing limit' specified by the Commission in a price-quality determination).[14]

1.20.5 Reclassifying transmission-related charges to pass-through costs[15] that EDBs are now able pass directly through to consumers such that recovery is not deferred for revenue smoothing purposes.[16]

1.21 The IMs decisions above are in place for the DPP4 reset and (consistent with the certainty purpose of IMs) we do not intend to revisit them during the DPP4 process.

1.22 Whether and how to specify a revenue smoothing limit is determined in the DPP decision. As such, we discuss this issue in Chapter 4, where we consider how financeability might be taken into account in the decisions we make in setting the DPP4 price path.

Structure of the rest of this paper

1.23 This paper is written with an informed reader in mind and assumes familiarity with Part 4 of the Commerce Act (1986) (the Act) governing regulation of EDBs.

1.24 The rest of this paper is structured as follows:

1.24.1 Chapter 2 sets out the place of financeability in the Part 4 regulatory framework.

1.24.2 Chapter 3 outlines how we propose to assess financeability at a DPP price-quality path reset.

1.24.3 Chapter 4 discusses DPP4 decisions where financeability might be relevant, with guidance on how financeability could be taken into account. Finally, Chapter 4 briefly notes the relevant tools available under a CPP.

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13 Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), Attachment D, paras D129 to D150.

14 For more information on improvements to the wash-up mechanism, see Ibid. paras D87 to D128

15 The transmission-related charges affected by this decision are set out in clause 3.1.2(2) of the "*Electricity Distribution Services Input Methodologies (IM Review 2023) Amendment Determination 2023 [2023] NZCC 35*".

16 Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), Attachment D, see in particular paras D10.3 and D77 to D81.

How you can provide your views

1.25 We are encouraging submissions to assist us in further developing our approach for resetting the DPP, including identification of issues or options which we have not identified.

1.26 We welcome your views on matters raised in this paper within the timeframes:

1.26.1 submissions by 5pm on Friday 15 March 2024

1.26.2 cross-submissions by 5pm on Friday 29 March 2024.

1.27 Responses should be addressed to:

Ben Woodham, Electricity Distribution Manager c/o
infrastructure.regulation@comcom.govt.nz

1.28 Please include 'Submission on financeability in EDB DPP4 reset' in the subject line.

1.29 We prefer submission of both a format suitable for word processing (such as Microsoft Word document) as well as a 'locked' format (such as a PDF) for publication on our website.

1.30 We discourage requests for non-disclosure of submissions so that all information can be tested in an open and transparent manner. However, we recognise that there may be cases where parties that make submissions may wish to provide information in confidence.

1.31 If it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is confidential.

1.32 Where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice their commercial position or that of another person who is subject to the information.

1.33 Both confidential and public versions of the submission should be provided.

1.34 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

Chapter 2 Financeability in the Part 4 regulatory framework

Purpose of this chapter

2.1 This chapter sets out the place of financeability in the Part 4 regulatory framework.

We can consider financeability where it is relevant and would assist in promoting the Part 4 purpose

2.2 Unlike some overseas regulatory regimes,[17] Part 4 does not set any express statutory duty or direction requiring us to consider financeability in our decision making.[18]

2.3 In our recent Part 4 IMs Review, we decided against prescribing a financeability test in the IMs. We set out our position that we can already consider, and indeed have previously considered, financeability where relevant and not inconsistent with promoting the Part 4 purpose - without needing such an IM change.[19]

2.4 Among other reasons for declining to introduce a financeability IM, we noted that compared to codifying a uniform approach to financeability testing for all circumstances in the IMs, our decision had the advantage of giving us the flexibility to consider financeability when appropriate, in a way that is most appropriate to the context – which requires judgment.[20]

2.5 Our position at this DPP reset remains the same – while there is no express direction in the Commerce Act to consider financeability, we consider that we may take financeability into account where relevant to our decisions, but only to the extent doing so would assist in promoting the Part 4 purpose.

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[17] For example, s 3A(2)(b) of the Electricity Act 1989 (UK) imposes a duty on Ofgem to “have regard to the need to secure that licence holders are able to finance the activities which are the subject of obligations imposed [under the relevant legislation]”. Section 2 of the Water Industry Act 1991 (UK) imposes a similar duty on Ofwat. In both cases Licensees have related responsibilities regarded their financing decisions, capital structure, risk allocation and are required to maintain an investment grade credit rating. When the Infrastructure Pricing and Regulatory Tribunal (IPART) determines NSW water entity prices under its regulatory regime, it tests the ability of the regulated business to finance its ongoing operations using non-statutory financeability tests that IPART has developed, applied, and reviewed in 2018. See IPART, “Review of our financeability test”, (November 2018) for these and other aspects of different regulatory approaches to financeability.

[18] Commerce Act (1986) section 53P(8)(a) provides the basis for setting an alternative rate of change to the DPP starting prices set under s 53P(3)(b). Section 53P(8)(a) is not a general statutory direction requiring us to consider financeability across all our decision making.

[19] Commerce Commission, “Part 4 IM Review 2023 Final decision Risks & Incentives topic paper“, (13 December 2023), Chapter 3, Topic 3f.

[20] Commerce Commission, “Part 4 IM Review 2023 Final decision Risks & Incentives topic paper”, (13 December 2023), para 3.565.3.

Financeability may be relevant to promoting s 52A

Our discretion when resetting the DPP

2.6 Under s 53P, before the end of every regulatory period we must reset the DPP by setting the starting prices, rates of change, and quality standards that apply to the following regulatory period. Section 53P gives us a relatively broad discretion in terms of how we set starting prices and rates of change. We must, however, exercise that discretion to promote the Part 4 purpose and – consistent with s 52S – apply the applicable IMs where relevant.

Part 4 concerns the regulation of the price and quality of regulated services for the long-term benefit of consumers

2.7 Financeability concerns may relate to the whole firm, for example its credit rating, ownership structure, or ability of the firm to service debt. By contrast, our role under Part 4 is to regulate the price and quality of regulated services, promoting the long-term benefit of consumers of those services by promoting outcomes that are consistent with outcomes produced in a workably competitive market – specifically the outcomes under s 52A(1)(a) to (d).[21] This does not extend to ensuring the financeability of the business supplying the regulated service, where issues could arise from factors that may not be related to Part 4 – for example, poor performance of unregulated business units, or financial management decisions such as the level of dividend payments or leverage.

2.8 Part 4 does not empower us to monitor or address financeability issues arising from the supply of unregulated goods and services, and we have no direct control over suppliers' financial management decisions (eg. dividends). This differs from some overseas regimes.[22]

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[21] For example, in the 2013 IM merits appeal judgment, the Court stated that "Part 4, including s 52A(1)(a), was not introduced to promote supplier's interests. The s 52A purpose statement makes it clear that in terms of incentives to invest, it is the interests of consumers in suppliers having appropriate incentives to invest that matter, not the interests of the suppliers themselves." *Wellington International Airport Ltd and Ors v Commerce Commission* [2013] NZHC 3289, at [761].

[22] Ofgem can and does impose conditions on licence holders relating to revenue ringfencing and minimum capital requirements. Part 4 of our Act has no powers to impose requirements such as revenue ringfencing and minimum capital requirements. Under ss 53C(2)(k) and 53D of the Act, we can require the public disclosure of consolidated information that includes information about unregulated goods or services, provided disclosure of such information is to enable us to monitor compliance with information disclosure regulation applying to regulated goods or services.

2.9 As such, Part 4 does not oblige us to tailor a price-quality path to fit with a supplier's particular financial concerns or structural arrangements, nor are we obliged to protect the financial sustainability of a given supplier. This is not contemplated by Part 4, and it may raise issues of consistency with the Part 4 purpose for us to protect a supplier from the consequences of its own structural or financial challenges (and transfer the burden of those to consumers) in a way that would not occur in a workably competitive market. Likewise, intervening for one supplier in such circumstances could create a moral hazard issue for other suppliers that undermines the long-term benefit of consumers of the regulated service.

2.10 To illustrate, if a supplier's corporate structure or the requirements of its shareholder(s), combined with investment needs of its network, mean that it cannot finance necessary investment, then its owner would likely be expected (in a workably competitive market) to either rearrange its circumstances or leave the market. For example, if a supplier's owner was unwilling to accept lower dividends in the short term or to raise and/or restructure its debt or equity, then the owner would have to contemplate allowing another owner to enter and provide the service.

Financeability of regulated services may be relevant to the Part 4 purpose

2.11 As noted in previous discussions of the economic principles that support our decision making within Part 4,[23] we consider that applying our ex-ante financial capital maintenance (FCM) principle assists us in balancing the promotion of the s 52A(1)(a) to (d) outcomes in setting a price-quality path.[24]

2.12 However, under certain conditions (as described in Chapter 3) the timing of cash flows, and the impact of that on financeability, may also be relevant to the promotion of s 52A(1) outcomes in the following ways:

2.12.1 Section 52A(1)(a) – access to capital on reasonable terms enables suppliers to invest and innovate.

2.12.2 Section 52A(1)(b) – if suppliers cannot access capital on reasonable terms, they may not be able to invest in maintaining services at a quality that meets consumers' demand.

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[23] Discussed most recently in Chapter 4 of Commerce Commission, "Part 4 IM Review 2023 Framework paper", (12 October 2022)

[24] The ex-ante FCM principle is that regulated suppliers should have the 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. See Ibid. paras 4.7-4.10.

2.12.3 Section 52A(1)(b) – conversely frontloading cashflow such that the return of capital to the supplier no longer reflects the flow of benefits from suppliers to consumers may undermine allocative efficiency. Such a front loading of cashflows may produce a price that is higher than it needs to be to recover an efficient spreading of costs over time, which can reduce consumption that consumers value above costs.

2.13 Because of these dynamics – and the way they affect the promotion of the Part 4 purpose – we may, where relevant, consider financeability in a price-quality path setting context. We discuss how we propose implementing this in Chapter 3, and its applicability to particular decisions in Chapter 4.

Chapter 3 Assessing financeability at a DPP reset

Purpose of this chapter

3.1 This chapter discusses how we propose to assess the financeability of regulated services when making decisions at a DPP reset. Specific decisions for the DPP4 reset where financeability considerations might be applied are discussed in Chapter 4.

How we intend to assess financeability for the DPP4 reset

Regulatory sense check of financeability

3.2 Given the concerns voiced by suppliers about financeability for DPP4 we are proposing for the DPP4 reset to carry out a financeability 'sense check'. The role of this financeability sense check is to assist us to understand the extent to which financeability issues may be relevant to this reset, and to inform how we might take financeability into account in our DPP4 decision making.

3.3 This chapter provides more detail on how we intend to approach this analysis, and how we intend to use it.

3.4 The financeability sense check will serve as a support tool for making decisions, not a deterministic test with prescriptive responses.

3.5 We are not proposing a bright line approach where we assess a supplier to be 'financeable' or 'not financeable' or to replicate a credit rating assessment. When we talk of 'assessing financeability' it is in a general sense, where we may draw on qualitative aspects such as the broader context of the DPP4 reset including economic outlook, and quantitative assessments derived from financial modelling of the price path as this is developed. [25]

3.6 The sense check is likely to involve a notional analysis to be satisfied that a financeability issue would exist for a prudent and efficient supplier under the proposed price path. If a financeability issue arises under the notional analysis, we would then assess whether there was in fact likely to be a financeability issue for the particular supplier.

3.7 This assessment of the actual circumstances of the particular supplier (where a notional issue has been identified) is important as it informs our assessment of whether there is a real risk that financeability concerns may disincentivise or otherwise impact investment in a way that would risk actual harm to the long-term benefit of consumers.

[25] We note that credit rating analyses proposed by stakeholders during that IMs process and that we propose to draw on also incorporate qualitative aspects alongside quantitative analysis of creditworthiness.

We will calculate financial ratios but not against thresholds or with prescribed outcomes

3.8 Our analysis will include financeability metrics and ratios, drawing on the approach of regulators in other jurisdictions, and credit rating agencies when assessing the financial position of businesses.

3.9 We are not proposing to assess or assign a credit rating or a formal financeability assessment or test in which we assess metrics against thresholds with prescribed responses should such thresholds be met or not.

3.10 Rather, we will consider the values of these metrics as well as the context and any identified causes when exercising our discretion in how we take financeability into account when resetting the DPP.

Initial notional analysis

3.11 Initial notional analysis would use benchmark 41% leverage and WACC assumptions,[26] and consider only ring-fenced electricity lines services costs and revenues.

3.12 Notional analysis helps avoid including situations where any financial constraints have arisen from an EDB's own conduct with respect to capital management or unregulated activities, that we are largely unable to observe and do not have the power to regulate. Failing to exclude these situations would undermine incentives to manage risks prudently. Additionally, given our regime is based on the regulation of services rather than suppliers, this helps isolate or 'ring-fence' the regulated portion of the business.

3.13 Within this notional analysis, financeability issues may arise following negative cash flows due to a combination of:

3.13.1 high forecast capex (net of capital contributions) relative to the supplier's RAB;

3.13.2 abnormally high forecasts of inflation; and/or

3.13.3 revenue smoothing via the X-factor at the start of the period or due to the revenue smoothing limit binding during the period.

[26] See Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), para 3.125 where we say that "We do not consider that regulated suppliers must match the benchmark assumptions, or that they need to raise capital in the same proportions as the benchmark. Rather, we consider that an individual supplier can deviate from the leverage assumption used to calculate the WACC without a material impact to its financing costs. "

3.14 In applying our judgment to specific decisions like those discussed in Chapter 4, the cause of negative cashflow will be relevant to any decision we make – and in particular to whether changes to the way the DPP is set are the appropriate response.

3.15 Negative cashflows on a short-term basis should not give rise to concerns on a credit rating style assessment, as these largely focus on cumulative measures such as leverage or interest cost to revenue ratios. However, a sustained period of negative cashflow may over time give rise to a prudent and efficient notional supplier either:

3.15.1 having to take on debt beyond a level reasonably necessary to maintain a notional BBB+ equivalent credit rating; or

3.15.2 seeking additional equity (and incurring the cost of doing so).

3.16 Outside the assumptions underpinning this notional analysis, a specific supplier could face negative cashflows and eventual financeability constraints because of:

3.16.1 interest costs that depart significantly from the notional benchmark assumption; or

3.16.2 actual opex or capex (in real terms)[27] that exceed the forecasts provided for under the DPP.

3.17 We will not – generally – consider the impact of departures from the benchmark assumptions in our notional assessment of financeability, this is in part because they may not have a determinative impact on actual cost of capital suppliers face, and because they will result from either:

3.17.1 activities by a supplier beyond the regulatory service, which we have neither a mandate to consider nor information gathering powers to assess; or

3.17.2 past decisions about capital management, which suppliers should bear the risk of to preserve the incentive to manage efficiently.

[27] Expenditure that is higher in nominal terms due to higher than forecast CPI inflation will be adjusted for in present-value terms by the introduction of a real IRIS mechanism and in cashflow terms by the annual CPI adjustment to the revenue path.

3.18 We note that this will 'generally' be the case, because there may be instances where it was prudent and efficient for a supplier to depart from the assumptions over the medium term. For example, where a significant natural disaster required an EDB to use its balance sheet alongside any insurance proceeds to repair its network, meaning its capacity to absorb additional cost or revenue shocks may be reduced. These situations will be necessarily fact-specific and reinforce the importance of an approach that incorporates judgment alongside quantitative analysis.

3.19 Where the driver of negative cashflows is real expenditure that exceeds DPP allowances, our view is that a CPP application is the most appropriate response where the supplier considers this heightened expenditure is a prudent and efficient way to meet consumer demands. We return to this in Chapter 4.

Actual financeability assessments

3.20 Analysis of a supplier's actual financeability is important because we do not want to intervene and risk price shocks or increases to consumers where there is insufficient risk of actual harm. Actual financeability analysis may require us to seek additional information on particular suppliers' circumstances.

3.21 The type of analysis and evidence sought would depend on the decision at hand we would expect suppliers to do what they can themselves to address financeability issues first before we considered imposing higher recovery from consumers. Evidence could include suppliers identifying the capital management steps they have taken already (such as additional borrowing or changes to the repayment profile of debts), and evidence they have about a lack of access to equity.[28]

3.22 In Chapter 4 we turn to decisions we must make as part of the DPP4 reset for which financeability may be relevant, and how financeability analysis may inform those decisions.

[28] Commerce Commission, "Part 4 IM Review 2023 Cost of capital topic paper", (13 December 2023), Chapter 7. We note the RAB multiple evidence from the cost of capital work in the IMs that suppliers consistently achieve RAB multiples above 1.0, implying that they have been able to find equity investors at an implied cost below WACC.

Chapter 4 Financeability and decisions in DPP4

Purpose of this chapter

4.1 This chapter sets out decisions the Commission must make as part of setting a DPP where we consider financeability analysis may inform choices about what best promotes the purpose of Part 4.

4.2 This includes where we might make adjustments if a sense check shows that there could be an issue for a particular supplier, and where financeability may be relevant to settings which apply more broadly.

4.3 We also discuss CPPs for addressing financeability of individual suppliers.

4.4 This chapter presents some emerging views for revenue settings in the DPP4 reset and seeks feedback ahead of our draft decision.

Decisions within a DPP reset

4.5 The decisions in a DPP reset we have identified where financeability may be relevant are ones that affect the timing of cashflows. These are:

4.5.1 determining an alternate X-factor to change the profile of cash flows during the regulatory period;

4.5.2 how we determine the revenue smoothing limit and;

4.5.3 the timing of the drawdown of wash-up balances;

4.5.4 additional allowances for equity issuance costs; and

4.5.5 considering an application for the Commission to apply an adjustment factor to asset lives.

Alternative X-factors

4.6 The rate of change in allowable revenue relative to CPI – referred to as the 'X-factor' allows tilting of allowable revenue over the regulatory period, trading off an initial price step with ongoing year-on-year changes in a present value neutral way.

4.7 The revenues that EDBs can earn in the first year of a DPP period are determined by the starting prices we set. In the remaining years of the period, net allowable revenues are determined by the prior year's net allowable revenue and a 'rate of change'. The rate of change is expressed in the form CPI-X, where 'CPI' reflects general inflation, and X is a percentage differential known as the 'X-factor'.

4.8 Section 53P(8)(a) provides for the Commission to consider alternative X-factors as an alternative to starting price adjustments if, in the Commission's opinion, this is necessary or desirable to minimise:

4.8.1 any undue financial hardship to the supplier; or

4.8.2 to minimise price shocks to consumers.

4.9 Our proposed approach to X-factors for DPP4 is presented in Chapter 5 of the DPP4 Issues paper. This includes the proposal to retain a default X-factor of 0% before considering price shocks or undue supplier financial hardship.[29]

Relevance of financeability

Smoothing to avoid price shocks to consumers

4.10 Any deferral of price increases via a positive X-factor to avoid price shocks to consumers must be funded in the short term by regulated providers. If this requirement would result in a prudent and efficient notional supplier either having to take on debt beyond a level broadly consistent with our notional BBB+ equivalent benchmark credit rating or seeking additional equity (and incurring the attendant cost of doing so), then it may no longer be 'necessary and desirable' in Part 4 terms to delay price increases (or to delay them to the extent otherwise necessary to avoid the price shock). This is because either:

4.10.1 where these additional costs are passed through to consumers, the total cost to consumers in present value terms would be higher than it would be without (or with a lesser degree of) smoothing; or

4.10.2 where these additional costs are not passed through to consumers, then the ex-ante expectation of a normal return may be undermined, weakening incentives to invest under s 52(1)(a).

4.11 Because of this, a supplier's ability to efficiently finance delayed cashflow may be relevant to our discretion to minimise price shocks in a way that promotes the long-term benefit of consumers.

Smoothing to avoid undue financial hardship to suppliers

4.12 We may also accelerate in-period cashflows via a negative X-factor if we decide it is necessary or desirable to minimise any undue financial hardship to the supplier.

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[29] This proposal was broadly supported in submission on this paper. Commerce Commission, Publication of submissions on the DPP4 Issues paper, (19 December 2023).

4.13 Conceptually this would involve a two-step process: first determining that the default X-factor would cause undue financial hardship, and then considering whether it is necessary or desirable to set an alternative X-factor for the purpose of minimising that hardship. A financeability analysis similar to that outlined in Chapter 3 may be relevant to inform both of these steps.

4.14 As we noted in our earlier issues paper, the reference in s 53P(8) to 'undue' financial hardship indicates that some level of financial hardship is not contrary to the Part 4 purpose, and we consider that:[30]

> financial hardship will be 'undue' only where it is to such an extent that it is inconsistent with the long-term benefit of consumers. This may be the case where, for example, the price path is set such that it would not be feasible for any prudent supplier to deliver services under it.

4.15 While this option remains open to us, alternative X-factors are a comparatively 'short' lever: they can only adjust cashflows on a PV-neutral basis over a five-year period, which may be insufficient to resolve substantial pre-existing financeability issues.

4.16 Nevertheless, it may be useful where a short-term gap needs to be covered in advance of a CPP application or other measures by the EDB to maintain their position.

Revenue smoothing limit

4.17 The EDB specification of price IMs allow the Commission to specify a present value neutral 'secondary' limit (the 'revenue smoothing limit') on allowable revenue beyond the 'primary' revenue cap. This mechanism is designed to prevent a confluence of regulatory outcomes (primarily incentive recoverable costs and/or the drawdown of wash-up balances) causing revenue and price volatility.

4.18 The form and details of this limit must be consistent with the overall promotion of the Part 4 purpose and are specified in a DPP determination.[31]

Relevance of financeability

4.19 The cashflow deferral dynamic described above for the X-factor applies here in a similar way, meaning financeability may also be relevant to how we implement these revenue controls.

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30 Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), Attachment H, para H41.

31 Commerce Commission, "*Electricity Distribution Services Input Methodologies (IM Review 2023) Amendment Determination 2023 [2023] NZCC 35*", clause *3.1.1.*

Approach to the revenue smoothing limit in DPP4

4.20 Recent changes to the IMs give us greater flexibility in how we specify the revenue smoothing limit in DPP4, and also make changes to the revenue which is subject to the limit. We will consider what limit, if any, would be appropriate in this context, taking into account any relevant financeability effects of our decision.

4.21 As noted in Chapter 1 we have already amended the IMs so that forecast allowable revenue for each year incorporates updated information about inflation. We have also removed pass-through costs (particularly transmission charges) from the revenue smoothing limit. That is, they are passed through after the revenue smoothing limit has been applied so they are not subject to this limit.

4.22 For DPP4 – in light of these changes and heightened levels of investment in distribution networks – our emerging view is that we are unlikely to retain the same approach taken to the limit during DPP3, under the previous IMs.

4.23 We discuss below the other aspects of the revenue smoothing limit where we have discretion, including how financeability may influence the settings we determine. These include:

4.23.1 whether the limit is specified in real or nominal terms;

4.23.2 whether the limit is specified by reference to the previous years' forecast revenue from prices (a 'ratcheting' limit) or by reference to the current year's allowable revenue;

4.23.3 whether the limit includes any adjustment for growth in demand - e.g. new connection growth substantially greater than forecast;

4.23.4 the size of any limit.

Nominal versus real limits

4.24 Specifying a limit in nominal terms (as a fixed percentage, not relative to inflation) – as was the case with the limit specified in DPP3 – defers recovery (potentially into the following regulatory period via the wash-up account) if inflation is substantially higher than forecast inflation where forecast allowable revenue net of pass-through costs exceeds the smoothing limit.

4.25 As noted above, the intent of this mechanism is to prevent multiple coinciding regulatory factors leading to price and revenue volatility – not to smooth the impact of economy-wide inflation. As part of the IM Review, changes to the revenue path to better manage the impact of inflation risk were made. Forecast net allowable revenue is now adjusted using an updated forecast of inflation. Setting a nominal revenue smoothing would undermine the intent of that amendment.[32]

4.26 Our emerging view is that a limit in real terms would best promote the Part 4 purpose.

Reference revenue against which the limit is specified

4.27 One option would be to specify the limit relative to the previous year's 'forecast revenue from prices'. In some circumstances where a supplier charges below the lesser of their maximum allowable revenue or the revenue smoothing limit in one year, this would reduce the level of revenue at which the revenue smoothing limit will bind in the following years.

4.28 Compounded over the regulatory period, this may give rise to a significant deferral in cashflows.

4.29 Alternatively, we could specify the revenue smoothing limit by reference to the current year's allowable revenue. However, this would be less effective in reducing any potential for price shocks to consumers.

4.30 It is the year-on-year change in revenue intended to be recovered from consumers (via forecast revenue from prices) that could give rise to a price shock for those consumers, so there is good reason to specify the limit in these terms.

4.31 We have not reached a view on the reference revenue against which to specify the limit, but consider financeability may be relevant to the decision. We are interested in stakeholder views.

Any adjustment for growth

4.32 In submissions on the IM Review and on the main DPP issues paper, submitters proposed the idea of including a 'quantity' adjustment to the smoothing limit.[33] Doing so would acknowledge that where consumer demand is increasing (or decreasing), the potential price shock caused by increasing revenue will be mitigated (or exacerbated).

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[32] Commerce Commission, "Part 4 IM Review 2023 Final decision Risks & Incentives topic paper", (13 December 2023), Attachment D.

[33] For example, Aurora Energy "Aurora Energy's submission on Commerce Commission Part 4 Input Methodologies Review 2023 - Draft Decision ",(19 July 2023), Section 4.3, and Aurora Energy, "Aurora Energy's submission on Default price-quality paths for electricity distribution businesses from 1 April 2025 Issues paper", (19 December 2023), para 72.

4.33 We have not reached a view on whether to include a quantity adjustment but consider financeability may be relevant to the decision especially where an EDB forecasts declining demand. We are interested in stakeholder views.

Size of the revenue smoothing limit

4.34 We have not reached a view on what the appropriate size of the smoothing limit is – and indeed it will depend on design decisions on real versus nominal limits and the reference revenue against which the limit is specified. However, we consider any limit:

4.34.1 should only bind in more extreme cases, and not capture ordinary variation in wash-up balances, IRIS recoverable costs, and quality incentive scheme payments; and

4.34.2 should acknowledge suppliers' ability to finance further deferral via the wash-up mechanism.

Timing of wash-up mechanisms

4.35 Following the IM Review, the CPI wash-up is now delivered as soon as possible within limits on data availability (on an updated forecast basis at the start of each year, and then on a two-year lag when actual data is available). This leaves EDBs less exposed to cashflow risks from CPI being higher than forecast.

4.36 Additionally, the drawdown of any wash-up balance is available on a two-year lag (subject to the revenue smoothing limit discussed above) but may be deferred to the end of the regulatory period (at the EDB's discretion and within the revenue smoothing limit discussed above).

4.37 This greater flexibility afforded to suppliers in managing the wash-up account balance serves to improve the overall financeability position with respect to inflation and demand risk.

Relevance of financeability

4.38 Under the IMs, the Commission has the ability at the start of the regulatory period to determine a 'schedule' for the drawdown of accrued wash-up balances. Given DPP4 is the first period where the 'account' style wash-up mechanism applies – and the recent period of high inflation meaning many if not most suppliers will have positive wash-up balances, we consider it unlikely that we will need to specify a drawdown schedule.

4.39 In future resets, we may consider the ability of suppliers to finance any further deferral in revenue when specifying the drawdown amount.

Additional allowances for equity issuance costs

4.40 Currently no equity issuance costs are provided in the cost of capital IMs. As part of a DPP (or CPP) where a supplier intends to issue new equity as a means of funding an increase in capital expenditure, we could consider an additional allowance to reflect the cost of issuing this equity.

Relevance of financeability

4.41 Where notional modelling and evidence from an EDB demonstrates that they need to issue new equity to finance investment, and that they are willing and able to do so, there's an argument that providing this allowance better supports ex-ante FCM.

4.42 We can specify either opex step-changes to account for this new one-off cost, or *ad hoc* additional allowances in allowable revenues (where the cost does not meet the definition of regulatory opex). We would expect an EDB to provide evidence of a new cost to support such an allowance.

4.43 This approach would be consistent with our position that suppliers who can issue new equity on reasonable terms should not encounter a financeability problem.

Asset life adjustment factors

4.44 The IMs provide for a discretionary shortening of asset lives for existing assets triggered by application from an EDB and the Commission considering that doing so would better promote the Part 4 purpose.[34]

Relevance of financeability

4.45 As any such adjustment would accelerate cashflows, it would have an effect on the financeability conditions the supplier faces. In considering whether asset life shortening promotes the Part 4 purpose, we may consider the financeability impacts of doing so.

4.46 We note that the deadline for applications is 29 February 2024, and in submissions on our issues paper no EDB indicated an intention to apply this mechanism, so this may not be relevant in DPP4, but could be relevant in future resets or necessitate a targeted process IM amendment if we later consider it necessary for DPP4.

4.47 While this adjustment was introduced in the context of mitigating potential economic stranding risk for existing assets, broader application may be an option to consider in the future.

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

Financeability and CPPs

4.48 In the absence of evidence of a widespread financeability problem, we may consider a CPP to be a better tool than the DPP for addressing an individual supplier's particular circumstances.

4.49 We would not generally consider financeability issues on their own as good grounds for a CPP application. However, where the motivation for the CPP – higher expenditure than is provided for in the DPP – is also the cause of a financeability issue for the supplier, then financeability could be relevant in setting the CPP to address those circumstances.

4.50 Relative to the DPP, CPPs provide a wider range to tools for changing the profile of cashflow, such as alternative depreciation or variations to the IMs that otherwise apply. CPPs also entail a deeper level of verification, consumer consultation and expenditure scrutiny, proportionate to a greater departure from DPP settings.

4.51 We would expect evidence from CPP applicants of the capital management steps they have taken already (such as additional borrowing or changes to the repayment profile of debts), and evidence they have about a lack of access to equity.[35]

4.52 Where consumers are in effect being asked to provide a substitute for new capital by paying higher prices in the short term (for example, where a trust owned EDB was seeking to maintain full trust ownership) we would expect consumer consultation on the CPP to address and seek views on this issue.

[35] Commerce Commission, "Part 4 IM Review 2023 Cost of capital topic paper" (13 December 2023), Chapter 7.