Sydney
WATER

14 September 2018

Dr Peter J Boxall, AO
Chair, Independent Pricing and Regulatory Tribunal
PO Box K35
Haymarket Post Shop NSW 1240

Dear Dr Boxall

Re: Sydney Water's response to IPART's draft financeability test

Thank you for the opportunity to respond to IPART's financeability test draft decision. We support IPART's initiative in undertaking frequent reviews of its regulatory approach, including the financeability test. These regular reviews ensure that IPART's regulatory methods evolve over time to fit the internal and external circumstances of the regulated business. They also ensure that IPART is across evolutions in best practice regulation.

We consider that IPART's draft decision has strengthened the financeability test's ability to further the objectives of the test, which are to:

- ensure that the financeability test assesses the impact of pricing decisions on the short-term financial sustainability of the regulated business; and
- identify and address a potential financeability problem in a manner which supports efficient and prudent investment decisions by regulated businesses, and supports the long-term interests of consumers[1].

In our view, the draft decision results in a financeability test that will adequately diagnose and remedy most financeability issues. In particular, we support IPART's position to assess financeability using both actual and benchmark inputs. This is because using actual and benchmark inputs will strengthen the test's ability to identify potential financeability concerns resulting from price determinations.

We have identified two aspects of the test that we consider could be further enhanced to meet the objectives of the review and reduce our administrative burden. Firstly, we note that IPART's draft decision has relied on Moody's global credit rating guidance, rather than the practice of Moody's when assessing the credit worthiness of Australian water utilities. Moody's adapts its global credit rating approach to fit the local circumstances. We encourage IPART to consider doing the same. Secondly, we note that the draft decision maintains the use of inflation-indexed

[1] IPART, *Review of our financeability test – Draft Report*, August 2018, p 11.

debt in the application of the benchmark financeability test. The rest of this submission details these two issues.

The financial ratios

We consider that the combination of ratios proposed by IPART in the draft decision are inconsistent with best practice, they do not fit the circumstances of Australian water utilities and they lack transparency. In our view, the financeability test should align closely with the ratios used by Moody's when it assesses our credit rating. This is because our credit worthiness depends on our performance against these ratios, as well as other factors considered by Moody's. Accordingly, our ability to access efficiently priced debt funding is underpinned by them. We urge IPART to apply the ratios used by Moody's when assessing Australian regulated water utilities, and not the general ratios contained in the global guidance.

Moody's regularly assesses our credit worthiness. Table 1 shows the factors Moody's considered when assessing our credit rating in a recent credit opinion. Moody's considers a suite of qualitative and quantitative factors. Of the quantitative metrics, Moody's calculates our FFO interest coverage, our gearing, our FFO over debt and our RCF over debt. It places a weight of 40% on these metrics. The rest of its assessment is based on qualitative factors.

Table 1: Moody's regulated water utility grid as applied to Sydney Water

Factors applied by Moody's
Factor 1: Business profile (50%)
a) Stability and predictability of regulatory environment
b) Asset ownership model
c) Cost and investment recovery (sufficiency and timeliness)
d) Revenue risk
e) Scale and complexity of capital program and asset condition risk
Factor 2: Financial policy (10%)
Financial policy
Factor 3: Leverage and coverage (40%)
a) FFO Interest Coverage
b) Net Debt / Regulated Asset Base
c) FFO / Net Debt
d) RCF / Net Debt

Source: Moody's, *Credit Opinion - Sydney Water Corporation*, October 2017, p 6.

The capital charge in the context of Moody's AICR relates to expenditure that is needed to maintain and replenish the regulated asset base. Moody's uses AICR for UK water utilities as the UK regulatory regime provides utilities with a regulatory depreciation allowance that is broadly equivalent to the expenditure required to maintain a stable asset base.

Moody's does not use the AICR for Australian water utilities because of a different regulatory approach to depreciation in Australia. Therefore, there is no consistent way to measure the capital charge in Australia. For this reason, Moody's uses the FFO interest coverage for Australian water utilities instead of the AICR metric.

We also note that the draft report has not applied the AICR using the formula used by Moody's in its global rating methodology guidance. Instead, IPART's draft decision is to adjust the formula so that the test is more conservative[2]. Moody's formula adjusts for capital charges, as shown in the formula below[3]:

$$AICR = \frac{FFO + (Interest\ Expense - Inflation\ Accretion) - Capital\ Charges}{(Interest\ Expense - Inflation\ Accretion)}$$

We prefer that IPART adopts an approach that is based on best practice, applicable to the Australian water utility context and is transparent. To this end, we support IPART adopting the financial ratios Moody's uses when assessing Sydney Water's credit worthiness, as shown in Table 1. If IPART considers that it is appropriate to depart from best practice, we urge IPART to investigate the consequences of its adjustments by conducting its own analysis; working with finance practitioners and credit rating agencies. This will ensure that the resulting test is applicable to the Australian water context and is effective in identifying potential financeability concerns.

Cost of debt assumption

We maintain our view that the cost of debt used in the financeability test should be nominal. IPART's draft decision to use a real cost of debt assumption is based on its view that:

- it does not overstate financeability concerns of the business by double counting inflation;
- it is consistent across the utilities IPART regulates; and
- it has no bearing on pricing decisions[4].

We do not agree with IPART that using the nominal cost of debt double counts inflation. This is because, as noted by Dr Hird, there is no material difference between the overall cash flows from nominal and inflation-linked bonds over the life of the bond[5].

[2] IPART, *Review of our financeability test – Draft Report*, August 2018, p 36.
[3] Moody's, *Rating methodology – Regulated water utilities,* June 2018, p 19.
[4] IPART, *Review of our financeability test – Draft Report*, August 2018, p 35.
[5] Competition Economists Group, *IPART review of financeability test*, June 2018, p 14.

As most of Sydney Water's operations are regulated by IPART, we strive to manage debt funding risks stemming from IPART's regulatory approach. Using the real cost of debt increases our risk because we are not able to emulate IPART's real cost of debt assumption. Nor is it feasible for us to enter a hedge to remove this risk. The markets for inflation-indexed bonds and their inflation-indexed swaps in Australia are extremely thin.

As we noted in our response to the issues paper, Sydney Water primarily uses nominal bond debt funding[6]. This is because it is readily available, liquid, efficiently priced and therefore preferred by investors. If we were to seek nominal funding and hedge to create a proxy for IPART's real debt instrument, the cost of doing so would be inefficient, and the resulting debt facility would be low in liquidity.

We consider that IPART's use of the real cost of debt in its financeability test introduces an unnecessary risk to the regulated businesses. We ask that IPART seeks the views from finance practitioners on the efficiency and cost of replicating IPART's assumptions in the market to test whether this is a practical or an efficient path to pursue.

If you would like to discuss this submission in further detail, please contact Liz Harloe, Principal Regulatory Economist on [redacted].

Yours sincerely

[redacted]

Zoran Peroski
Regulatory Economics Manager

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[6] Sydney Water, *Sydney Water's submission to IPART's financeability test issues paper,* June 2018, p 2.