



Review of our financeability test Independent Pricing and Regulatory Tribunal PO Box K35 Haymarket Post Shop NSW 1240

Dear Dr Boxall,

NSW Treasury response to request for submissions on IPART's August 2018 draft report, *Review of our Financeability Test* ("Draft Report")

NSW Treasury ("Treasury") monitors several regulated utilities on behalf of the Treasurer, who is one of two shareholding Ministers in NSW's State-Owned Corporations. These utilities, listed below, are subject to IPART's oversight and may be affected by changes to its financeability test.

- Sydney Water Corporation
- WaterNSW
- Hunter Water Corporation
- Essential Water

This submission provides feedback on proposals in the Draft Report. In general, Treasury is supportive of these proposals. Treasury is particularly supportive of using inputs for a benchmark-efficient business as this may highlight issues with the internal consistency of building block model calculations.

NSW Treasury is supportive of the submissions from the state-owned utilities and will rely on them to present their views on points not raised in this letter. NSW Treasury welcomes the opportunity to provide its view and looks forward to continuing to work with IPART on regulation in the future.

Yours sincerely,

Jim Dawson Executive Director – Commercial Assets NSW Treasury

13 September 2018

NSW Treasury's comments and observations of the Draft Report

NSW Treasury is supportive of most of the proposals in the Draft Report; however, one proposal gives us cause for concern. IPART has proposed in its Draft Report to use the real cost of debt in the calculations of the financial metrics used in the financeability test. NSW Treasury is of the view that the nominal cost of debt should be used. IPART has adopted a Moody's Investors Service (Moody's) financial metric, Adjusted Interest Coverage Ratio (Adjusted ICR or AICR) for use in the financeability test. Treasury's concerns with this are the following:

- 1. NSW Treasury do not believe the AICR metric is being used in the way it was intended.
- 2. Calculation of inputs into the AICR
- 3. Calibration of benchmark values of the credit metrics to a real methodology

Moody's use of Adjusted ICR

The use of the AICR to assess financeability puts stakeholders at risk of not appropriately capturing financeability concerns in the short term, as it effectively disregards the real-world inflation component of interest that water utilities will have to pay, irrespective of their capital structure's mix of inflation-linked or nominal debt. We are of the view that IPART has relied on Moody's use of this ratio substantially and, potentially, inappropriately in its justification of the AICR's use.

Moody's use of the Adjusted ICR essentially makes two adjustments – a primary one for capital charges and another, secondary one for inflation accretions.

We firmly contend that the intended focus of Moody's use of the AICR for water utilities is the capital charge component and not inflation accretions. Moody's 2006 paper *UK Water Sector: Key Ratios Used by Moody's in Assessing Companies' Credit Strength* effectively states as much in its rationale for use of the AICR (pp 5-6, 12).

Moody's refers to Ofwat's revenue building block model for UK water utilities in its explanation of capital charge adjustments for the AICR. This model differs from that of IPART in that it includes capital charge recoveries that do not necessarily increase RAB but do increase revenue and cash-based FFO metrics, particularly relative to RAB. This inflates these metrics in a counterintuitive way, as these recoveries will be used for required capital works, the cost of which are not captured as operating expenses, nor do they impact FFO. Furthermore, these capital charges can vary substantially between water utilities. This leads to a lack of comparability in unadjusted FFO.

This adjustment is the driver for Moody's using the AICR. IPART, on the other hand, specifically excludes it from its AICR in the Draft Report (p 38 footnotes), likely because it was intended for a different model. Rather, IPART builds its basis from the Moody's AICR for excluding the inflation component of interest, or the real cost of debt.

Regulated water utilities are compensated for the cost of debt they incur. In establishing its AICR, Moody's makes a secondary adjustment for inflation, where utilities' capital structure comprises inflation-linked debt. IPART has interpreted this adjustment to support the notion that if debt is inflation-linked, then a nominal cost of debt would double-count the inflation for which the utility is to be compensated and overstate a financeability concern.

However, in the Moody's paper, inflation adjustments are alluded to as an almost incidental adjustment to refine the AICR, rather than a driver of its use, or even a necessary component of it (page 8). Its inclusion is predicated on the *potential* for an increasing

inflation-linked debt market for water utilities in the UK. However, most of the UK water utilities have less than 50% of the notional balance of their debt portfolio in inflation linked debt or inflation-linked swaps. See Chart 1 and the accompanying evidence from the utilities' annual reports in Appendix A. Given this, it can be further argued that this is a secondary consideration based on a potentiality, rather than an appeal for analysis to be based on a real cost of debt.

The inapplicability of such an analysis is emphasised by the lack of a market for inflationlinked debt in our context. Using the real cost of debt for the benchmark utility assumes the benchmark utility can fund itself entirely with inflation linked debt. Even in an inflation market with far greater liquidity like the UK, utilities are only funding themselves with half their debt portfolio in inflation-linked debt. Australian utilities would have difficulty in achieving even a 50% inflation-linked portfolio.

AICR Calculation

The calculation of AICR is not clear in the draft report. Equation 2 in the draft report states that AICR is calculated as such:

Equation 2.
$$AICR_t = \frac{FFO_t + r_t}{r_t}$$

however;

Equation 3 in the draft report calculates the AICR as:

Equation 3

 $AICR_t = \frac{Adjusted \ FFO_t + r_t}{r_t}$

where:

 $Adjusted FFO_t = FFO_t + Infl portion of interest expense$

Treasury believes that the FFO may be overstated in equation 3 and is unsure of its application, particularly as we understand that a motivation behind IPART adopting the AICR was to remove the inflation component. Removing the inflation component of interest is the adjustment that Moody's makes in its AICR. The numerator in the above is effectively the same as that of the ICR, which also reflected in the worked example provided by IPART.

Calibration of Benchmark Values

Treasury are also concerned that the benchmark values used for the proposed credit metrics have not been calibrated using a real cost of debt. Moody's, S&P and Fitch have a rich database which has been used to calculate credit metrics in the nominal world but have not extended that to real interest rates. Treasury would like IPART to review if the benchmark values for the real world and the nominal world would be the same.

Appendix A

Chart 1: UK Utility portfolio debt type mix.



Source: Moody's 30 March 2015 Sector Comment on GB Regulated Networks and Water Utilities

Examples of UK Utility Debt Mix from Annual Reports and other company issued media reports.

Thames Water

As a regulated water company, our bills are linked to movements in inflation, which increases or decreases the amount of money we have available to pay for the interest on our debt. For that reason, we have also linked around half of our debt to inflation.¹

Anglian Water

At the year end, taking into account interest rate swaps, 58.4% (2016: 58.5%) of Anglian Water's borrowings were at rates indexed to RPI, 35.9% (2016: 36.0%) were at fixed rates and 5.7% (2016: 5.5%) were at floating rates.² Anglian Water Group Limited Annual report and consolidated financial statements for the year ended 31 March 2017 p. 83.

Severn Trent

The group's policy is to maintain 40% to 70% of its interest-bearing liabilities in fixed rate instruments.³

- ² Anglian Water Group Limited Annual report and consolidated financial statements for the year ended 31 March 2017 p. 83.
- ³ Severn Trent: Report and financial statements for the year ended 31 March 2018

¹ Thames Water: Our-Finances-Explained-October-2017 p16

Northumbrian Water

The Company's policy is to keep a minimum 50% of its borrowings at fixed rates of interest. At 31 March 2018, 64% (31 March 2017: 65%) of the borrowings of the Company were at fixed rates of interest.⁴

Southern Water

Southern Water's debt portfolio is 23% of debt is inflation linked.⁵

South West Water

South West Water has a diversified funding mix of 60% fixed, 15% floating and 25% indexlinked borrowings.⁶

United Utilities Group PLC

Long-term sterling inflation index-linked debt provides a natural hedge to assets and earnings. At 31 March 2018, approximately 54 per cent of the group's net debt was in index-linked form, representing around 33 per cent of UUW's regulatory capital value.⁷

⁴ Northumbrian Water Limited Annual report and financial statements for the year ended 1 March 2018 p. 45

⁵ Greenlands: Annual Report and Financial statements for the year ended 31 March 2017 p. 60.

⁶ South West Water Annual Report and Financial Statements 2018 p. 20

⁷ United Utilities Group PLC: Full year Results for the year ended 31 March 2018 P. 14