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Vector submission on financeability in EDB DPP4 reset

1. This is Vector's ('our,' 'we,' 'us') submission on the Commerce Commission's (Commission) Financeability Paper for the default price-quality path (DPP) reset. [redacted].

2. We are pleased to see the Commission is engaged and alive to the financeability issues in the electricity distribution sector. Vector is not alone in raising the various challenges electricity distribution businesses (EDBs) face in funding future capital investment. These challenges are brought about by inflation pressures and interest rate increases, coupled with growing investment requirements to facilitate the energy transition and enhancing network resilience in the face of more adverse weather caused by climate change.

3. Disappointingly though, the Commission has re-affirmed its position from the Input Methodologies (IMs) review that they will not implement a financeability test, and instead is proposing for the DPP4 reset to carry out a financeability 'sense check' to assist their understanding of financeability issues which may be relevant to this reset. The paper sets out how the Commission might take financeability into account in its DPP4 decision making.

4. As we said in the IM review the heart of sector's concerns is the Commission's laissez-faire approach to how it considers financeability - where cash funding is considered at the Commission's full discretion in the context of a DPP reset (or perhaps customised price-quality path (CPP) application) against undefined metrics, processes and correction mechanisms. All of this adding to the long-standing cashflow challenges already imposed through indexation which back-ends EDBs' cashflows and provides a large portion of equity return via a non-cash revaluation of the asset base.

5. We agree with Transpower who, in their submission to their individual price-quality path (IPP), shared:

   "Our view is that, to the extent possible, today's consumers should pay for today's costs. Any long-term deferral of revenue is unlikely to be consistent with a workably competitive market. Customers are charged our regulated rate of return on deferred revenue recovery…

   […] the Commission's decision to index our RAB has deferred a significant proportion of our RCP4 revenue into the future. Further deferrals for smoothing purposes, not in line with the purpose of Part 4, may impact our financing needs."[1]

6. As noted by the Commission, their approach to financeability is out of step with other jurisdictions who have a statutory obligation to consider financeability (for e.g., the UK has a specific licence condition). Whilst the Commerce Act does indeed not contain such direction, the Part 4 purpose to promote the long-term benefit of consumers by promoting outcomes consistent with those produced in workably competitive markets as well as providing suppliers with incentives to invest. This means the Commission must consider suppliers' financial position and outlook, including shareholder expectations for utility companies, especially when not addressing these issues could lead to underinvestment in an EDB's network.

7. As well as being out of step with other jurisdictions we are also concerned that there is a lack of evidence or expert opinion to support the Commission's "full discretion" approach. We consider it good regulatory practice for there to be a strong evidence base for significant regulatory decisions. None has been provided by the Commission on their approach to considering financeability. Furthermore, Vector and other suppliers have provided expert reports on financeability in the Commission's IM review process. We are disappointed that the financeability paper issued by the Commission does not appear to have engaged with these expert reports. We strongly encourage the Commission to do so along with additional expert reports that no doubt will be provided throughout the DPP reset process.

8. There is a twofold risk to consumers resulting from the Commission's current approach to financeability. Firstly, the Commission's current approach to financeability leads to uncertainty

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[1] Transpower, Transpower Individual Price-Quality Path 2025 (RCP4): Issues Paper (21 February 2024), para 41 - 43

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for investors which may lead to suppliers being unable to attract capital - leading to underinvestment. Secondly, the risk for consumers is that EDBs will have no choice but to slow or halt investment if they encounter financeability issues as it is highly unlikely that an EDB would spend at a level that put them into financial difficulty. Underinvestment by EDBs will result in a slower energy transition and less resilience in networks in the face of more extreme weather events.

9. The Part 4 Purpose Statement is clear that regulation must provide suppliers with incentives to invest. The Commission's current unstructured approach to financeability is in our view a dis-incentive to invest. Under investment is not in the long-term interests of consumers or the country. The regulatory regime needs to provide for both debt and equity holders to receive returns (in cash) to incentivise investment at a level required for secure, affordable and resilient electricity networks in the face of increasing severe weather events and increasing demand brought about by the transition to a low emissions economy. Getting the energy transition right will mean affordable, secure and clean energy for all of New Zealand.

10. It is critical that EDBs are able to finance the investment required to enable deep, rapid decarbonisation. To do this EDBs will need to access both local and international capital markets. Investors in these markets need a level of certainty in the New Zealand regulatory regime before providing that capital. Important to this being whether future cashflows can sustain the expected returns of those investors.

11. The right regulatory funding settings need to be in place to ensure both debt and equity holders can receive returns in accordance with the minimum level implicit in the Commission's own regime. Without confidence around cashflows and the ability to finance, EDBs will have few options other than to dial back their investment programmes.

12. The six largest non-exempt EDBs in New Zealand Aurora, Orion, PowerCo, Unison, Vector and Wellington Electricity (also referred to as the "Big Six") commissioned Oxera Consulting LLP to produce a report[2] in response to the Commission's financeability paper.

13. Oxera describes:

> *"[…] concerns about the level of detail that has been specified by the NZCC in relation to its planned approach to financeability, and whether this will provide a sufficient basis for an informed engagement with the industry at DPP resets in relation to robustly assessing the financeability of the DPP package."*[3]

The Commission has taken on board issues raised…

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[2] Oxera Consulting LLP, Response to the New Zealand Commerce Commission consultation on the financeability of electricity distribution services in the fourth default price-quality path (DPP4), 15 March 2024

[3] Ibid p.39-40

Revenue smoothing limits

14. As part of the IM Review, the Commission made 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. The paper affirms that setting a nominal revenue smoothing would undermine the intent of that amendment.

15. We acknowledge and agree with the Commission's emerging view is that a limit in real terms would best promote the Part 4 purpose.

Access to capital

16. The Commission has also rightfully outlined EDBs' lack of access to capital as evidence in their consideration of a supplier's actual financeability:

    "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."

17. There are huge benefits to consumers (and hence, the regulator) in suppliers being able to attract capital. The Commission needs to consider:

    a. The need for new capital to expand electricity networks to enable electrification and the absence of licence conditions;

    b. The ability to attract and retain capital for as long as the assets are expected to be utilised; and

    c. The impact that poor 'investability'[4] and financeability may have on EDBs' cost of capital in the long term.

18. EDBs need to be able to safeguard the attraction and retention of capital. The Commission should have regard to ensuring that cashflows allow for the returns expected by the providers of capital i.e., cashflows that enable interest to be paid and dividend distributions to be made. A firm may find it has investability issues if providers of capital are of a view that there is uncertainty over the firm being able to deliver the expected level and frequency of returns to those capital providers. Capital providers invest in utilities as they are known for paying stable returns.

Costs of raising equity

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[4] Ibid Section 2, Oxera defines and elaborates on the term 'investability'. Vector urges the Commission to consider investability alongside financeability in the DPP reset.

19. Equity raising costs are transaction costs incurred when EDBs fund capital investment through equity. As EDBs' capital expenditure rises to enable New Zealand's decarbonisation, it is likely that EDBs may need to raise equity. The Commission's current weighted average cost of capital (WACC) method does not compensate EDBs for transaction costs involved in the issuance of equity.

20. The Commission is explicitly seeking input on the level of equity issuance cost. Currently, the Commission does not offer an explicit allowance for the cost of raising new equity.

21. At the IM final decision, the Commission explained that suppliers should use their lowest-cost source of equity to fund the equity portion of new investment, and that for most suppliers retained earnings will be sufficient to meet these needs. However, equity issuance costs are a legitimate business expense, through a percentage allocated to the transaction cost of issuance and the accompanying legal fees.

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23. The Commission also needs to consider the direct and indirect costs of raising equity. Direct costs are the transactional costs of the issuance. Indirect costs are the discount to market that equity issuances are typically made at.

24. Oxera notes on this point:

> *"If the planned investment programme within the DPP requires an equity injection, we consider it appropriate for the NZCC to provide an allowance to cover the cost associated with it, given that an efficiently operated network is likely to have to incur it. In the consultation, the NZCC indicates that it could consider providing an allowance for the new equity issuance as a part of a DPP where a supplier intends to issue new equity. There is a benefit in defining the allowance upfront, to reduce uncertainty and promote investor confidence, especially given that an option of a pass-through, if considered, will also require estimates because some of the costs of equity issuance are indirect."*[6]

…But the paper is missing fundamental inputs into financeability processes

Revenue smoothing limits and P0 adjustment

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25. It is important that the Commission is consistent with its past practices when implementing P0 adjustments at the start of a DPP period. It is important to note that all prior DPP resets have resulted in unconstrained price resets that immediately implement the regulated revenue allowance. This has been the case despite historic calls from suppliers to smooth these impacts (including formal legal challenge and appeal on the need for a specific IM on the Starting Price Adjustment) the Commission since the current regime has been in place has elected to apply unconstrained P0 adjustments. It is therefore incumbent that the Commission is even-handed and consistent in its application of the P0 i.e., applies its historical practice. Supporting the position of the Commission following its strongly held position of unconstrained P0 prices is that most of the expected increase in prices for DPP4 will arise from external factors such as inflation and interest rates. The impact on the P0 from increased supplier investment is small. The Commission's past practice is when interest rates or inflation have fallen, the benefits of these falls have been passed on to consumers at each reset. We can see no reason why this historical practice should not be also applied for DPP4 as the Commission has set prices on the best available external settings information at each reset. To not pass on changes in those external settings immediately at the DPP4 reset would have no precedent and would be in our view be unprincipled as well as being inconsistent with a workably competitive market.

26. To not apply consistency undermines confidence and certainty in the regime going forward and goes against the heart of Part 4 – to promote certainty for regulated suppliers and consumers. Regarding the setting of revenue caps that apply within a DPP period the Commission also needs to be mindful of the basis it has set caps in the past. In the DPP3 reasons paper the Commission states that its expectations are that the revenue cap it set would bind infrequently. Therefore, any caps to apply within DPP4 need to be set on the same basis or strong arguments presented as to why the "bind infrequently" rationale for the cap in DPP3 no longer applies in DPP4.

27. Later in this submission we have prescribed a methodology to calculate values for revenue caps such that ensure that all EDB revenues due within the DPP4 period can be recovered within the period (if indeed the Commission was to apply revenue caps).

Cashflow recovery within the regulatory period

28. The Commission in its decision on the IM framework identified ex-ante real financial capital maintenance (FCM) as a fundamental economic principle for the Part 4 regime. When considering smoothing to mitigate price shocks, the Commission must be mindful of this key economic principle and ensure that the entire revenue allowance be recovered within the DPP4 regulatory period (i.e., no planned deferral of maximum allowed revenue (MAR) between DPP4 and DPP5, including wash-ups from DPP3 and wash-ups for periods 1 to 3 of DPP4,).

29. The intergenerational consequences also need to be weighed when setting caps especially if these caps were to have the effect of pushing revenues out beyond the DPP4 period. Shortfalls in revenue that are recovered in future periods are effectively a cross subsidy of today's consumers. Consideration should also be given to any deferral of revenue from one period to

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another future period does result in an EDB's prices not strictly complying with the Electricity Authority's pricing principles as prices need to be subsidy free.

30. Another issue with the capping of revenues, that then results in wash-up balances, is that it magnifies the back ending of cash flows issue caused by the indexation of the asset base. This means that investors funding investments today need to wait a considerable time until those investments deliver a cash return. This cannot be consistent with promoting investment for the long-term benefit of customers.

31. Whilst section 1.20.4 of the paper discusses compliance with the revenue smoothing limit specified by DPP4, the paper does not state if this includes the recovery of wash up balances. We urge the Commission to clarify that all revenues, including wash-ups and incentive revenue will be recovered within DPP4.

32. Our views on the avoidance of cashflow deferrals is defended in Oxera's Big Six commissioned report, they explain that:

    "Accordingly, good regulatory practice suggests that cash flow deferrals only happen under very specific circumstances where these deferrals are planned ex ante, and the means by which the deferrals are effected are known by investors—such that any implications for risk of cash flow recovery can be understood and priced, as needed, by investors. Otherwise, network controls generally allow the network to price up to the revenue corresponding to the estimates based on the regulatory building blocks. Failure to do so may imply a shortfall between the allowed revenues and required cash flows within the regulatory period— the purpose of the financeability testing is to avoid such a shortfall. In other words, a reasoned, principles-based, ex ante mechanism to defer revenue recovery needs to be developed and assessed for its impact before any deferral is introduced."[7]

33. They also describe that the introduction of cash flow deferral introduces or increases at least two types of risks:

    a. *a regulatory risk, as regulators cannot offer binding commitments that their successors will honour in full any pledges that they make today regarding expected future returns;*

    b. *a systematic interest rate risk, as the NPV of a longer-duration stream of cash flows is more sensitive to changes in interest rates than that for shorter-duration streams.*[8]

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[7] Oxera Consulting LLP, Response to the New Zealand Commerce Commission consultation on the financeability of electricity distribution services in the fourth default price-quality path (DPP4), p.33-34

[8] Ibid p.37

34. Vector agrees with Oxera's conclusion that if deferrals are introduced it would be necessary to include allowances for these additional risks in the determination of the allowed revenue.[9]

Not paying dividends or restructuring as a means to raise debt and equity

35. The Commission indicates a view below, that EDBs can, as a general rule, not pay dividends as a means of handling cashflow shortfalls.

> *"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."*

36. We would argue that utility investors have certain expectations when it comes to dividend payouts, not paying a dividend (or paying a lower-than-expected dividends) for a long period of time is not sustainable, and it is unclear from the above statement how long "short term" is (with a huge difference between 1 year and 5 years).

37. The Commission's WACC assumes a 41% leverage is maintained throughout DPP4. Therefore, 59% of funding comes from equity holders. As some EDBs may have limited access to equity, cash shortfalls will be funded by debt. As a result, leverage percentage will change during DPP4. This would increase the cost of capital above the rate used to set DPP4 revenue.

38. We are bemused at the Commission's statement on restructuring of debt. As far as we are aware the Commission assumes a supplier hedges its debt in a 90-day window at the beginning of the DPP. Restructuring of debt would lead to the unwinding of those hedging instruments at a significant cost. Could the Commission clarify whether they are considering allowing these costs as pass through costs?

39. We are also surprised that the Commission would suggest that a solution for a supplier facing financeability issues should be to sell their business. In a workably competitive market, which is growing and delivering expected returns to investors the assumption should be attracting capital would not be an issue. If a BBB+ business operating with 41% leverage was forced to sell due to financeability issues caused by the inability to raise capital, then this would suggest a failing of the regulatory framework / settings and should be deeply concerning to the regulator.

40. On the impact of supplier failure, Oxera states that:

[9] Ibid p.37

> *"[…] good regulatory practice should seek to ensure that the industry as a whole remains resilient and attractive for investors, creating sufficient innovation and investment and not disincentivising investment consistent with the Part 4 purpose."*[10]

41. We also refer to Oxera's analysis on the importance of dividends for utility investors which describes:

> *"[…] a catering theory that supports that investors in utilities may have a specific preference for stable and high dividends due to institutional, clientele and behavioural explanations. The theory also suggests that a reduction in the dividend yield may cause investors to reduce their holdings in utilities"*[11]

42. Oxera concludes independently that:

> *"[…] it is important for the NZCC to be mindful of the investor demand for dividend payments, as the lack of these may disincentivise investors to commit capital into utilities, which is particularly required in the EDBs' context of expected growth to deliver the energy transition in New Zealand. As such, the NZCC should include dividend yield testing as part of its financeability test."*[12]

Presumptions around group level access to capital

43. The Commission's financeability "sense check" on the notional firm appears to stray into companies' unregulated businesses:

> *"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.*
>
> *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."*

44. This interpretation of the actual firm is contrary to the way the Commission makes assessments across the rest of the DPP where solely the regulated part of the business (the EDB) is considered. For example, the Commission is considering reviewing EDBs' ability to deliver

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[10] Ibid p.43

[11] Ibid p.30

[12] Ibid p.31

increased capital expenditure, and we very much doubt they would consider the EDBs' wider group ancillaries in helping deliver their expenditure forecasts. The Commission has no regulatory precedence to adopt this approach; we insist that the notional and actual firm relates solely to the regulated entity.

'Patient capital'

45. The s52R purpose of the IMs is to promote regulatory certainty. One of the largest sources of uncertainty at present is the ability of electricity distributors to fund the investments needed to facilitate the energy transition in Aotearoa New Zealand.

46. This uncertainty includes:

    - what electricity distribution and transmission prices customers will experience in the next and following regulatory periods;
    - whether electricity distributors can expect to recover their costs, including a fair return on investment, within the same regulatory period that electricity distribution services are provided to customers;
    - how much cash flow will be available to electricity distributors to fund operations, pay transmission charges, contribute to capital projects and service debt;
    - how much capital needs to be raised by electricity distributors and their shareholders, and when;
    - whether electricity distributors will incur financial challenges for investing to meet demand and maintaining network service levels.

47. This uncertainty has arisen due to:

    - policy and regulatory changes;
    - unforeseen inflation and rising interest costs;
    - unanticipated demand for electricity reflecting decarbonisation initiatives;
    - the Covid-19 pandemic and associated operating and supply chain constraints;
    - significant weather events which have adversely impacted electricity distribution networks
    - regulatory mechanisms including revenue cap wash-ups and limits causing deferred revenue recovery, with significant amounts of allowed revenue unrecoverable during the period, for example DPP3 revenue deferred to DPP4.

48. More than ever, investors require certainty over their decision-making, and we caution against the Commission's claim that:

    "[…] 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)."

49. In regard to the statement above we would encourage the Commission to provide any information they have gained from their engagement with investors on this matter. The current

revaluation of the asset base already backends cashflows it would be useful for the Commission to provide evidence that investors are prepared to accept a further deferral of cashflows and therefore returns.

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

50. The Commission uses a BBB+ credit rating to set its cost of capital (WACC). It will not be possible for the Commission to assess the shift away from EDBs' credit rating of BBB+ without having suitable thresholds against which financial metrics are compared.

51. Oxera states that:

> *"[…] in addition to specifying metrics, we find it essential for the NZCC to work with some thresholds for those metrics, which the NZCC currently does not intend to do. Otherwise, it is unclear how the NZCC will interpret the ratios it calculates."*[13]

52. The Commission contradicts their position that they will calculate financial ratios but will not measure them against thresholds or assign ratings in paragraph 3.15 stating that:

> *"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:*
> - *having to take on debt beyond a level reasonably necessary to maintain a notional BBB+ equivalent credit rating; or*
> - *seeking additional equity (and incurring the cost of doing so)."*

53. They contradict this again in paragraph 4.10 stating:

> *"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)."*

54. In both cases, it would not be possible to "sense check" financeability suitably without thresholds or financial metrics. Further, not having a predefined agreed set of thresholds or methodology means that materially meaningful issues may be missed.

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[13] Ibid p.41

55. We also consider that the Commission has failed to consider the timing consideration of the above statement in regard to the deferral of price increases. The Commission expects EDBs to hedge their debt position for the DPP in a 90-day period prior to the DPP commencing. This 90-day window is before the final decision. If the Commission introduces or amends a "positive X-factor" in the final decision which reduces expected cashflows then the hedging is likely to be significantly mismatched to the underlying debt position.

CPPs as a solution to a supplier's financeability issues

56. Part of the Commission's logic in rejecting calls for financeability to be expressly addressed within an existing or a new IM was that a CPP application is available for individually impacted EDB businesses. We do not accept this logic. Without knowing with confidence how the Commission intends to approach financing and cashflow considerations (as is the objective of IMs) it would seem highly unlikely that regulated EDBs would apply for a CPP to address financeability concerns.

57. If an EDB applied for a CPP, they would be in the same position as they would under the DPP as there is no financeability IM for CPPs like there is none for DPPs. Therefore, we remain unclear on what the Commission would do on the issue either for a CPP or a DPP.

58. CPPs are also cost intensive and the timeframe between starting an application and approval is long – over two years. There is also no guarantee of the outcome and once a CPP application has been submitted it cannot be withdrawn.

59. In summary CPPs do not resolve the investor uncertainty issue and Vector cannot see how a CPP is an answer to significant and consistent financeability concerns now raised across the sector.

Vector's financeability model highlights some key concerns…

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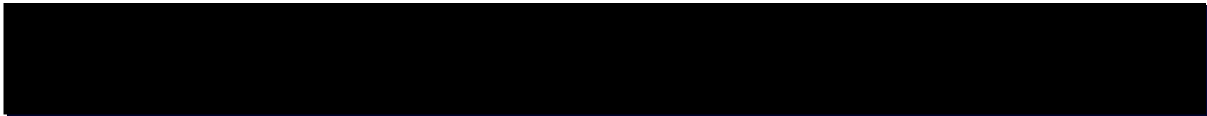
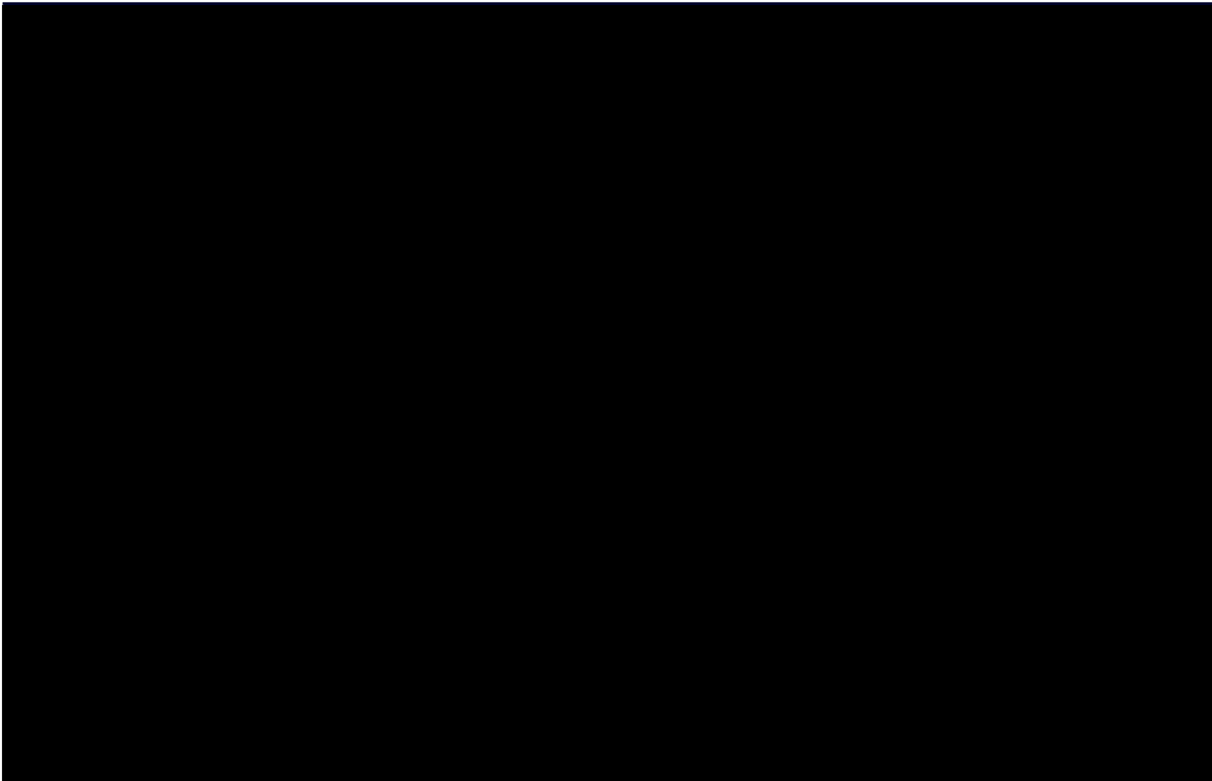


62. They note in particular the importance of the DPP4 starting price adjustment and conclude:



63. Their analysis also shows that capex forecasts and customer contributions have a considerable impact on financeability.

64. With the Electricity Authority due to release its emerging views on distribution pricing due in April 2024, we would like assurances from the Commission that they have taken account of the possible outcomes from the Authority's work in their assessment of EDB financeability.

…But also, some solutions to consider

65. As outlined previously, for any DPP period it is essential that all EDB revenues that would be earned by the EDB without caps or smoothing being applied are received by the EDB within the DPP period. This will help avoid unintended financeability issues from the capping or smoothing processes and is consistent with sound regulatory practice. We have prescribed below a methodology to calculate values for revenue caps such that this can be achieved.

66. Our suggested approach is as follows:

[14]

[15] Ibid p.5

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1. Calculate the MAR for DPP4.

2. Determine all revenue accruals from DPP3 and DPP4 that are due to be drawn down within DPP4 in the absence of revenue capping or smoothing. These should include:

    a. Other Regulated Income (Loss on Disposals) – Forecast loss on disposals based on the average for RY21 to RY24. Use this as the forecast for RY26 to RY28 (this is excluded from MAR).
    b. DPP3 Washup Balance – accrual amounts from:
        i. The accumulated Pricing CPI impact (i.e., the difference between ANAR and MAR) for RY24 and RY25
        ii. Other regulated income (loss on disposals) for RY24 and RY25

3. Setup the following calculations to determine the rollover of the revenue washup account per section 3.1.4 of the Final Input Methodologies, where the wash-up account balance for a disclosure year is:

    a. The wash-up account balance for the previous disclosure year; plus
    b. A time value of money adjustment; plus
    c. Wash-up accrual amount for the disclosure year; equal to: Pricing CPI Impact + Other regulated income; minus
    d. Wash-up drawdown amount for the disclosure year; which is up to the washup account balance two years prior

4. Set P0 (RY26) revenue cap and revenue smoothing limit (RY27 to RY30) such that:

    a. the washup account balance at the end of RY28 is fully drawn down by the end of RY30; and,
    b. Ensure that RY29 and RY30 MAR is also recovered within DPP4 (not capped)

67. We are happy to discuss our suggested approach with you in more detail, to ensure that all EDB revenues due are received within the DPP4 period.

Yours sincerely

Richard Sharp

GM Economic Regulation & Pricing