IPART
Independent Pricing and Regulatory Tribunal
New South Wales

Review of the financeability test 2018

Round Table – Tuesday 22 May 2018
IPART – Level 15, 2-24 Rawson Place, Sydney NSW 2000

Please bring photo ID for sign in at the building reception

AGENDA

Item	Time	Session
-	9.30 am	**Registration**
1	10.00 am	**Welcome and overview (Chair)**
2	10.15 am	**Session 1: Objectives of the financeability test**
		Introduction, IPART Secretariat Discussion and questions from attendees
3	10.45 am	**Session 2: Ratios, benchmarks and adjustments**
		Introduction, IPART Secretariat Discussion and questions from attendees
4	11.25 pm	**Session 3: Addressing a financeability concern**
		Introduction, IPART Secretariat Discussion and questions from attendees
5	11.55 pm	**Closing Remarks and next steps (Chair)**
-	12.00pm	**Close**

FINANCEABILITY REVIEW
OBJECTIVES OF THE FINANCEABILITY TEST

Round Table **Session 1**

Topics	Key points	Potential discussion questions
The objectives of the test	**A financeability test can be used to assess the impact of our pricing decisions on the financial viability of:** 1. a benchmark efficient business, and/or 2. the actual business (our 2013 approach)	▼ Do you agree with our proposed objectves for the financeability test? ▼ Should we continue to conduct financeability tests?
Which businesses are tested	**In the 2013 test, we conduct a test if:** ▼ the prices we set determine the revenues of the business ▼ the business is part of an entity with a distinct capital structure We conduct the test on the portion of the business for which we are setting prices.	▼ Do you agree with the 2013 criteria we used to decide whether to conduct a financeability test? ▼ Have we applied the financeability test to the appropriate price reviews? ▼ Should we test the regulated portion of the business as a default?
Actual or benchmark inputs	Our 2013 test uses the business's actual inputs. Alternatively, it could be based on the inputs of a benchmark efficient business.	▼ Should we conduct two separate tests?

	Pros	Cons
Actual	▼ Can identify if the business is financially viable	▼ Less consistent with our regulatory approach ▼ Requires additional information
Benchmark	▼ More consistent with WACC ▼ More consistent with our regulatory approach	▼ Does not assess the actual business ▼ Potentially limited use as a stand-alone test

Topics	Key points	Potential discussion questions
How should we calculate interest expense (cost of debt)?	We calculate a real cost of debt in the WACC, but the financeability test uses a nominal cost of debt. Instead, in the financeability test we could use: ▼ the real cost of debt in the WACC for the benchmark test ▼ the business's actual cost of debt, excluding inflation, in the actual test – to acknowledge that the return for inflation is capitalised in the RAB	▼ How should we calculate the interest expense in the financeability test?

How do we currently conduct the financeability test?

1. We calculate and rank three financial ratios for the business.
2. We compare the three calculated ratios against our benchmark ratios (for a target Baa2 credit rating). We assess whether the business faces potential financial concerns over the next regulatory period.
3. If we identify a financeability problem, we extend the time horizon for our analysis (if possible) and engage with the business.
4. We assess whether we should make an NPV-neutral adjustment to prices to address financeability concerns.

IPART
Independent Pricing and Regulatory Tribunal
New South Wales

FINANCEABILITY REVIEW
RATIOS, BENCHMARKS AND ADJUSTMENTS

Round Table **Session 2**

Topics	Key points	Potential discussion questions
Target credit rating	We need a target credit rating to compare the business's financial metrics against. We use a BBB target credit rating (equivalent to Moody's Baa2 rating) which is consistent with how we set the WACC.	▼ Should we use a BBB target credit rating across all industries?
Which financial metrics do we use?	**The 2013 test uses three metrics:** ▼ FFO interest cover ▼ Debt gearing (regulatory value) ▼ FFO divided by debt There are many more financial metrics we could consider (see 'Potential additional financial metrics' column on the right).	▼ Are the current metrics appropriate? ▼ Are there any additional metrics we should use, and if so why?
Benchmark ratios	Each metric needs a benchmark ratio that a business should meet to pass the financeability test. **The benchmarks in the 2013 test need updating:** ▼ there is significant overlap between rating levels ▼ rating agencies have refined their benchmark ratios since 2013	▼ How should we set the benchmark ratios for our financial metrics?
Identifying a financeability concern	We rank the financial ratios in order of importance: FFO interest coverage and the debt to RAB ratios, before FFO to debt ratio. A business does not necessarily need to meet every ratio in each year to pass the test.	▼ Should we rank our financial ratios or adopt a weighting? ▼ Are there any improvements we can make to our current ranking? ▼ Should we set out a step-by-step decision process to assess if a financeability problem exists? ▼ Are there any other factors we should consider when we analyse the financial ratios?

Potential additional financial metrics

RCF/debt
Measures a company's debt burden relative to operational income, after paying dividends
(FFO–dividends paid)/debt

Internal financing ra
Measures extent to which an entity has cash remaining to finance capex after dividends
(FFO–dividends paid)/capex

Adjusted interes cover ratio
Measures a company's ability to meet its interest payments, taking into account regulatory depreciation
(FFO + interest–RAB depreciation)/interest

Return on capital employed
Allows assessment of overall returns against the WACC
Profit after tax/RAB

Return on regulated equity
Allows assessment of the returns earned by equity providers against the cost of equity
(EBIT–tax–(cost of debt x net debt))/ equity component of the RAB

IPART
Independent Pricing and Regulatory Tribunal
New South Wales

FINANCEABILITY REVIEW
ADDRESSING A FINANCEABILITY CONCERN

Round Table
Session 3

Topics	Key points	Potential discussion questions
Identifying the source of a financeability concern	**Employ a three stage test to assess whether the regulated prices are:** 1. Set too low for even a benchmark efficient business. 2. Sufficient for a benchmark efficient business but insufficient for the actual regulated business. 3. Sufficient for the actual regulated business on average, but the timing of cash flows creates short-term financial problems.	▼ Do you think the proposed three stages would identify the source of a financeability concern? ▼ Does our proposed financeability test capture temporary cash flow problems?
Remedies to address a financeability concern	**The remedy applied should depend on the source of the concern** 1. If it is due to regulatory error, we should correct the regulatory error. 2. If it is due to imprudent or inefficient business decisions, we should alert the business's owners to the potential need to inject more equity, accept a lower rate of return on equity, or both. 3. If it is due to temporary cash flow problems, we should consider adjusting prices in a way that is neutral to the business in present value terms. This adjustment should be limited to the upcoming regulatory period.	▼ Do you agree that our proposed remedies to address a financeability concern are appropriate? ▼ Are there other remedies that we should consider, and in what circumstances might it be appropriate to apply these remedies? ▼ Do you think that any NPV-neutral adjustments to prices should be limited to the upcoming regulatory period?
Process to address a financeability concern	**The process is dependent on the source of the concern.** If we confirm the source is due to temporary cash flow problems, we would work with the business to attempt to shape the price profile to overcome the temporary financial problems while maintaining the present value of the revenue stream.	▼ Is our proposed process for addressing a financeability concern workable and reasonable?

What next?

Submissions to the Issues Paper are due **1 June 2018**

We expect to release a Draft Report in **August 2018** and a Final Report in **November 2018**

IPART
Independent Pricing and Regulatory Tribunal
New South Wales