Submission on the 2023 Input Methodology Review

# Including a financeability test in the Input Methodologies for electricity distribution businesses

19 July 2023

Richard Sharp
GM Economic Regulation and Pricing
Vector Limited
PO Box 99882
Newmarket
Auckland

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**Submission on including a financeability test in the Input Methodologies for electricity distribution businesses**

Dear Richard,

We are pleased to provide our submission on including a financeability test in the Input Methodologies for electricity distribution businesses. This has been prepared in response to the Part 4 Input Methodology Review 2023 Draft Decision – *Financing and incentivising efficient expenditure during the energy transition*. We understand that this submission will be submitted by Vector Limited to the Commerce Commission in response to the Draft Decision.

This report is provided in accordance with the terms and conditions set out in the attachment. Please contact Lynne Taylor in the first instance if you have any questions.

Yours sincerely

Lynne Taylor
Executive Director
PwC Consulting
lynne.taylor@pwc.com
021 779 088

Mark Robinson
Director
PwC Consulting
mark.d.robinson@pwc.com
021 665 786

# Submission on including a financeability test in the Input Methodologies for electricity distribution businesses

This submission is in response to the Part 4 Input Methodology Review 2023 Draft Decision – *Financing and incentivising efficient expenditure during the energy transition* - Topic 3f (Draft Decision Paper). The draft decision is to not adopt a financeability test in the Input Methodologies (IMs). This is because the Commerce Commission (the Commission) considers that 'we do not need an explicit test in the IMs to consider financeability'.[1]

However, the purpose of the IMs is to promote regulatory certainty as stated in s52R of Part 4 of the Commerce Act. Regulatory certainty is consistent with the s52A purpose of regulation to provide suppliers and investors' confidence to invest in long-lived regulated infrastructure. Including a financeability test in the IMs is consistent with both of these objectives and aligns with international regulatory practice. Importantly, it complements other proposed changes to the IMs to address cash flow and financeability concerns for electricity distributors in the context of the energy transition.

We therefore submit that a financeability test should be included in the IMs to better meet the objectives of the IMs and the Part 4 regulatory framework. Including a financeability test in the IMs would also better give effect to s53P(8)(a) by ensuring that both the price shock and financial hardship criteria are addressed in the IMs.

In this submission we outline the critical role of electricity distributors in the energy transition in Aotearoa New Zealand, and how Part 4 regulation can support and enable this transition. We then consider the role of input methodologies in promoting certainty for investors in long-lived electricity distribution infrastructure. We outline why financeability under regulated revenue caps is important for promoting critical investment, and why including a financeability test in the IMs better meets the regulatory objectives than the optional approach proposed in the Draft Decision Paper.

**The role of electricity distribution businesses in Aotearoa New Zealand's energy transition**

Climate change and the need to decarbonise Aotearoa New Zealand's economy are driving increased electrification as energy users switch from carbon based fuels to electricity generated from renewable sources. This will require significant investment in renewable generation, and transmission and distribution infrastructure over at least the next two regulatory periods.

In our recent publication, Building Prosperity through the Energy Transition, we highlight the significance and criticality of timely investment in electricity infrastructure to support New Zealand's decarbonisation policies and address the impacts of climate change. As our energy supply becomes more concentrated as we increase our reliance on the electricity sector to provide our energy needs, it will be critical that the electricity supply chain becomes more resilient

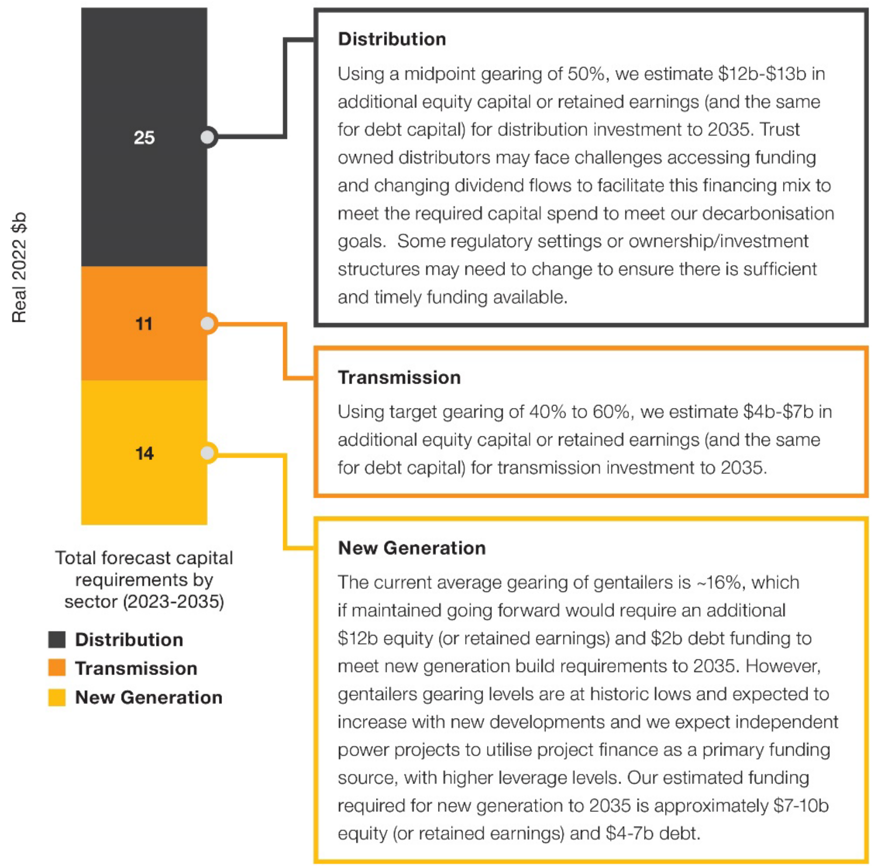
[1] Commerce Commission, Part 4 Input Methodology Review 2023 Draft Decision – Financing and incentivising efficient expenditure during the energy transition, para X39

than ever. Resiliency applies to market, system and network design, physical asset performance, operating capability and financial capacity.

Electricity distributors are critical to the energy transition because it is demand led, and therefore distribution network connection, capacity and resilience investments will increase significantly relative to recent levels of investment.  We are already seeing this in elevated capex, AMP expenditure forecasts and customer connection applications.

We estimate that $50 billion will be spent on electricity infrastructure by 2035 to aid in decarbonising Aotearoa New Zealand, and about 50% of this will be undertaken by electricity distributors.  This will need to be sourced from a combination of debt and equity funding. Shareholder equity capital and retained earnings and customer contributions to dedicated assets will be important sources of funding through the transition.  We have also estimated that $12b-$13b of debt funding will be required by electricity distributors to 2035, as illustrated overleaf.

**Total forecast capital requirements by sector (2023 - 2025)**




*Source: PwC, Building prosperity through the energy transition*

**Regulatory context**

Over the remainder of the current regulatory period, and throughout the next two regulatory periods it is critical that there is sufficient access to capital to finance the investment needed to respond to the significant increase in demand for electricity. Local and international capital will be required to finance this investment. Maintaining a stable and predictable environment will be

critical for attracting capital, including green capital, to New Zealand as there will be competing global demand for it.

As the IMs will apply for the next two regulatory periods, it is critical that the 2023 IM review ensures that the regulatory rules and processes adequately support this critical period of investment for electricity distributors.

There is a growing body of evidence that the inability to connect to distribution and transmission networks will be a significant factor preventing countries reaching their energy transition goals. Regulatory constraints and the need to process and fund significant connection activity are emerging as blockages to the pace of the transition required. For example the British Energy Security Strategy recognises the crucial role of the electricity network to support the energy transition, and '*the need for it to be transformed at scale and pace to ensure it is fit for the future*'.[2]

New Zealand's current 'just-in-time' regulation for development of new transmission and distribution spend has served us well in the past for spend efficiency but going forward will likely constrain renewable growth. Additionally, just-in-time approvals will restrict the ability to develop long term capital plans and support contractor workforce capacity to service a portfolio of major developments. Adjusting these settings to allow for early and increasing spend, increasing flexibility in the regulatory settings to adapt to large unforeseen capex, and streamlining regulatory approvals will all assist with executing elevated levels of grid and network investment. The regulatory settings must consider the financeability of the network programmes which are being approved.[3]

**Input methodologies**

Appropriate financing of investment is consistent with promoting incentives and the s52A purpose statement. Regulatory certainty is also consistent with this objective and is the primary purpose of the IMs. It is therefore appropriate to consider whether refinements to the IMs can enhance regulatory certainty for investors at a time when such significant amounts of investment need to be made.

Under the current regulatory settings, considerable uncertainty for customers, electricity distributors and investors has emerged since the IMs were last reviewed. A major factor has been the build-up of significant unrecovered revenue during DPP3 due to revenue cap limits. This uncertainty continues as we look forward to future regulatory periods, including those years

[2] Department for Business, Energy & Industrial Strategy in conjunction with Ofgem, Electricity Networks Strategic Framework: Enabling a secure, net zero energy system, August 2022
[3] PwC, Building prosperity through the energy transition, 1 December 2022, page 11

when significant network investment is required to meet demand and provide appropriate levels of network performance and resilience.

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 debt needs to be raised by electricity distributors and their shareholders, and when
- whether electricity distributors will incur financial penalties for investing to meet demand and maintaining network service levels.

This uncertainty has arisen due to:

- policy and regulatory changes, including the Government's Emissions Reduction Plan (ERP) and the Transmission Pricing Methodology (TPM)
- 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 expenditure incentives causing revenue volatility
    - revenue cap wash-ups and limits causing deferred revenue recovery, with significant amounts of allowed revenue unrecoverable during DPP3.

The Draft Decision Paper includes refinements to the revenue cap for electricity distributors to reduce volatility and improve regulatory certainty. In making these decisions it is acknowledged that volatile cash flows or cash flow constraints may force suppliers to defer or avoid investment that would otherwise be in consumers interests.[4]

The concept of financial capital maintenance (FCM), which is one of the core economic principles which underpins the IMs, provides the expectation that electricity distributors will be able to recover their reasonable costs over time. However it is the profile of cash flows which is most important from an investment and funding perspective.

Accordingly electricity distributors need certainty about the revenue they may expect to recover during a regulatory period and their ability to finance the investments they are expected to make. This includes whether the benchmark cost of capital is achievable during a regulatory period given the regulated revenue allowance and revenue cap limits and the assumed level and profile of investment. It is not only the cost of debt, but the amount of debt which needs to be determined.

[4] Draft Decision Paper, D36 and D37

The Draft Decision Paper includes refinements to the form of control for electricity distributors to reduce the impact of some of the factors listed above in future regulatory periods. These include changes to mitigate the amount of deferred cost recovery through lagged wash-ups and exposure to unanticipated inflation, changes to transmission charge recovery, and reopeners for material unforeseen demand.

But there are other mechanisms which could also be employed to enhance regulatory certainty, consistent with the s52R purpose of the IMs. These will provide more confidence to electricity distributors, investors and funders to proceed with the network development and enhancement projects necessary to deliver Aotearoa New Zealand's energy transition.

**Financeability testing**

International regulators apply financeability tests to check that revenue cap regulation allows an efficient notional supplier to generate cash flows sufficient to meet its financing needs.[5] In New Zealand there is no explicit financeability test applied when determining revenue caps for electricity distributors, instead the Commission has in the past invited interested parties to submit financeability analysis for consideration when price paths/revenue caps are set.

The criteria published in 2012 for DPP1 for assessing the financeability of an electricity distributor were:

- the supplier is unable to finance its reasonable investment needs and meet its debt repayments as they fall due; and/or
- it is not reasonable or possible for the supplier to alter its behaviour to finance its reasonable investment needs and meet its debt repayments as they fall due.[6]

As far as we are aware, there were no financeability criteria published for DPP2 or DPP3. A number of submissions on the 2023 IM review (including those prepared by NERA and Oxera)[7] have proposed more explicit consideration of electricity distributor financeability. NERA's submission demonstrated how this could be achieved in a low cost way suitable for default price-quality path regulation. NERA proposed a simple test to cross check the consistency of the notional funding requirements for each distributor with the credit rating assumptions in the benchmark cost of capital using metrics employed by the ratings agencies such as S&P and Moody's.[8]

We have recently undertaken similar financeability analysis for electricity suppliers using the notional benchmark assumptions consistent with the regulatory cost of capital. We confirm that this is relatively straight forward analysis, suitable for inclusion in the DPP financial model, including functionality to stress test for unanticipated inflation and expenditure.

[5] For example those described in footnote 194 of the Draft Decision Paper

[6] Commerce Commission, Resetting the 2010-15 Default Price-Quality Paths for 16 Electricity Distributors, 30 November 2012, paragraphs 6.1, 6.11 and 6.12

[7] NERA, Financeability considerations under the DPP, 16 January 2023 and Oxera, Review of the NZ Commission's WACC setting methodology, 3 February 2023

[8] Draft Decision Paper, 3.283

**Draft decision**

The Draft Decision Paper states that the decision is to not include a financeability test for those electricity distributors subject to price-quality regulation, as follows:

> *We do not consider adopting a financeability test in the Part 4 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.*[9]

The Draft Decision Paper describes the factors which the Commission may consider if it elected to assess the financeability of regulated suppliers, as follows:

> *If we decided that considering financeability would be relevant and not inconsistent with promoting s52A in a particular context, then we could have regard to the thresholds of minimising "any undue financial hardship to the supplier" or "price shock to consumers", where appropriate,* [s53P(8)a].[10]
>
> *In considering financeability, we would expect to assess a range of factors, including:*
>
> - *to the extent relevant, the characteristics of the benchmark (efficient) firm in terms of target credit rating and financeability metrics, and the actual firm;*
> - *the likelihood and costs of potential underinvestment (harm to consumers' long-term benefit under s52A);*
> - *the likelihood and cost of bankruptcy, while noting that acquisition of poorly performing suppliers may better promote s52A (including impact on consumers and the efficiency of prices) than frontloading cashflows; and*
> - *the likelihood and magnitude of additional sources of finance.*[11]

We agree that there are a number of factors which could be considered when assessing the financeability of regulated suppliers. The first factor described above is consistent with NERA's proposal for a standard financeability assessment to be included in the default price-quality path financial model to provide a cross check against the benchmark regulatory cost of capital. This is similar to the approaches adopted by Ofgem and IPART.

**Why it is consistent with the IMs to include a financeability test**

We support the inclusion of a formal financeability test in the IMs, to be applied at the time price-quality paths are set to test the financial resilience of electricity distributors. This test should be used as a trigger for further investigation into the ability of an electricity distributor to finance its planned expenditure and maintain a credit rating consistent with the regulatory cost of capital. This proposal would provide greater regulatory certainty, and therefore would better promote

[9] Draft Decision Paper, 3.288
[10] Draft Decision Paper, 3.297
[11] Draft Decision Paper, 3.298

incentives to invest in regulated infrastructure, than the optional approach which is currently preferred by the Commission.

The decision not to include a financeability test in the IMs because financeability can be considered otherwise is not compelling.  The s52R purpose of the IMs is to promote regulatory certainty. One 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.  This is directly relevant to the impact of decarbonisation on regulated suppliers which is the central context for the IM review as outlined in Chapter 2 of the Context and Summary Paper.[12]

Accordingly it is consistent with the IM review framework and the purpose of IMs to include a financeability test in the IMs to help to ensure that the regulatory settings for electricity distributors are consistent with the financing expectations of the benchmark supplier.  This will enhance the s52A purpose to incentivise investment at a time when there is significant amount of investment in electricity network infrastructure needed to meet increased demand and improve resiliency, as New Zealand becomes more reliant on electricity to meet its energy needs.

Knowing for certain that electricity distribution business financeability is a factor that will be considered when regulated revenue caps are set will provide more confidence to electricity distributors, investors and funders to invest in the long-lived infrastructure necessary to deliver Aotearoa New Zealand's energy transition.

Inclusion of a financeability test in the IMs would also give better effect to s53P(8)(a). The IMs include a provision for smoothing price increases during a regulatory period to avoid price and revenue volatility and to mitigate against price shocks to consumers.  In the current IMs this is given effect in clause 3.1.1 as follows:

> *3.1.1(1)(b) the Commission may specify a limit or limits on the annual maximum percentage increase in forecast revenue from prices*

The draft decision is to modify this clause as follows:

> *3.1.1(1)(b) forecast revenue from prices less forecast pass-through costs must not exceed the revenue smoothing limit for each disclosure year of the regulatory period*

Both of these limits are specified as caps, not collars.  Thus the limits have the primary purpose of capping the amount of revenue able to be recovered in a pricing year for the benefit of consumers.  This is consistent with the s53P(8)(a) provision for minimising price shocks to consumers.

The consequence of the limits is that any allowable revenue which is capped[13] is deferred into future years, reducing the cash flow available to the electricity distributor for providing regulated services.  However, the IMs have no limit which restricts the amount of allowable revenue which

[12] Commerce Commission, Context and summary of Draft decisions, Part 4 Input Methodologies Review 2023, 14 June 2023

[13] In the current IMs, this includes pass through and recoverable costs.  The draft decision is for pass through costs to fall outside the limit.

is not able to be recovered within a pricing year or a regulatory period. The IMs therefore currently do not address the second component of s53P(8)(a) which is to minimise any undue financial hardship for suppliers. Including a financeability test in the IMs would address this omission and would better give effect to s53P(8)(a) by ensuring that both the price shock and financial hardship criteria are addressed in the IMs.

**Attachment**

This report has been prepared for Vector Limited to respond to the 2023 IM Review Draft Decisions on financeability testing for electricity distributors.

This report has been prepared solely for this purpose and should not be relied upon for any other purpose. We accept no liability to any party should it be used for any purpose other than that for which it was prepared.

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The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise. The statements and opinions expressed in this report are based on information available as at the date of the report. We reserve the right, but will be under no obligation, to review or amend our report, if any additional information, which was in existence on the date of this report, was not brought to our attention, or subsequently comes to light.

This report is issued pursuant to the terms and conditions set out in our letter of engagement for regulatory assistance with Vector Limited, dated 28 April 2016 (including the deed of novation dated 16 July 2018) and statement of work dated 3 July 2023.