SYDNEY DESALINATION PLANT
ABN 50 125 935 177
Sydney Desalination Plant Pty Ltd
Suite 19, Level 17, Australia Square
264 George Street Sydney NSW 2000
www.sydneydesal.com.au
Phone: (02) 8599 8532
Email: info@sydneydesal.com.au

Dr Peter Boxall
Independent Pricing and Regulatory Tribunal (IPART)
PO Box K35
Haymarket Post Shop NSW 1240

1 June 2018

Review of financeability tests – Response to Issues Paper

Dear Dr Boxall,

Thank you for the opportunity to provide Sydney Desalination Plant Pty Limited's (SDP's) views on IPART's 2018 review of its financeability test. SDP supports IPART's initiative to undertake this review. Periodic assessments such as this review, and the 2017 WACC methodology review, are important in ensuring that IPART's approaches to regulation remain fit for purpose over time, reflect evolving regulatory best practice, and are well understood by all stakeholders.

SDP agrees with IPART's Issues Paper that there are benefits to conducting financeability tests when IPART sets regulated prices. The most important benefit is that financeability tests can provide an important sense check on pricing decisions, to confirm that the regulatory allowances IPART sets are sufficient to ensure that regulated businesses remain investment grade. If IPART's pricing decisions result in businesses being unable to maintain investment grade credit worthiness, the businesses' cost of borrowing will rise. These costs will ultimately be borne by consumers – either through higher prices or through reduced capital investment, or both. Therefore, it is essential to the long-term interests of consumers that IPART conducts financeability tests when making pricing decisions, and that those tests are able to identify and address genuine financeability problems early.

For these reasons, SDP supports IPART's proposed objectives for this review – namely, to ensure that:[1]

1. The financeability test effectively assesses the impact of IPART's pricing decisions on the short-term financial sustainability of the regulated business.
2. IPART's process for identifying and addressing a potential financeability problem supports efficient and prudent investment decisions by regulated businesses, and supports the long-term interests of consumers.

IPART has sought submissions on its preliminary views on a number of aspects of its financeability test. SDP agrees with IPART's assessment in the Issues Paper that its financeability test is, on the whole, working well. SDP therefore agrees with almost all of IPART's preliminary views set out in the Issues Paper. SDP has however identified a few areas in which IPART's proposed financeability could be improved to better achieve the objectives of the test.

Our submission is structured as follows:

- Attachment 1 sets out SDP's views on the key areas in which we consider IPART's proposed financeability test could be improved. In most cases, our recommended improvements are minor refinements to the approach already proposed by IPART in the Issues Paper.

[1] Issues Paper, May 2018, p. 9.

- Attachment 2 presents empirical evidence that the market for inflation-indexed corporate bonds in Australia is, for all intents and purposes, non-existent.
- Attachment 3 summarises SDP's views on all of the consultation questions on which IPART has sought comment.

SDP looks forward to working constructively with IPART during its review of financeability tests.

Should you wish to discuss or clarify any aspect of our proposal, SDP would be pleased to engage with IPART further.

Please direct any questions regarding our submission to Justin De Lorenzo – Chief Financial Officer (02 8599 8535).

Yours sincerely,

[redacted]

Keith Davies
Chief Executive Officer
Sydney Desalination Plant

Attachment 1 – SDP's views on key matters raised in the Issues Paper

This Attachment sets out SDP's views on the following consultation questions posed in the Issues Paper:

1. Objective of the financeability test;
2. Proper diagnosis of financeability problems;
3. Use of a nominal versus real cost of debt;
4. Use of quantitative data in the financeability test;
5. Financial metrics to be used in the financeability test;
6. Adjustments to financial metrics;
7. Ranking of financial metrics;
8. Financial metric benchmarks;
9. NPV-neutral adjustments to prices;
10. Appropriateness and workability of the process IPART proposes for addressing financeability concerns;
11. Other implementation issues.

Objective of the financeability test (Question 5)

The Issues Paper proposes the following revised objectives for the financeability test:[2]

- ensure our pricing decisions would allow an efficient investment grade-rated business to raise finance during the regulatory period (benchmark test), and
- assess whether the utility would meet this benchmark (actual test) during the regulatory period.

SDP agrees with the discussion in the Issues Paper on the objectives for the financeability test – namely, that the financeability test should be used to detect errors in IPART's pricing determinations (e.g., through mis-estimation of efficient costs) that could create a financeability problem for a benchmark business, and that the financeability test should be used to generate an early warning that the actual business may face a financeability problem under IPART's pricing determinations.

SDP considers that the first of IPART's proposed objectives for the financeability test could be made clearer if reframed slightly in the following way:

- ensure our pricing decisions would allow an efficient ~~investment grade-rated~~ business to ~~raise finance~~ maintain an investment grade rating during the regulatory period (benchmark test).

In SDP's view, the financeability test should focus less on whether the pricing decision would allow an efficient business to raise *any* finance, and more on whether such a business can raise finance ***on reasonable terms*** that would ultimately promote the long-term interests of consumers. If IPART can ensure that, under its pricing decisions, an efficient business can maintain an investment grade rating over the regulatory period, then it follows that such a business ought to be able to raise any required finance on efficient and reasonable terms.

Therefore, SDP submits that the primary objective of the financeability test should be to ensure that at least an efficient business, with an investment grade rating, is able to remain investment grade, under IPART's pricing decision.

It would also be appropriate, as the Issues Paper proposes, for the financeability test to assess whether the actual businesses are likely to meet this benchmark during the regulatory period. The examination of the

[2] Issues Paper, May 2018, p. 16.

actual business is important in potentially providing an early warning in relation to financeability issues which would impact on consumers if realised.

Proper diagnosis of financeability problems (Question 22)

IPART proposes in the Issues Paper to structure its financeability test in three stages:

1. Apply the ‘benchmark’ test and compare the results to pre-specified benchmarks.
2. Apply the ‘actual’ test and compare the results to pre-specified benchmarks.
3. Examine cash flows in both the actual and benchmark tests to identify whether there are financeability problems in individual years.

IPART seeks views on whether this three-stage process would identify effectively whether any financeability concern is due to (a) IPART setting the regulatory allowance too low; (b) the business taking imprudent/inefficient decisions; and/or (c) cash flow timing. IPART considers that application of the benchmark and actual financeability tests would identify whether IPART has set regulatory allowances too low. However, the benchmark and actual tests proposed by IPART differ only in gearing and cost of debt used. Specifically:[3]

- The benchmark test uses the same gearing and cost of debt used to set the notional revenue requirement;
- The actual test uses the business’s actual cost of debt and actual gearing (relative to RAB) of the business; and
- All other aspects of the notional revenue requirement (RAB, opex, capex, etc.) remain the same and as per the draft decision.

Hence, neither test will identify whether, for example, IPART has set too low an opex (or capex or depreciation) allowance. In other words, both tests assume implicitly that the costs that the business (benchmark and actual) will incur over the regulatory period equals the cost allowances provided by IPART in its pricing decision.

By way of example, Box 1 below provides an example from the energy sector of how erroneous regulatory decisions in relation to opex allowances can result in regulated businesses facing financeability problems. The specific example provided shows that, in the event that a regulator determines that a material reduction in the opex actually being incurred by a business is warranted, it may not be feasible for such reductions to occur rapidly and without additional cost. Businesses may have to incur transitional costs, for instance, due to external obligations imposed by legislation or other regulations (e.g., employment law or safety regulations). If these costs are not allowed for within the regulatory decision, then the businesses affected may face material cash flow shortfalls and financeability difficulties – as the example below shows.

IPART’s benchmark and actual tests would not identify such financeability problems because, as noted above, both tests assume that the costs incurred by the benchmark or actual business exactly match the regulatory allowance. In circumstances where regulated businesses consider that IPART has set ***any*** of the building block components of the notional revenue requirement too low, it should be open to the regulated businesses to present evidence on the impact of the regulatory decision on financeability, and seek allowances to be set in such a way as to address any financeability concerns.

SDP considers that the proper forum to submit such evidence would be in response to IPART’s draft decision on each of the building block components of revenue. The onus should fall on regulated businesses to submit evidence if they consider IPART’s regulatory allowances to be unreasonably low. The evidence that businesses are permitted to submit, to demonstrate that regulatory allowances have been set too low, should include the adverse impact on financial metrics of setting regulatory allowances that are unreasonably low.

That is, SDP does not propose that this issue warrants a change to IPART’s proposed approach to financeability tests. Rather, SDP submits that, in identifying concerns about opex or other cost allowances, one of the relevant pieces of evidence to consider is the effect that the allowance has on financeability.

---

[3] Issues Paper, May 2018, Box 3.1, p. 12.

Box 1: Example of financeability problems imposed by regulatory decisions in relation to opex allowances

In April 2015 the Australian Energy Regulator (AER) set opex allowances for a number of electricity distribution businesses in NSW and the ACT. A number of those decisions determined that the businesses' revealed opex in the base year (from which efficient opex over the forthcoming regulatory period were to be forecast) were inefficiently high. The AER consequently set the level of efficient base year opex between 24% (Ausgrid) and 32.8% (ActewAGL) lower than revealed opex, and then used this revised base year level to forecast efficient opex over the regulatory period. This meant that the opex that the businesses were allowed to recover over the regulatory period was very materially lower than the opex they were actually incurring.

In order to bring their actual expenditure in line with allowed expenditure, the businesses had to reduce their workforces materially. The businesses submitted to the AER that in order to reduce their workforce, it was necessary for them to offer voluntary redundancy payments to their employees as the terms of the prevailing Enterprise Bargaining Agreements (EBAs) they had entered into prohibited them from making involuntary redundancies. The very large reductions in opex required in order for the businesses to match the allowances provided by the AER required the businesses to downsize their workforces significantly. This meant that the associated redundancy costs over the regulatory period were very material.

None of these transition costs were factored into the AER's opex decision. The AER argued that consumers should not pay for the businesses to become more efficient. As these additional costs were not allowed for by the regulator, they had to be absorbed by the businesses over a relatively short (four to five year) period. The businesses presented analysis to the AER that showed a very material deterioration in financeability over the regulatory control period, owing to the additional redundancy costs and the time it would take for the businesses to transition to the immediate and significantly reduced opex allowance provided by the AER. These issues had not been factored into the AER's decisions. All of the businesses affected in this way by the AER's opex decision sought a merits review of those decisions. The Australian Competition Tribunal ruled in favour of the businesses, deciding that the AER had erred in its opex decisions in a number of ways. In doing so, the Australian Competition Tribunal held that the businesses were "shackled with EBAs that effectively restrict their ability to efficiently reduce their workforce in the regulatory period – that restriction being attributable to an exogenous factor, namely, the Fair Work Act 2009 (Cth)", and that it had been incorrect for the AER to disregard in its opex decision the obligations imposed by the existing EBAs.

Source: AER regulatory decisions for Ausgrid, Essential Energy and ActewAGL, April 2015; Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1

Use of nominal versus real cost of debt (Question 11)

Currently, IPART uses a nominal cost of debt in its financeability test. The Issues Paper proposes that, in future, IPART should use a real cost of debt because using a nominal cost of debt in the financeability test may exaggerate financeability problems for actual and benchmark businesses.[4] IPART argues that as it provides compensation for inflation by indexing the RAB, it only needs to compensate businesses for the real cost of debt and equity in the WACC allowance.

IPART is correct that, in expectation, over the life of the regulated assets, investors will (under IPART's method for setting prices) recover the real return they require, and compensation for expected inflation. However, as compensation for inflation is capitalised into the RAB and recovered over many decades, businesses may face a mismatch of cash flows within individual regulatory periods. IPART recognises this possibility but notes that:[5]

> *… businesses can manage the mismatch of when they are compensated for inflation; for example, by issuing bonds with lower-interest coupons to match the regulatory allowance. We think our test should not identify a financeability problem because of the way we compensate the business for inflation.*

And:[6]

[4] Issues Paper, May 2018, p. 22.
[5] Issues Paper, May 2018, p. 22.
[6] Issues Paper, May 2018, p. 32.

> *…we think businesses can manage when they are compensated for inflation by reducing the amount of interest they repay in cash; for example, by issuing bonds with lower-interest coupons, to better align to the regulatory allowance. In effect, the business could issue bonds that index the debt for inflation in a way that matches the RAB indexation.*

SDP disagrees with IPART's contention that regulated businesses can manage the mismatch of cash flows caused by delayed recovery of compensation for inflation by issuing inflation-indexed bonds. The market for inflation-indexed corporate bonds in Australia (for private issuers of debt, such as business in the circumstances of SDP) is extremely thin. Private corporate entities in Australia largely procure debt which incurs a nominal cost of debt. There is no market for inflation-indexed corporate bonds in Australia to speak of. For example, as Attachment 2 shows, there is no evidence that any Australian corporate has issued inflation-indexed bonds since 2010. Therefore, it is unrealistic to expect businesses such as SDP to manage this cash flow timing mismatch in this manner.

Since a benchmark efficient business in SDP's circumstances cannot feasibly manage cash flow risk arising from delayed recovery of compensation for inflation, SDP considers that the financeability test should allow for the identification of financeability problems that are created by the way IPART compensates businesses for inflation.

Furthermore:

- SDP understands that, in Australia, Moody's (and other rating agencies) conduct rating assessments (and calculate relevant financial metrics) using the nominal rather than real cost of debt.
- The benchmark ratios that IPART proposes to use (derived using Moody's guidance) are based on the nominal rather than real cost of debt because they are derived using actual rating decisions issued by Moody's. Therefore, a financeability test implemented using the real rather than nominal cost of debt is likely to understate any genuine financeability problem, potentially leading IPART to conclude, incorrectly, that a business faces no financeability problem when in fact it does. Alternatively, IPART would have to derive a set of benchmark metrics that use the real cost of debt, but it is unclear how that would be done since, as noted above, Moody's and other rating agencies conduct rating assessments in Australia using the nominal cost of debt.

During the roundtable discussion on 22 May 2018, IPART noted that it appears that Moody's uses the real cost of debt when conducting credit rating assessments for regulated water businesses in the UK, and referred stakeholders to page 21 of Moody's current rating methodology for Regulated Water Utilities 2015 as evidence of this point. Moody's sets out in its rating methodology its formula for calculating the Adjusted Interest Coverage ratio. One of the terms in that formula is 'Inflation Accretion.' Moody's explains that:[7]

> *Inflation Accretion typically arises when the regulatory authority sets tariffs for the water utility in real terms, using a real rate of return, and then allows the utility to adjust tariffs annually by an inflation index. In this type of regulatory model, such as used in the UK, the utility's RAB is also revalued annually by inflation.*

This is consistent with the regulatory approach that IPART uses: IPART sets a real WACC allowance, which is then applied to a RAB indexed using outturn CPI inflation. IPART may have concluded that because the regulatory approach described in Moody's rating methodology aligns with the regulatory approach IPART follows, it would be appropriate to mirror in the financeability test Moody's use of the real cost of debt when conducting credit rating assessments for regulated water businesses in the UK.

However, it is important to recognise that the approach described in Moody's rating methodology assumes that businesses are able to raise inflation-indexed debt:[8]

> *Hence, inflation-linked debt aligns the debt service requirements with the utility's future cash flows, because the utility only pays a real rate of interest on the outstanding principal, which is adjusted annually by an inflation index.*

It is implicit in this statement that if businesses cannot issue inflation-indexed debt (e.g., because there is an insufficiently liquid market for such debt), then it is not feasible for regulated businesses to align their (nominal) interest payments on debt to regulated cash flows under the regulatory approach described

---

[7] Moody's Investors Service, Rating methodology – Regulated Water Utilities, December 2015, p. 21.

[8] Moody's Investors Service, Rating methodology – Regulated Water Utilities, December 2015, p. 21.

above. The analysis presented in Attachment 2 demonstrates that it is not feasible for privately-owned businesses to issue inflation-indexed debt in Australia because there is no market for such debt at the present time.

If businesses cannot issue inflation-indexed debt to align their actual interest costs to the regulatory allowance, then it would be inappropriate for Moody's to use the real cost of debt when conducting credit rating assessments. Indeed, as noted above, our understanding is that Moody's uses the nominal, rather than the real, cost of debt when conducting credit rating assessments for Australian firms.

For these reasons, SDP considers that IPART should maintain its existing approach of using the nominal cost of debt when conducting its financeability tests.

Use of quantitative data in the financeability test (Question 14)

During the roundtable discussion, it was proposed that IPART should seek to determine an overall credit rating for each of the businesses it regulates, by assessing the quantitative and qualitative factors that rating agencies consider when conducting credit rating assessments. SDP's understanding of this proposal was that IPART should effectively seek to replicate in full the rating methodologies used by rating agencies such as Moody's.

IPART's preliminary view expressed in the Issues Paper is that it "should continue with a solely quantitative assessment of financeability", rather than take account of the qualitative factors that rating agencies consider when conducting rating assessments.[9] IPART notes that such an approach would be:

- More transparent for stakeholders; and
- More compatible with IPART's objective for the financeability test. IPART emphasised that the financeability test assesses a business's financial health, which is best done using financial data.

SDP agrees strongly with IPART's view that it should focus only on a quantitative assessment of financeability (using financial metrics), rather than seeking to replicate rating agencies' rating methodologies by also accounting for qualitative factors. SDP notes that the qualitative factors that rating agencies take into account are very subjective and involve considerable judgment. Attempting to emulate the qualitative aspects of rating agencies' rating assessments would lower the transparency of financeability test and potentially introduce scope for inconsistent regulatory decisions for different businesses. Under the approach proposed by IPART, which would entail only quantitative assessments of financeability, any stakeholder could independently replicate IPART's analysis. This would serve to promote the predictability of the regulatory framework.

IPART has itself noted that it does not seek to assign an overall credit rating when conducting financeability assessments.[10] SDP concurs with this sentiment.

SDP also makes the following relevant points:

- None of the other regulators cited in the Issues Paper—including the ESC, Ofgem and Ofwat—seek to replicate the qualitative aspects of rating agencies' assessments, when performing financeability tests. All of these regulators focus exclusively on the quantitative assessment of financial metrics alone. For example:
  - Ofgem, like IPART, states explicitly that its "financeability analysis does not intend to replicate the different rating agencies' methodologies" because the rating agencies' qualitative assessments involve judgment (which is difficult to replicate) and because the three rating agencies (Moody's, Fitch and Standard & Poor's) "tend to focus on different criteria in their evaluations."[11]
  - Ofwat states that "Each credit rating agency adopts a slightly different approach, including making company specific adjustments for individual items which reflect the specific circumstance of each company's capital structure, operations or financing. Some of these adjustments reflect company specific issues that are shareholder matters (furthermore one

[9] Issues Paper, May 2018, p. 25.

[10] Issues Paper, May 2018, p. 29.

[11] Ofgem, Strategy decision for the RIIO-ED1 electricity distribution price control – Financial issues, 4 March 2013, p. 25.

> company is not rated). We do not therefore follow the precise approach of any credit rating agency."[12]

- If IPART were to revise its financeability test to incorporate the qualitative factors that rating agencies assess, that could lead to IPART opining on its own regulatory framework, the latter being a key qualitative assessment within rating agencies' credit rating methodologies. IPART opining on its own regulatory framework would introduce an unwanted conflict of interest into the assessment process.
- IPART does not have the required skill and experience to undertake credit rating assessments.
- A regulator providing a credit rating assessment could negatively impact a credit rating agency's view of the utility which in turn would negatively impact that utility's cost of funds.

For the reasons described above, SDP submits that IPART should—as proposed in the Issues Paper—conduct its financeability tests solely by making quantitative assessments of financial metrics, and not seek to assign a credit rating to individual regulated businesses by also assessing the qualitative factors that rating agencies have regard to.

Financial metrics to be used in financeability test (Questions 16 and 17)

The Issues Paper proposes that IPART would continue to use three financial metrics in its financeability test:[13]

1. FFO interest cover;
2. Debt to RAB (i.e., gearing); and
3. FFO over debt.

SDP supports the continued use of these three metrics on the grounds that these indicators are used commonly by rating agencies, such as Moody's, when conducting rating assessments.

IPART also seeks views on whether additional financial metrics should be used. SDP considers that the three financial metrics proposed by IPART should be the default metrics used in IPART's financeability test. However, SDP considers that IPART's financeability test should provide an opportunity for individual businesses to propose (e.g., through the price reset process) additional metrics that reflect their particular, relevant circumstances.

By way of example, SDP submitted (during IPART's 2017 WACC methodology review) that businesses in SDP's circumstances differ from other water businesses that IPART regulates. Specifically, SDP is subject to a limited term concession. Under the terms of that concession, SDP is obligated to repay its debt in full (i.e., principal and all interest owed) within the concession period. This is standard industry practice for companies with limited term concessions, and represents an immutable characteristic of SDP that would be shared by a benchmark efficient entity in the circumstances of, and with a similar degree of risk as is faced by SDP.

Given this characteristic, the Debt Service Coverage Ratio (DSCR), which measures SDP's ability to repay principal as well as interest, is an important financial metric that SDP's lenders (and lenders to any firm under similar limited term concession obligations) monitor. Therefore, the DSCR would, in SDP's view, be an appropriate financial metric for IPART to consider for any business in SDP's circumstances. Given that other water businesses regulated by IPART operate in circumstances where they do not face similar limited term concession obligations, it would be unnecessary for IPART to assess the DSCR when conducting financeability tests for those businesses.

The DSCR is only one example of an additional financial metric that IPART could consider, in certain circumstances. SDP submits that:

- IPART could consider on a case-by-case basis (e.g., when conducting price resets for individual businesses) whether any additional financial metrics should be evaluated as part of the financeability test for the business in question;
- The onus should fall on individual businesses to make a case for use of additional financial metrics, over and above the three default metrics proposed by IPART; and

[12] Ofwat, Delivering Water 2020: Our final methodology for the 2019 price review, December 2017, p. 197.

[13] Issues Paper, May 2018, p. 27.

- The key criterion for consideration of any additional metrics is whether those metrics provide additional relevant information on the financeability of the business in question, in respect of innate, immutable characteristics of the business in question. That is, any additional metric would have to be appropriate for a benchmark efficient business with the relevant characteristics and circumstances (e.g., with a fixed concession period). This would prevent regulated businesses 'cherry-picking' metrics.

Note that if SDP's submission were adopted by IPART, there would be no need for IPART to define multiple benchmark efficient entities. IPART would simply need to recognise that the characteristics of the businesses it regulates do differ in certain ways, and that these differences should be reflected in the efficient benchmark used when regulating those businesses.

Adjustments to financial metrics (Question 9)

As noted in the Issues Paper, IPART makes adjustments to the financial metrics it uses in its financeability test for operating lease and superannuation (pension) obligations, mirroring some of the adjustments to financial data that Moody's makes when conducting rating assessments. Moody's rationale for making these adjustments is to reflect more accurately the cash flow requirements and obligations of firms. SDP considers that these adjustments to financial metrics are appropriate.

SDP notes that the adjustments that IPART currently makes for lease and superannuation obligations were developed during IPART's 2013 review of its financeability tests using the latest Moody's published methodology at that time.[14] As noted in the Issues Paper, Moody's has subsequently updated its methodology for making adjustments to financial data.[15] Whilst Moody's approach to adjustments for superannuation obligations has remained largely unchanged, Moody's has made some changes to its treatment of operating leases. Further, as recognised in the Issues Paper, Moody's is presently consulting on whether it should revise further the adjustments it makes to financial data for operating leases, following changes to accounting standards.[16]

SDP's view is that the purpose of the financeability test should be to ensure that IPART's pricing decisions are sufficient to allow at least an efficient business to maintain an investment grade rating. Therefore, it is important that the financial metrics used in IPART's test mirror the financial metrics (including any adjustments) employed by rating agencies such as Moody's when they conduct rating assessments.

However, SDP recognises that Moody's may make changes to its approach to computing the relevant financial metrics from time to time, and these methodological changes may occur between IPART's periodic reviews of its financeability tests. In the interests of promoting regulatory certainty and predictability, SDP considers that IPART should not immediately reflect any changes in Moody's methodology, but rather update the financeability rules in line with its normal review cycle, say every five years. If IPART considers that Moody's has revised its methodology in a very material way that may warrant a more frequent change to its financeability test, SDP considers that IPART should consult on whether those changes should be adopted, and offer stakeholders the opportunity provide views on the proposed changes.

Ranking of financial metrics (Question 19)

The Issues Paper proposes that IPART will continue its practice of not assigning explicit numerical weights to each of the financial ratios it considers in its financeability test because, unlike Moody's (which does give specific numerical weight to each metric), IPART's task is not to assign an overall credit rating.[17] SDP agrees with IPART that it is neither necessary nor desirable for IPART to apply explicit numerical weights to each financial ratio, for the reason IPART has identified.

---

[14] Moody's Investors Service, Moody's Approach to Global Standard Adjustments in the Analysis of Financial Statements for Non-Financial Corporations, December 2010.

[15] Moody's Investors Service, Financial Standard Adjustments in the Analysis of Non-Financial Corporations, December 2016.

[16] Issues Paper, May 2018, p. 21.

[17] Issues Paper, May 2018, p. 29.

IPART does, however, propose to apply a qualitative ranking of the metrics in order of relevance and, in particular, to maintain its current practice of placing most importance on the FFO interest cover and debt to RAB ratios, with somewhat less weight on the FFO to debt ratio.

SDP notes that, as summarised in Table 1, Moody's latest rating methodology for regulated water utilities gives equal weight to FFO interest cover and FFO to debt (12.5% weight each) and slightly less weight on the Debt to RAB ratio (10%).[18] Collectively, the financial metrics considered by Moody's receive 40% of all weight in its rating assessments.

Table 1: Moody's sub-factor weightings for financial ratios

Financial ratio	Weighting
Adjusted interest coverage **or** FFO interest coverage	12.5%
Net debt/RAB **or** debt/capitalisation	10%
FFO/net debt	12.5%
RCF/net debt	5%
Total weighting for financial ratios	40%

Source: Moody's Investors Service, Rating methodology – Regulated Water Utilities, December 2015, p. 6

SDP considers that even if IPART does not give explicit numerical weights to each metric, it should at least reflect qualitatively the weight that Moody's gives to each ratio (since the purpose of IPART's test to check if regulated businesses can maintain an investment grade rating). This means that IPART should give most (and equal) importance to the FFO interest cover and FFO to debt ratios, and slightly less weight to the Debt to RAB ratio. This would align IPART's financeability test better with the rating assessments of rating agencies such as Moody's.

Financial metric benchmarks (Question 18)

The Issues Paper notes that the existing financial ratio benchmarks IPART uses in its financeability test (reproduced in the Table below) are potentially difficult to interpret because each ratio has a wide range and there is significant overlap in the ratios between credit ratings.

Table 2: IPART's current financial ratio benchmarks

Metrics	A3	Baa1	Baa2	Baa3	Ba1
FFO/interest	>2.9x	2.3-2.9x	1.7-2.5x	1.4/1.5-1.7x	<1.4/1.5x
Debt/RAB[a]	<60%	80-85%	60-91%	90->100%	>100%
FFO/debt	>10%	>10%	<6-10%	5-8%	<4%

a Regulatory value.

Source: Issues Paper, May 2018, Table 5.1, p. 28

IPART notes that, as part of this review, it intends to revise the benchmark ratios for each financial metric so that they:

- reflect current best practice (e.g., for credit rating agencies and lenders);
- reduce or eliminate any overlap where appropriate; and
- reflect the circumstances of the businesses we regulate.

SDP agrees with the limitations of the existing benchmark ratios that IPART has identified, and also agrees that it would be desirable to improve the benchmark ratios so as to limit the scope for misinterpretation and ambiguity – principally by eliminating overlaps in the ratios across credit ratings. Given the limited time

[18] Moody's also gives some limited weight, 5%, to the RCF to debt ratio.

available to respond to the Issues Paper, SDP has not had an opportunity to consider fully how such improvements could be implemented. SDP may undertake further analysis in this regard during the course of this review.

SDP also makes the following submissions in relation to the methodology for developing benchmark ratios:

- The Issues Paper reproduces in Table 5.2 a set of benchmark ratios that Moody's published in 2015, which differ from the existing benchmark ratios that IPART currently use. Those ratios are more straightforward to interpret than IPART's existing benchmark ratios as there is no overlap between credit ratings. However, SDP submits that the benchmark ratios presented in the Table 5.2 have limited relevance to regulated water businesses in Australia as they are derived from Moody's Global Rating Methodology, which reflects "Moody's approach to assessing credit risk for rated issuers in the regulated water utilities sector, globally."[19] In other words, the benchmarks presented in Table 5.2 reflect the financial metrics of regulated water utilities in a wide range of jurisdictions, and the companies operating in those other jurisdictions may face different operating environments, regulatory regimes, financial policies and business models to the businesses regulated by IPART. In SDP's view, it would be more appropriate for the benchmark ratios used in IPART's financeability test to be developed using actual past credit rating opinions for Australian firms. These would represent more relevant benchmarks than those developed by reference to the financial performance of companies in other jurisdictions. This was the methodology used by IPART in 2013 to develop its existing benchmark ratios, and also the basis for the benchmark ratios submitted by SDP in its 2016 revised pricing proposal to IPART.[20]
- SDP supports the approach of using the thresholds/triggers used by Moody's to either upgrade a firm's credit rating ('up-drivers') or downgrade a firm's credit rating ('down-drivers') in order to develop the relevant ratio benchmarks. Once again, this was the methodology used by IPART in 2013 to develop its existing benchmark ratios, and also the basis also the basis for the benchmark ratios submitted by SDP in its 2016 revised pricing proposal to IPART.
- SDP considers that the benchmark ratios used by IPART in its financeability test should not be developed by reference to past rating decisions for State-owned corporations, such as Sydney Water or Hunter Water. These businesses enjoy implicit Government support, and this support is reflected in their credit ratings in particular the publicly available ratings. Both Sydney Water and Hunter Water enjoy a very strong liquidity position arising from their financing arrangements with TCorp. As such, their credit ratings are not truly standalone ratings. Therefore, SDP supports IPART's 2013 approach of using standalone regulated businesses in other sectors (e.g., regulated Australian energy networks that are not State-owned) to develop its benchmark ratios.

NPV-neutral adjustments to prices (Question 26)

The Issues Paper proposes that in future, the remedy for an identified financeability problem should depend on the source of the problem:

- A NPV-positive adjustment might be appropriate if the financeability problem was caused by a regulatory error. For example, the solution to a financeability problem caused by IPART setting too low a WACC allowance would be to increase the WACC allowance (which would be a NPV-positive remedy).
- A NPV-neutral adjustment (e.g., a re-profiling of revenues through acceleration of the regulatory depreciation allowance) would be appropriate if the financeability problem was caused by a mismatch in the timing of cash inflows and outflows.
- If the source of a financeability problem is imprudence or inefficiency on the part of the business, then it should be the responsibility of the owners of the business, and not consumers, to manage the financeability problem.

SDP supports the proposition that the remedy for a financeability problem should be tailored to the source of the problem. SDP also agrees with IPART's proposed remedies under the different circumstances described above.

[19] Moody's Investors Service, Rating Methodology – Regulated Water Utilities, December 2015.

[20] SDP revised pricing proposal – Supporting Appendices, 24 October 2016, Appendix 10.2.

In relation to NPV-neutral adjustments, IPART states the following:[21]

> *Our current preliminary view is that we should limit any NPV-neutral adjustments to prices to the upcoming regulatory period, but we are seeking feedback from stakeholders about whether this approach is feasible in practice.*

It is unclear to SDP what IPART intends when it suggests limiting NPV-neutral adjustments to the forthcoming regulatory period. One interpretation is that, in the event a financeability problem is identified, IPART would not commit to implementing financeability remedies beyond the upcoming regulatory period as that would effectively bind a future Tribunal's decisions. This, in SDP's view, would be a reasonable position for IPART to take. IPART should judge at each price reset, whether a financeability problem is likely to exist over the forthcoming regulatory period, and what remedy (if any) would be appropriate.

SDP notes, however, that the standard NPV-neutral solution for re-profiling cash flows – the acceleration of the regulatory depreciation allowance – will affect depreciation allowances in subsequent regulatory periods. This is because, by speeding up the recovery of a fixed quantum of capital, more is recovered in the current period, which leaves less to be recovered in future periods. Hence, the implementation of a NPV-neutral, accelerated depreciation remedy would inevitably affect future regulatory periods beyond the upcoming one. SDP considers this to be appropriate as it requires no particular action from any future Tribunal.

An alternative interpretation of IPART's statement is that only cash flows within a given regulatory period could be re-profiled to address a financeability problem. That is, under this interpretation any acceleration of cash flows in Years 1 and 2 of a regulatory period would have to be 'caught up' by the end of that regulatory period. This may not be a feasible or desirable approach, depending on the severity of the problem. For example, if the financeability problem is very acute, shifting revenues from Year 5 of a regulatory period to Year 1, in a NPV-neutral fashion, may inadvertently cause a cash flow shortfall in Year 5, thereby deferring the financeability problem rather than addressing it appropriately.

Restricting the re-profiling of revenues within a single period may also create undesirable volatility in prices in individual years by increasing the revenues that need to be recovered through prices in some years of the period, and depressing the revenues that need to be recovered through prices in other years. Re-profiling revenues over multiple periods would allow a smoother profile of prices to consumers because the required price changes in any one year would unlikely be large.

SDP considers that the former interpretation is appropriate – that IPART would address any financeability problems by taking action within the current regulatory period, even if that action has an impact on cash flows in future regulatory periods, so long as the current Tribunal does not bind any future Tribunal into taking any particular action. An example would be accelerating depreciation allowances for the current regulatory period, where that advance is not caught up by the end of that regulatory period.

Proposed process for addressing financeability concerns (Question 27)

The Issues Paper seeks views on the reasonableness and workability of IPART's proposed process for addressing financeability problems identified.

Overall, SDP considers that IPART's proposed process appears to be sound. IPART has proposed a number of appropriate improvements to its financeability test, including:

- Steps to diagnose properly the underlying cause of a financeability problem; and
- Remedies tailored to the nature of the financeability concern.

For the avoidance of doubt, SDP submits that IPART's current process for setting regulatory allowances should not be replaced by a process of back-solving for a particular set of financeability metrics. In particular, financeability tests should not be used to lower regulatory allowances if the regulated business is found to pass the financeability test comfortably (e.g., because management has taken prudent financing decisions).

[21] Issues Paper, May 2018, p. 33.

In SDP's view, the purpose of IPART's financeability test is to prevent regulated prices being set so low that even an efficient regulated business may encounter financeability problems. SDP submits that the financeability test should not be used to set an upper bound for regulated prices or to become a replacement for the current approach to setting allowed revenues via a process of back-solving to a particular set of financeability metrics.

SDP proposes that IPART make an explicit statement in its financeability guidelines to the effect that it will not use the financeability test as a basis for lowering regulated revenues that are derived from its building block approach to revenue setting. Equity investors, credit rating agencies and lenders would interpret such a statement positively.

Other implementation issues

Need for step-by-step guidance on process for assessing financeability (Question 20)

IPART seeks views on whether it should publish in advance prescriptive guidance on precisely how (having run the benchmark and actual tests) it will decide if any financeability concerns exist.

SDP considers that, in the interests of transparency and regulatory certainty, IPART should provide some upfront guidance on how it intends to assess financeability. However, this guidance should not be overly prescriptive or limit IPART's ability to exercise appropriate judgment to address future circumstances that cannot be foreseen in advance. A purely mechanistic decision rule for implementing the financeability test would be undesirable.

Relevant considerations when analysing financial ratios (Question 21)

IPART seeks feedback on any other considerations not canvassed in its Issues Paper that should be taken into account when it analyses the relevant financial ratios in its benchmark and actual tests.

SDP considers that IPART should set out transparently its methodology for calculating the relevant financial ratios, the benchmarks it will use, and also publish the results of its calculations so that stakeholders can understand how IPART has reached its conclusions about financeability.

However, SDP submits that IPART should not publish inputs to its calculations (or the calculations themselves) that could reveal commercially-sensitive information. SDP suggests that IPART engage with businesses when implementing its financeability test, at each price reset, to identify any commercially-sensitive information that should be kept confidential.

Scope of data considered by IPART (Question 8)

The Issues Paper notes that some of the companies it regulates have both regulated and non-regulated businesses. IPART states that:

- As a default, it will conduct financeability tests on only the portion of the company for which it is setting prices; and
- It intends to consider on a case-by-case basis whether it should conduct its financeability tests using information on the whole business.

SDP supports the general regulatory principle that IPART should restrict its collection of information to only the data needed to conduct its financeability test and only on the portion of the company for which it is setting prices. This would limit the regulatory compliance burden on businesses.

Attachment 2 – Evidence on the depth of the Australian market for inflation-indexed corporate bonds

As noted in Attachment 1, IPART suggests in the Issues Paper that regulated businesses can manage the mismatch of cash flows caused by delayed recovery of compensation for inflation under its regulatory approach by issuing inflation-indexed bonds. SDP has analysed historical data on the market for inflation-indexed bonds in Australia. This analysis shows that:

- There is no evidence of Australian corporates issuing inflation-indexed bonds since 2010; and
- The market for inflation-indexed government bonds in Australia is relatively thin.

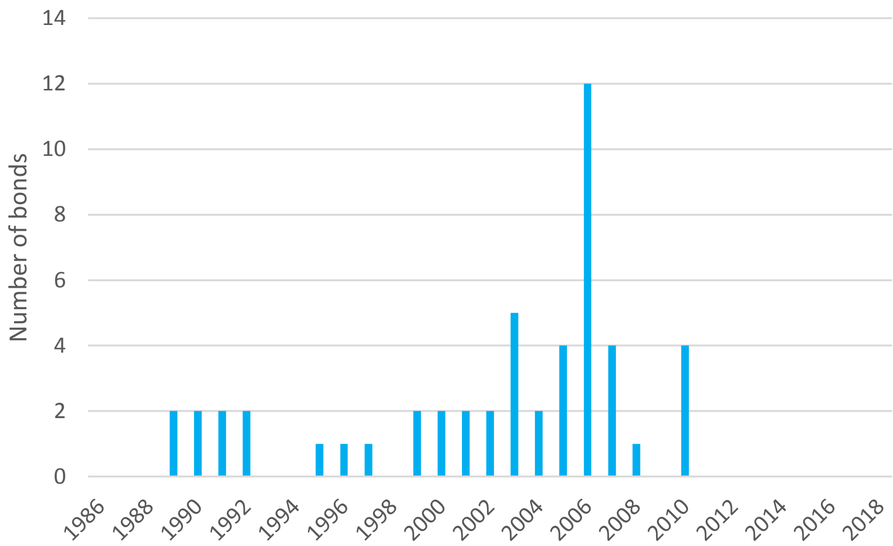
Given this evidence, it is unreasonable to expect businesses such as SDP to manage cash flow timing mismatch created by IPART's treatment of inflation by issuing inflation-indexed corporate bonds.

There is presently no market for inflation-indexed corporate bonds in Australia

SDP collected data from Bloomberg on all inflation-indexed and nominal corporate bonds issued in Australia since September 1988 that are yet to mature. We identified 3,366 outstanding corporate bonds in total. Of these, just 51 are inflation-indexed bonds; the remaining 3,315 are nominal bonds. As Figure 1 and Figure 2 show, of the inflation-indexed bonds presently outstanding, none were issued by Australian corporates since 2010.

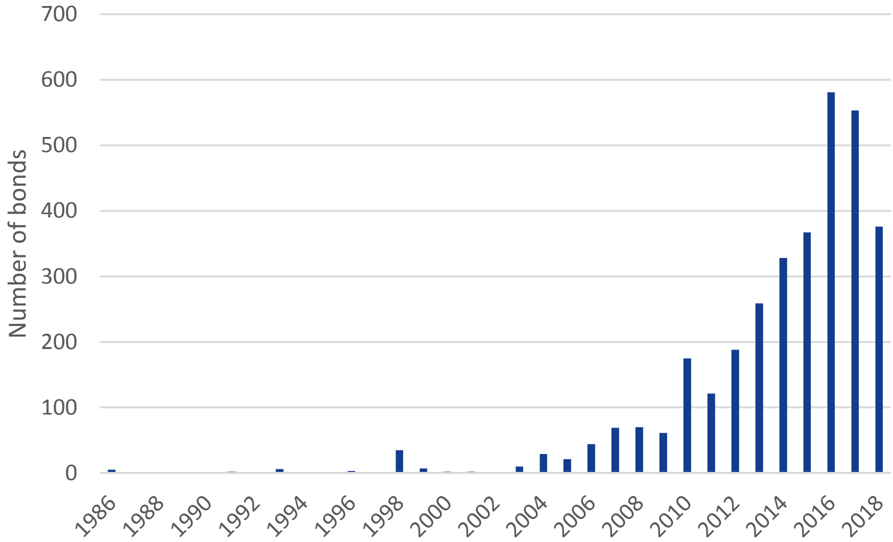
This suggests that there is no viable, liquid market for Australian inflation-indexed bonds that borrowers such as SDP can access in order to manage cash flow mismatches arising from IPART's treatment of allowances for inflation.

Figure 1: Inflation-indexed corporate bonds issued in Australia that remain outstanding



Source: Bloomberg data, SDP analysis

Figure 2: Nominal corporate bonds issued in Australia that remain outstanding



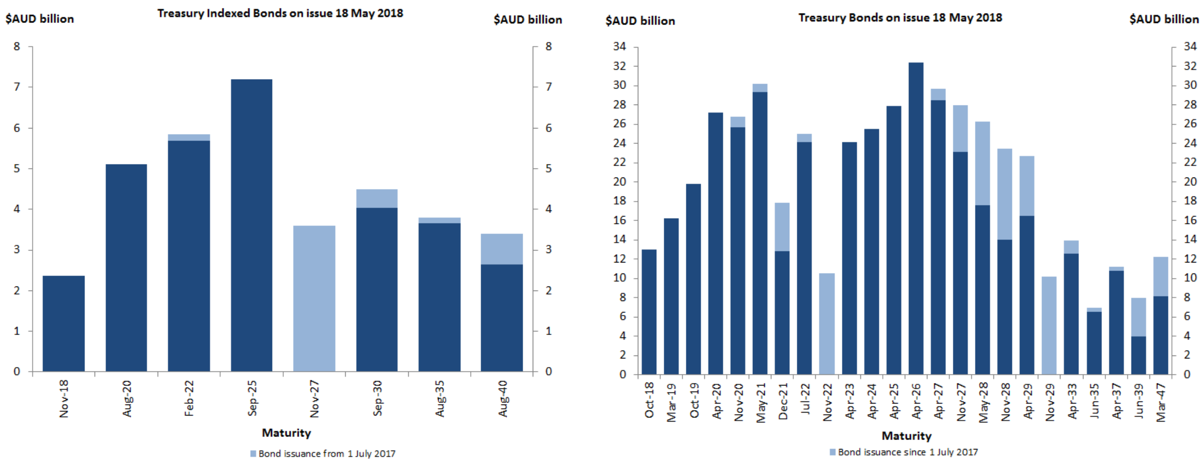
Source: Bloomberg data, SDP analysis

The market for inflation-indexed Government bonds in Australia is thin

In 2017, there was only one inflation-indexed bond issued in Australia. That bond, which raised $3.6 billion, was a 10-year bond issued by the Australian Commonwealth Government. No inflation-indexed bonds were issued by any Australian borrower in 2016. Thus, it appears that the Australian market for inflation-indexed bonds is currently limited to bonds issued by the Australian government.

However, the value and frequency of inflation-indexed Commonwealth Government bonds are considerably lower than for nominal Commonwealth Government bonds, as evidenced in Figure 3 below. This suggests that even the market for inflation-indexed Government bonds in Australia is very thin.

Figure 3: Recent issuances of inflation-indexed and nominal Government bonds



Source: Australian Office of Financial Management

Attachment 3 – SDP's responses to questions posed in Issues Paper

	Consultation question	SDP response
1	Do you agree with our guiding objectives for the review? Are there other objectives we should consider?	Agree.
2	Do you agree that we should continue to conduct financeability tests?	Agree.
3	Do you agree with the criteria in the 2013 test that we used to decide whether to conduct the financeability test for a specific business? Are there other criteria we should consider?	Agree with proposed criteria.
4	Have we have applied the financeability test to the appropriate price reviews since the 2013 financeability review?	Yes.
5	Do you agree with our proposed objectives for the financeability test?	The primary objective of the financeability test should be to ensure that at least an efficient business, with an investment grade rating, is able to remain investment grade, under IPART's pricing decision.
6	Do you agree with our preliminary view that we should conduct separate financeability tests, using inputs for a benchmark efficient business and for the actual business?	Agree – subject to response to Question 22.
7	Do you agree with our preliminary position that as a default, we should conduct the financeability test on the portion of the business for which we set prices?	Agree.
8	Do you agree that we should consider on a case-by-case basis whether to conduct the test using financial data for the whole business?	Agree. However, as a general principle, IPART should restrict its collection of information to only the data needed to conduct the test.
9	Do you agree with the adjustments we make for lease expenses and pension benefits?	Agree. However, IPART should ensure that these adjustments are made in line with Moody's latest methodology.
10	Should we consider any other adjustments to the inputs we use to calculate our financial metrics?	Adjustments for lease and pension obligations are the most relevant adjustments for IPART to make.
11	Do you agree with our preliminary view that we should calculate a real cost of debt in the financeability test?	No. Moody's conducts its ratings assessments using the nominal cost of debt. IPART's financeability test should follow (the quantitative aspects of) Moody's methodology. Australian corporate lenders' borrowing costs in private debt capital markets are expressed on a nominal basis.
12	Do you agree with our preliminary view that our approach to estimating tax payments in the 2013 test remains reasonable? Are there changes we should consider to the way we calculate tax payments in the financeability test?	Agree with approach to tax treatment proposed in Table 4.2 of the Issues Paper.

	Consultation question	SDP response
13	Do you agree with our preliminary view that we should continue to assess a business's financeability over the upcoming regulatory period?	Agree.
14	Do you agree with our preliminary view that we should continue to use quantitative data to assess a business's financeability?	Agree.
15	Do you agree with our preliminary view to continue to use a BBB target credit rating across all industries?	Agree.
16	Do you think the current metrics are appropriate?	Agree.
17	Are there any additional metrics we should use, and if so why?	IPART should allow businesses to propose financial metrics that reflect their particular circumstances (and the circumstances of an efficient business with the same risk characteristics). IPART should assess these proposals on a case-by-case basis.
18	How should we refine the benchmark ratios for our financial metrics?	IPART should update its existing benchmarks using more recent information and ensure that the benchmark ranges do not overlap between credit ratings.
19	Should we rank our financial ratios or adopt a weighting? If you think a ranking is appropriate, are there any improvements we can make to our current rankings?	IPART should adopt the same ranking of financial ratios as in Moody's latest rating methodology. There is no need for IPART to apply explicit numerical weights to different financial ratios.
20	Should we set out a step-by-step decision process to assess if a financeability problem exists?	IPART should provide some upfront guidance on how it will assess financeability in order to promote transparency and regulatory certainty. However, this guidance should not be overly prescriptive or limit IPART's ability to exercise appropriate judgment. A mechanistic decision rule would be undesirable.
21	Are there any other factors we should consider when we analyse the financial ratios?	IPART should set out transparently its methodology for calculating the relevant financial ratios, the benchmarks it will use, and also publish the results of its calculations so that stakeholders can understand how IPART has reached its conclusions about financeability. However, IPART should not publish inputs to its calculations (or the calculations themselves) that could reveal commercially-sensitive information.
22	Do you think the three stages we have proposed to conduct the financeability test would identify whether a financeability concern is due to: • setting the regulatory allowance too low • the business taking imprudent or inefficient decisions, and/or • the timing of cash flows?	Agree. However, the actual and benchmark tests proposed by IPART will not capture every possible source of financeability problems. IPART should consider (during individual price reviews) submissions from businesses on any financeability concerns arising as a result of IPART's regulatory decisions that are not identified by its benchmark or actual tests.
23	Does our proposed financeability test capture the relevant temporary cash flow problems that might require a timing adjustment to regulated income?	No. See response to Question 22.

	Consultation question	SDP response
24	Do you agree that our proposed remedies to address a financeability concern are appropriate?	Agree.
25	Are there other remedies that we should consider, and in what circumstances might it be appropriate to apply these remedies?	Agree that the possible remedies that IPART has identified are comprehensive.
26	Do you think that any NPV-neutral adjustments to prices should be limited to the upcoming regulatory period?	IPART cannot commit to providing remedies for a financeability problem beyond the forthcoming regulatory period. However, the standard NPV-neutral remedy for a financeability problem, acceleration of depreciation, will likely affect depreciation allowances in future regulatory periods.
27	Is our proposed process for addressing a financeability concern workable and reasonable?	Agree with proposed process. However, financeability tests should not be used to lower regulatory allowances (e.g., if regulated businesses pass the financeability test comfortably).