IPART financeability test – ratio calculations

December 2014

We conduct a financeability test in price reviews where we use a building block model. The purpose of the test is to assess the implications of our determinations for the financial sustainability of a utility. The financeability test allows us to identify instances where there may be financial sustainability issues.

The financeability test requires us to calculate three financial ratios:

- **Funds from operations (FFO) interest cover**: calculated as FFO plus interest expense divided by interest expense.\(^1\) This is a coverage ratio and measures a utility’s ability to service its debt.

- **Debt gearing (regulatory value)**: calculated as debt divided by the regulatory value of fixed assets.\(^2\) This is a leverage ratio and measures a utility’s ability to repay its debt.\(^3\)

- **FFO over debt**: calculated as FFO divided by debt.\(^4\) This is a more dynamic measure of leverage than debt gearing and a useful indicator of a utility’s ability to generate cash flows.

We invite stakeholder comments on our proposed changes to our financeability test by **Friday 13 February 2015**

1. **What are we proposing to change**

We are considering making some minor changes to the way we calculate the financial ratios. These changes will bring our calculations more in line with the way Moody’s calculates its financial ratios for Australian regulated utilities. We are not proposing to change any other aspects of our 2013 financeability policy.\(^5\)

2. **Why are we proposing these changes**

We engaged Kanangra to conduct a peer review of our financial ratio calculations.\(^6\) The purpose of the peer review was to identify if the calculations in our current financeability model for metropolitan water reviews are in line with Moody’s methodology for Australian regulated utilities. Kanangra identified a number of changes which will bring our calculations more in line with Moody’s Australia. At this stage, our preference is to accept Kanangra’s proposed changes.

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\(^1\) We previously calculated this ratio as FFO plus net interest divided by net interest. FFO refers to adjusted FFO.

\(^2\) We previously calculated this ratio as net debt divided by the regulatory value of fixed assets plus working capital.


\(^4\) We previously calculated this ratio as FFO divided by net debt.


\(^6\) Kanangra, *Advice to IPART concerning the calculations of metrics*, November 2014.
3 Our proposed changes to the financeability test

Table 3.1 outlines our proposed changes to our financeability ratio calculations.7

<table>
<thead>
<tr>
<th>Financeability testing parameters</th>
<th>IPART April 2014 template</th>
<th>Proposed changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue</td>
<td>Includes 50% of non-regulated revenue</td>
<td>We propose to include 100% of non-regulated revenue</td>
</tr>
<tr>
<td>Cash flow from Operations (CFO)</td>
<td>Receipts from customers less operating cost less tax paid less change in working capital</td>
<td>We propose to exclude one-off gains or losses from sale of assets</td>
</tr>
<tr>
<td>FFO (unadjusted)</td>
<td>Pre-tax profit plus depreciation less tax</td>
<td>We propose to use cash flow from operations prior to movements in working capital</td>
</tr>
<tr>
<td>Debt (last actual/historical financial year)</td>
<td>A hardcoded input value provided by utilities</td>
<td>We propose to include all debt on balance sheet plus capitalised operating leases plus shortfall in defined benefit pension obligations</td>
</tr>
<tr>
<td>Debt (forecast) and debt roll-forward</td>
<td>Opening debt plus or minus cash</td>
<td>We propose to no longer deduct cash from debt</td>
</tr>
<tr>
<td>Adjusted interest expense</td>
<td>Interest expense plus ½ operating lease expense</td>
<td>We propose to use actual interest expense plus ½ of current year lease obligations plus interest rate(^a) times the shortfall on pension obligations</td>
</tr>
<tr>
<td>Adjusted net debt</td>
<td>Debt less cash plus operating lease debt plus superannuation adjustment</td>
<td>We propose to no longer deduct cash from debt</td>
</tr>
<tr>
<td>Net debt / (RAB plus working capital)</td>
<td>Adjusted net debt divided by adjusted RAB plus working capital</td>
<td>We propose to exclude working capital and do not adjust the RAB</td>
</tr>
<tr>
<td>FFO to debt</td>
<td>Adjusted FFO divided by adjusted net debt</td>
<td>We propose to use adjusted debt (excluding cash)</td>
</tr>
</tbody>
</table>

\(^a\) Actual interest rate as submitted by the utility.

4 Where to from here?

We propose to start using our amended financeability test after consulting with stakeholders and making a final decision in early 2015.

We invite stakeholders to contact us directly for any questions regarding our proposed change by Friday 13 February 2015.

Inquiries regarding this fact sheet should be directed to:

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7 Changes are relative to the financeability test contained in the June 2014 building block template on our website. An Excel version of our building block model, including these calculations can be found here.