IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Financeability tests and their role in price regulation

Other Industries — Final Decision
January 2011

IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Financeability tests and their role in price regulation

Other Industries – Final Decision
January 2011

ISBN 978-1-921628-78-8 S9-59

Inquiries regarding this document should be directed to a staff member:

Alex Oeser	(02) 9290 8434
Eric Groom	(02) 9290 8475

Independent Pricing and Regulatory Tribunal of New South Wales
PO Box Q290, QVB Post Office NSW 1230
Level 8, 1 Market Street, Sydney NSW 2000

T (02) 9290 8400 F (02) 9290 2061

www.ipart.nsw.gov.au

Contents

1 Executive summary

In making price determinations, the Independent Pricing and Regulatory Tribunal of NSW (IPART) considers how our pricing decisions are likely to affect the regulated business's 'financeability' over the determination period by applying a financeability test. We have recently completed a review of our approach for conducting this test and responding when the test indicates that the business may face short-term financial viability concerns.

As part of our review, we released a discussion paper [1] that explained our current approach to the financeability test, and how we have responded in recent determinations when the test identified potential financeability concerns. The paper also discussed the main issues to be considered as part of the review, set out our preliminary views on these issues, and sought stakeholder responses.

The purpose of this report is to explain our final decisions on the approach we will use for future price determinations in conducting financeability tests and deciding how we will respond to potential financeability issues. We consider that our decisions improve the transparency of our approach and provide greater certainty to the businesses we regulate, the NSW Government (as owner and shareholder of many of these businesses), the ratings agencies and consumers, while still allowing us scope to respond to the specific circumstances of each determination.

1.1 What are our final decisions on the approach for assessing and responding to financeability concerns?

After carefully considering stakeholders' responses to our discussion paper, we decided that in making future price determinations, we will be guided by the following approach in conducting financeability tests and responding to financeability concerns:

1. Determine the appropriate risk profile for the regulated business (very low, low, average, high or very high), based on the risk category assigned to it by NSW Treasury.
2. Measure the business's likely financeability in each year of the determination period by using its forecast cashflows and its **actual gearing ratio** to compute the following financial ratios:
   a) funds from operations cover
   b) funds from operations/total debt
   c) debt gearing

1 IPART, *Discussion Paper - Financeability tests and their role in regulation,* September 2010.

   d) pre-tax interest cover.

3. Compute its likely or notional credit rating in each year of the determination period, based on the appropriate risk profile and these financial ratios.

4. Determine whether the business faces potential financial concerns over the determination period by identifying any years when its notional credit rating falls below our benchmark credit rating of between BBB+ to BBB.

5. Identify the likely reasons why the notional credit rating is below this benchmark.

6. Identify the options available to the business's managers and shareholders to manage the identified financeability concerns, then quantify the potential impacts of these options and flag those we consider a sound means of addressing the concerns.

7. Assess whether it is necessary for us to make an explicit regulatory adjustment to address the financeability concerns and, if so, decide on the most appropriate form of that adjustment. Our preferred options in relation to any form of adjustment are to:
   a) choose to set the WACC above the midpoint within the feasible range (for the purpose of determining the business' annual revenue requirements using the building block model), or
   b) include an allowance in the annual revenue requirements (in addition to the building block cost allowances) to ensure that the business can address immediate financeability issues, then return this allowance to customers (including a rate of return) in future determinations.

1.2 How do these decisions differ from our current approach?

Our final decisions on the approach that will guide us in assessing and responding to financeability issues in future determinations do not substantially differ from our current approach. However, they provide greater clarity and transparency about the approach.

In relation to conducting the financeability test, the only significant difference is that we have decided to consistently use the business's actual gearing ratio for computing the financial ratios (instead of deciding between the actual and notional ratios). We consider the actual gearing ratio to be the most appropriate, as the purpose of the financeability test is to measure the business's ability to remain financially viable over the determination period. This depends on its actual gearing ratio, not the notional gearing ratio, as the latter reflects our view of the efficient capital structure for a typical Australian network utility, which may be different to the business's actual structure. The use of the actual gearing ratio also more closely reflects commercial practice.

However, we will continue to use the notional gearing ratio in calculating the business's revenue requirements using the building block model. We consider that this is the most appropriate gearing ratio for this purpose, as the revenue requirements reflect our view of the business' efficient costs including the efficient gearing level.

In relation to identifying the options for addressing potential financeability concerns and deciding if and how to make a regulatory adjustment for this purpose, our final decisions provide more clarity on our position and preferred options:

- We consider that where prices are set to recover the efficient costs of providing regulated services over the life of the assets used to provide the services, responsibility for addressing short-term financeability issues should rest in the first instance with the regulated business and its owners/shareholders. For example, the business may be able to better manage its debt or make savings in other areas; the shareholders may be able to provide equity injections or reduce the dividends they take from the business.

  Therefore, while we recognise that any decision to use equity injections or dividend reductions rests with shareholders, we will continue to flag them as options where we believe them to be a sound means of addressing financeability concerns. Flagging these options, particularly in our draft report, will provide the Government and other stakeholders with an opportunity to comment or engage in a discussion with us before we make our final decisions. This will help us to gauge whether or not the business is likely to be able to manage the financeability risk without regulatory intervention.

- If we consider that the regulated business is unlikely to be able to manage the financeability risk by itself, we will consider the options for making a regulatory adjustment to address the risk. We consider that these adjustments should not alter the assumptions underlying the building block model. As noted above, our preferred options are to:
  - Set the WACC at a value that is above the midpoint of the feasible range. We have used this method in the past, and consider it reasonable to retain the discretion to use it in the future where our consideration of the section 15 requirements of the *Independent Pricing and Regulatory Tribunal Act 1992* (the IPART Act) indicates that such an adjustment is appropriate.
  - Include an explicit allowance to enable the business to address its immediate financeability concerns, and return this allowance to customers (along with a rate of return) in future determination periods. We consider this option is more transparent, and also has the advantage of being revenue neutral in net present value (NPV) terms.

1.3 How is the rest of this report structured?

The rest of this report explains our review and final decisions in more detail:

- Chapter 2 provides more context for the review, and describes our current approach to conducting and responding to financeability tests.
- Chapter 3 summarises stakeholders' responses to the issues raised in our discussion paper for this review.
- Chapter 4 discusses our considerations in making our final decisions, including our responses to stakeholder views.

2 Context for the review

Financeability refers to the capacity of a business to finance its activities – including its day-to-day operations and its capital investments to replace, renew and expand the infrastructure required for these activities. In this report, the term is used interchangeably with financial viability, particularly short-term financial viability.

One indicator of a business's financeability is the credit rating that credit rating agencies such as Moody's, Standard & Poor's and Fitch assign it. Many firms rely on debt and equity markets to finance new capital expenditure, and refinance debt related to past capital expenditure on a regular basis. The providers of debt typically focus on credit ratings to determine how much they will charge, and firms with a lower credit rating usually face higher debt financing costs. If a firm's rating falls below investment grade (ie, less than BBB), it may have difficulty raising finance at a cost it can afford, and this may threaten its short-term financial viability.[2]

In line with our obligations to consider the impact of our pricing decisions on the regulated businesses, the Government and consumers, IPART considers how our decisions may affect the business's financeability.[3] This involves conducting a financeability test and, if necessary, making a regulatory adjustment to enable it to address any short-term financeability issues.

The sections below describe our current financeability test, and discuss how we have decided to address short-term financial viability risks in past determinations.

---

2 Credit ratings can be used to compare fixed-income securities, such as bonds, bills and notes. Most companies are issued a rating based on their financial strength, future prospects and past history. Companies that have manageable levels of debt, good earnings potential and good debt-paying records will have good credit ratings. Investment grade refers to the quality of a company's credit. In order to be considered an investment grade issue, the company must be rated at 'BBB-' or higher.

3 These obligations are set out in section 15 of the IPART Act or other instrument (such as the relevant statute or terms of reference) where the decisions are not taken under the IPART Act. For convenience the rest of the document refers to the requirements of Section 15 of the IPART Act but this should be read to include the comparable factors relevant to decisions taken under other instruments.

2.1 IPART's current financeability test

For most determinations, we base prices on our estimate of the revenue the regulated business will require to meet its efficient costs over the determination period. We use a 'building block' approach[4] to calculate these costs and, in theory, this approach gives the business the opportunity to recover its costs and remain financially viable in the long term. However, it does not necessarily ensure that it will be able to finance its operating and capital costs in the short-term, such as over the 4 or so years of the determination period. Therefore, before we finalise our pricing decisions we apply a financeability test to understand how our decisions are likely to affect a business's short-term viability.

Our current financeability test involves taking the following steps:

- deciding on the gearing ratio to be used in computing the financial ratios, which may be different to that used in calculating the WACC
- computing the financial ratios using our decision on the gearing ratio and the business' forecast cash flows (based on our preliminary pricing decisions)
- computing the business's likely credit rating in each year of the determination period using these financial ratios; and
- identifying any potential financeability issues by comparing the likely credit ratings to our benchmark credit rating.

If we identify potential financeability issues, we then consider likely causes of these issues and the options for addressing them. This may include adjustments to the timing of costs allowed or prices to improve cash flows.

2.1.1 Deciding on the gearing ratio

For calculating the WACC, we generally use a notional gearing ratio in line with well-established regulatory practice. This ratio is generally 60%, but may vary with the specific circumstances of the sector of operation of the business.

However, for some parts of our financeability test, we have used both notional and actual gearing in the past. As Table 2.1 shows, for most water determinations we have used the business's actual gearing ratio to assess financeability. However, in a few determinations, we used a notional gearing of 60% and in one we used both notional and actual. In all cases, the actual gearing ratio was below the notional gearing ratio.

4 The building block model comprises an allowance for each of the following costs, efficient capital, operating and maintenance expenditure, a rate of return on the regulatory asset base, the cost of working capital and depreciation of the RAB.

Table 2.1 Gearing used for the financeability test in previous IPART determinations

Determination	Year	Actual or notional gearing
State Water	2010	Actual
Wyong Shire Council and Gosford City Council (water)	2009	Actual
Hunter Water Corporation	2009	Actual
Sydney Catchment Authority	2009	Actual
Sydney Water Corporation	2009	Actual
Wyong Shire Council and Gosford City Council (water)	2006	Actual
Sydney Water and Sydney Catchment Authority	2005	Actual
AGL access arrangement	2005	Notional
Country Energy access arrangement	2005	Notional
NSW electricity distribution networks	2004	Actual and notional

Source: past IPART decisions. http://www.ipart.nsw.gov.au

2.1.2 Computing the financial ratios

The aim of the financial ratios we compute is to measure the business's financial risk over the determination period, primarily in terms of its ability to repay its debt from its forecast cash flows, interest and principle, and level of gearing. We focus on 4 financial ratios:[5]

- **funds from operations cover,** calculated as funds from operations plus interest expense, divided by the interest expense
- **funds from operations over total debt,** calculated as funds from operations divided by average total debt
- **debt gearing,** calculated as debt minus cash, divided by the regulatory value of fixed assets minus working capital
- **pre-tax interest cover,** calculated as EBIT plus non-recurrent expenses minus capital contributions, divided by the interest expense.

These ratios are the same as those used by NSW Treasury. This ensures that our financeability assessments of the businesses we regulate are consistent with those of their shareholder.

2.1.3 Computing the likely or notional credit rating

In computing the business's notional credit rating over a determination period, we place equal weight on each of the 4 financial ratios. We determine which of 5 possible business risk categories the business fits into (very low, low, average, high or very high) based on the risk category NSW Treasury has assigned it. We then

5 These ratios are computed from our financial statements. 'Fund from operations' is defined as pre-tax profit plus depreciation minus tax paid minus change in working capital.

compare each of its financial ratios with the benchmark ratios a business in this risk category requires to achieve certain credit ratings. For example, a business in the low risk category requires a lower pre-tax interest cover than a business in the high risk category to achieve the same credit rating.

2.1.4 Testing against target or benchmark credit ratings

In analysing the results of our financeability test, we adopt an investment-grade credit rating of between BBB+ to BBB as the benchmark. This is the same as the credit rating we use in estimating the cost of debt as part of our WACC calculation. It is also consistent with the benchmark credit ratings used by other Australian regulators. We consider that a business faces potential financeability issues in any year where its likely credit rating is below the benchmark.

2.2 How we have addressed financeability issues in past determinations

In making past determinations, we have considered financeability as part of our assessment of the section 15 requirements of the IPART Act. Having considered the factors set out in section 15 of the IPART Act, including the financial impacts of determinations, we have sometimes made adjustments that improve cash flows for the regulated business. In some cases, we adjusted the shape of the price path; in other cases we chose a WACC above the midpoint from within the feasible WACC range.

3 Stakeholder views on issues raised in our discussion paper

In our discussion paper, we described our current approach and raised a range of issues to gauge stakeholders' satisfaction with this approach and identify the level of support for options for improving it. We also set out our preliminary views and sought stakeholder responses.

We received submissions from 3 stakeholders: Sydney Water, Hunter Water and State Water.[6] Overall, these stakeholders supported most aspects of our current approach. The main questions on which they commented were:

- Should IPART use the actual or the notional gearing ratio in computing the financial ratios?

6 Full submissions can be accessed on our website.

- When we identify potential financeability concerns, what consideration should IPART give to options we are not empowered to mandate and the business may not itself be able to implement (such as dividend reductions and equity injections)?
- When we consider a regulatory adjustment is necessary to manage the financeability concerns, what form should this adjustment take?

3.1 Stakeholder views on the appropriate gearing ratio

In our discussion paper, we asked stakeholders whether we should use an actual or a notional credit rating in computing the financial ratios as part of our financeability test. In recent decisions we have more often used the business's actual gearing ratio, but for some decisions we used the notional gearing ratio we used in calculating the WACC.

In their submissions, Sydney Water and Hunter Water supported using the actual gearing ratio, while State Water stated a preference for the notional gearing ratio:

- Sydney Water noted that the purpose of the financeability test is to ensure that the level of revenue allowed in IPART's determination is consistent with the ongoing financial viability of the business. Given this, it argued that the test can only be meaningful if it is based on the business's actual gearing ratio.
- Hunter Water submitted that the use of the actual gearing ratio is consistent with the methodology applied by the credit rating agencies.
- State Water argued that it is inconsistent to adopt a benchmark or notional gearing level for the purpose of determining the WACC, and the actual gearing for the purpose of determining the impact of regulatory decisions (including WACC) on financial viability.

3.2 Stakeholder views on the options IPART should consider for addressing financeability concerns

In our discussion paper, we indicated that our preliminary view was that the responsibility for managing short-term financial viability issues rests in the first instance with the regulated business or its owners/shareholders. We identified a range of options open to these parties, including equity raising through either a direct equity injection from shareholders or a reduction in the dividends to shareholders. We indicated that while it was not our role to determine specific funding strategies to address short-term financial issues, we considered it important that we consider all the options. In addition, we noted that equity raising can involve significant costs, so if this option were necessary the regulator would need to consider whether it was appropriate to include an allowance for those costs in the revenue requirement.

Hunter Water and State Water commented on this issue. Both agreed that the responsibility for addressing short-term financial viability issues belongs to the business and its shareholders, and agreed that it was not the regulator's role to determine specific funding strategies to address these issues.

Hunter Water noted that options that require action by the shareholder, such as dividend reductions, are often not readily implementable by the business. It stressed that before making any recommendation or assumption that such an option will be used to address short-term financeability concerns, IPART should discuss the matter with the shareholder to confirm that it is willing and able to take such an action.[7] It also submitted that a failure of the shareholder to accept lower dividend payments or to provide equity injections may result in the business breaching its operating license conditions if it subsequently needs to defer capital expenditure to manage the financeability concerns.

State Water submitted that if IPART uses an appropriate notional gearing ratio in the financeability test (as well as in calculating the WACC), in theory the business should pass the financeability test. Where a business fails such a financeability test, then the assumed financial risk is likely to be too high and a lower notional gearing ratio should be used in both calculating the financeability test and calculating the WACC.

3.3 Stakeholder views on form that necessary regulatory adjustments should take

In the discussion paper, we identified a range of options for the form that necessary regulatory adjustments could take, including making adjustments to the inputs for our building block model such as accelerated depreciation and choosing a WACC value that is above the midpoint in the feasible range. We also indicated that our preliminary view was that we were not in favour of adjusting the building block inputs to address financeability concerns, due to the likely impacts on pricing efficiency, the credibility and consistency of the regulatory regime and intergenerational equity.

Generally, stakeholders submitted that regulatory adjustments to address financeability concerns should be made within the WACC. In particular, Hunter Water argued that the WACC should be adjusted within the target band.

7 We would note that while we have raised these options in the past we have not sought to make commitments on behalf of the Government or in any way require the Government to provide equity or adjust dividend payouts.

4 IPART's considerations and final decisions

After carefully considering the issues stakeholders expressed in their submissions, we decided to largely maintain our current approach to conducting the financeability test, but to use the business's actual gearing ratio in computing the financial ratios. We consider that the business's financial viability is best assessed by using annual revenues and interest expenses based on actual gearing. The nominal gearing does not represent the actual financial situation of a business and is used for the purpose of the building block model only.

In relation to identifying the options for addressing potential financeability concerns, we also decided to continue to canvass a range of options, including equity injections and dividend reductions. We consider that the requirements under section 15 of the IPART Act oblige us to consider (among other things) all the potential financial impacts of our decisions, and to try to achieve the best balance between these requirements in making our overall decision. This means we need to consider and quantify all the available options for addressing financeability concerns and form a view on those that are likely to best meet this objective.

Therefore, although we believe responsibility for managing short-term financeability issues should rest with the businesses and their owners in the first instance, and recognise that we cannot, and do not wish to, mandate dividend reductions or equity injections, we will flag any options we consider to provide a better means of addressing financeability concerns than adjustments to the price determination.

In relation to the form that regulatory adjustments, should they be deemed appropriate, should take, we decided that selecting a value for the WACC within the feasible range determined by our normal analysis can play a role in addressing financeability concerns. However, we may also consider including an explicit allowance for addressing immediate financeability concerns with the revenue requirements. This option has the advantage of being more transparent. In addition, the allowance can be returned to customers in future determinations, making it revenue neutral in net present value terms.

Our analysis of the main issues raised in stakeholder submissions is outlined below.

4.1 Using the actual gearing ratio in computing the financial ratios

As our discussion paper noted, for most of the utility businesses we regulate, we use a notional gearing ratio of 60% for the purpose of determining the WACC. However, for the financeability test, we have decided it is most appropriate to use the actual gearing ratio. This allows us to assess the impact of a pricing decision on the financial viability of a regulated business.

As Table 4.1 illustrates, the actual gearing levels of the businesses we regulate maybe quite different to the notional gearing level of 60% used in determining the WACC. Therefore, the use of the notional gearing level in the financeability test would reduce the validity of this test. More specifically, as the actual gearing level tends to be significantly lower than the notional gearing ratio, using the latter in the financeability test would generally result in a much lower credit rating than the business is likely to achieve.

Table 4.1 Level of actual gearing ratios used in recent IPART determinations

Determination	Year	Gearing used in financeability test	Expected actual gearing over regulatory period
State Water	2010	Actual	25% to 45%
Hunter Water	2009	Actual	36% to 53%
Gosford	2010	Actual	10% to 25%
Wyong	2010	Actual	35% to 57%
Sydney Catchment Authority	2009	Actual	35% to 37%
Sydney Water	2008	Actual	46% to 47 %
Gosford	2006	Actual	7% to 10%
Wyong	2006	Actual	16% to 18%

Source: Various IPART reports. State Water 2010, p 180. Hunter Water 2009, p 180. Gosford 2009, p 150. Wyong 2009, p 163. Sydney Catchment Authority 2009, p 105. Sydney Water 2008, p 138. Gosford 2006, p 89. Wyong 2006, p 90. All are available on IPART's website: http://www.ipart.nsw.gov.au

State Water submitted that it is not consistent to use a different gearing ratio in the WACC and the financeability test. However, we disagree with this view. We consider that the financeability test is a separate tool from the building block model, with a different purpose. This purpose is to assess the short-term impact of a pricing decision on the utility, under its current financing structure. In contrast, the building block model is a systematic approach for determining the efficient costs of the utility that should be recovered over time. Given these different purposes, we do not consider it to be inconsistent to use different gearing assumptions.

4.2 Identifying the options for addressing potential financeability concerns

In considering this issue, we confirmed our preliminary view that, where prices are determined under the building block approach, it is reasonable to expect that in the first instance, responsibility for addressing short-term financial viability risks rests with the management and owners of the businesses. We also decided that where the financeability test identifies that a business potentially faces such risks, our first step should be to identify and quantify all the options available to its management and owners to manage the risks without regulatory intervention. These options may include equity injections and dividend reductions.

We considered Hunter Water's concerns in relation to our consideration of equity injections or dividend reductions. We agree that the decision to use one of these options is a matter for the owners, and that it is not the regulators' role to decide how the owners (or the business) should respond when there is a material deterioration in the credit rating. We also note that while other regulators have at times set requirements for equity injections or dividend reductions,[8] IPART cannot, and would not wish to, set such requirements.

Nevertheless, we consider that equity injections and dividend reductions may, in certain circumstances, be reasonable ways to address financeability issues in the context of the IPART Act. For example, under section 15 of the IPART Act, we must consider the impact of pricing determinations on customers as well as on the business's financial position. Where there are already significant increases in costs and pressures on prices, consideration of this factor may limit the scope to address financeability concerns through additional increases in prices. In addition, under section 15 of the IPART Act, we are required to consider the recovery of efficient costs and avoidance of monopoly rents. This suggests we should seek to set prices to recover efficient costs, but no more, over the life of the assets. Any adjustment to prices on financeability grounds would need to be offset by lower revenues in subsequent years.

Given the above, we consider it important that we consider all options available to the business and its owners to address financeability concerns, including equity injections and dividend reductions, and flag those we consider to be preferable. We will not mandate equity injections or dividend reductions. Under our current legislation, we do not have the powers to decide on equity injections. Neither would we become involved in negotiating for any such injection. That said, IPART may make suggestions regarding ways for an entity to deal with financeability difficulties and is not obliged to obtain the agreement of the entity or its shareholders before making any such recommendation or suggestion. Whether or not this course of action is taken is, of course, the decision of the businesses' shareholders.

It is important to note that the financeability test will be first undertaken at the draft stage of the pricing determination process, and the key findings will be clearly communicated to stakeholders in the draft report. This means that if it appeared that a regulated business will lose its BBB credit rating during the upcoming determination period, the business, its shareholders and customers would be made aware of this issue and provided with the opportunity to express their views, analysis and preferred solutions.

8 For example, Ofwat, in its 2009 pricing review, used equity injections to improve financeability.

4.3 The form that regulatory adjustments to address financeability issues should take

Once we have considered stakeholders' views on the options for managing the financeability risk raised in our draft report, we will be able to form a view on whether the business and its shareholders can address this risk on their own.

Various options are available to the business's management, owners and regulators when a business faces financial difficulties. In principle, we consider that these are matters for the owners and that it is up to the business or the shareholder to decide what to do when there is a material deterioration in the credit rating. For example, management can look to defer expenditures, increase efficiency, grow revenue, or refinance existing debt. Owners play a key role in encouraging such actions by managers, determining dividends and considering equity injections. The regulator also plays an important role in considering expenditure deferrals and encouraging efficiency. Beyond this, most of the options available to the regulator revolve around increasing revenues through higher prices.

If, after having considered financial impacts and the other requirements of section 15 of the IPART Act we decide that the business needs a regulatory adjustment to ensure its financial viability, we would have to decide on an appropriate adjustment. We agree with stakeholders that, in some cases, it may be appropriate to set the WACC above the midpoint. However, where we consider higher revenues may be warranted, we also see merit in specific adjustments that can be readily tracked over time and demonstrated to be revenue neutral (in net present value terms).

Our final decision is that, where necessary, we may consider the following courses of action to address financeability issues:

1. choose a WACC above the midpoint within the feasible range, or
2. include an explicit allowance to temporarily allow the business to address immediate financeability issues. This allowance will be returned to customers, including a rate of return, making it NPV neutral.

We would be concerned to ensure that the adjustment does not provide excessive returns, reward inefficiency or 'bail out' a company that has encountered financial distress as a result of its own behaviour. As with all price-related decisions, we will consider the impact on customers of making any such adjustment.

4.3.1 Setting the WACC above the midpoint within the feasible range

As noted above, we have sometimes set the WACC above the mid-point in price determinations. We consider it reasonable to retain our discretion to do this again in cases where our consideration of the section 15 requirements of the IPART Act indicates that this is the best course of action. However, we do not propose to adjust any of the individual WACC parameters to address financeability issues. Our position is that the choice of the WACC parameter values should not be influenced by the outcome of the financeability test. In particular, the WACC should be commensurate with market conditions at the time of a decision and not used as a tool to solve financeability issues in the modelling.

We will not make a direct adjustment to any of the individual WACC parameters. As part of our building block model, we determine a commercial rate of return and the parameters that are used for the calculation of this WACC are sourced from the financial markets. Amongst other things, this ensures that our approach is unbiased and applied consistently over time. It also helps to provide longer-term assurance on future cash flows and reduces financial and regulatory risks.

4.3.2 An explicit revenue allowance

A further option we will consider is the inclusion of an explicit 'financeability allowance' within the revenue requirement (in addition to the building block cost allowances). This allowance would be returned to customers (including a rate of return) in future determinations. This form of adjustment would result in higher prices for consumers in the short-term, to ensure that the business has sufficient funds to address its immediate financial viability concerns. However, the additional costs borne by consumers would be returned to them (in the form of lower prices) once the financial position of the business has improved sufficiently. This means that the option would be revenue neutral for the business in NPV terms.

This second option has the advantage of being more transparent, and so is likely to be preferable in cases where the financeability concerns are more significant and addressing them will involve greater costs. Again, the impact of any adjustment on customers would be carefully considered by IPART.

In our discussion paper, we identified adjusting the depreciation rate as an alternative form of regulatory adjustment. As with including an explicit financeability allowance, this option has the advantage of being revenue neutral. That is, while customers would bear higher depreciation costs in the short-term, these costs would be returned to them through lower depreciation costs in a future determination period. However, as this option is no more transparent than choosing a WACC about the midpoint of the feasible range, we prefer the option of including an explicit allowance. In particular an explicit adjustment will cover a fixed amount of costs whereas the choice of a WACC above the midpoint does not.

This paper sets out principles according to which IPART will consider financeability issues in the future. As with all regulatory decisions, IPART will consider each circumstance on a case-by-case basis and set out our decisions and reasoning in relevant reports.