WATER SERVICES
ASSOCIATION OF AUSTRALIA

WSAA Submission

IPART Review of Financeability Test

September 2018

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1.0 Introduction

Thank you for the opportunity to provide a submission in response to IPART's draft report on the review of the financeability test. WSAA congratulates IPART on its openness to refining its regulatory methodology.

The Water Services Association of Australia (WSAA) is the peak body that supports the Australian urban water industry. Our members provide water and sewerage services to over 20 million customers in Australia and New Zealand and many of Australia's largest industrial and commercial enterprises.

WSAA has consistently argued that it is in the long term interests of consumers to include tests of financial viability and sustainability (financeability) of water utilities in the regulatory framework. Identifying emerging financial viability problems before they become critical can avoid price shocks to customers.

When necessary, customers accept the need for gradual price rises if they are well explained and justified. However, sudden price shocks undermine affordability, can create hardship for some customers, and weaken customers' perceptions of value for money of their water and wastewater provider.

WSAA considers that IPART's framework represents a step-change in considering financial viability within the regulatory framework. The Draft Report provides a comprehensive and sophisticated approach to testing for financeability concerns, analysing the source of financeability issues and identifying the remedies that could be employed to address any concerns. A strong approach to financeability also supports confidence in a stable regulatory environment.

Key to the framework are IPART's objectives for the test and its broad approach to implementation.

2.0 Objectives and approach

IPART's Draft Report establishes two new objectives for the financeability test:

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

To meet these objectives the draft decision is to conduct the test using both benchmark and actual inputs. Previously it only examined actual outcomes (in an environment when gearing was below benchmark levels).

The major innovation in the approach is that it expands the scope of the test to encompass all sources of viability concerns. IPART has acknowledged that financeability issues could be caused by inefficient business decisions, changes in the wider external environment, or by potential errors in price determinations; and it has designed the financeability framework accordingly. Significantly the Draft Report puts forward a number of new remedies to address any concerns:

- If the source of a concern is due to a regulatory setting, we would correct the regulatory setting
- If the source of concern is due to imprudent or inefficient business decisions, we would alert the business's owners to the potential need to inject more equity, accept a lower rate of return on equity, or both.

- If the source of a concern is due to temporary cash flow problems, we could consider an NPV-neutral adjustment to prices (page 53)

WSAA strongly supports the new objectives and testing with benchmark and actual inputs, and the scope of remedies provided.

It is worth emphasising what an important evolution this is on IPART's past approach (and of other tests used by regulators in Australia). The 2013 Decision effectively confined the role of the financeability test to dealing with short-term timing issues. It stated:

> The objective of the financeability test is to assess the short-term financial sustainability of the utility.

This view was carried through to the potential solutions where the decision only contained one remedy:

> Consider making a NPV neutral adjustment if it is found that shareholders or management of a utility cannot feasibly address financeability concerns.

NPV neutral solutions have also been favoured by other regulators such as the Essential Services Commission in Victoria. Implicit in this view is that regulatory decisions guarantee long term viability. Under this circumstance financeability was/is reduced to merely a timing issue.

3.0 Comments on the metrics

Judging from the submissions to IPART's Issues Paper, the most contentious aspects of the framework surround the departure from the normal metrics for measuring financial viability employed by Moody's and other ratings agencies. Specifically use of real cost of debt rather than nominal cost of debt and the form of the Adjusted Interest Coverage Ratio (AICR).

Our view is that the financeability test is diagnostic not deterministic. For many of its functions IPART is required to set legally binding prices or set legally binding methods to set prices. This requires a high degree of precision. In contrast, the purpose of the financeability test is to diagnose whether cashflows are sufficient for the utility to remain financially viable. It does not appear to be the intention to attach a legal weight to the financeability test. Nor is it specified to provide a strict pass or fail on the test. Instead multiple indicators are used to provide insight into whether the utility may face financing concerns and the source of those concerns.

As such WSAA considers that IPART should rely on existing well understood credit metrics used by Moody's and other agencies for rating Australian water utilities, rather than creating a bespoke set to suit its regulatory approach. For example, we understand that in Australia Moody's uses the following ratios:

- FFO Interest Coverage
- Net Debt/Regulated Asset Base
- FFO/Net Debt
- Retained Cash Flow/Net Debt

As set out in Moody's 2018 Methodology it is clear that they have an understanding of the various RAB indexation arrangements that operate in different regulatory jurisdictions and the impact that these have on the individual ratios. If these ratios are appropriate for the credit rating process, then they should also be sufficient for a financeability test.

This overarching view leads to a number of observations.

Firstly we consider that the Retained Cash Flow/Net Debt metric has a role to play in testing for financeability. As Moody's notes 'Dividend obligations can be substantial, quasi permanent outflows that affect the ability of a water utility to cover its debt obligations'.

Secondly we note IPART's draft decision is to use an AICR rather than the FFO/Interest Coverage ratios. This is likely to cause confusion. Moody's uses the AICR in the United Kingdom to provide for the depreciation allowance, but not in Australia because of the lack of an equivalent approach to estimating capital charges. However, IPART's definition is not the same as the Moody's ratio. IPART's draft formula does not adjust the ratio for capital charges and would deliver quite different outcomes. We consider that this will create a source of considerable confusion in the measurement and interpretation of the indicator, particularly since IPART's Draft Report references the target range of ratios for its definition of AIRC against that provided by Moody's (different) definition of AICR.

Thirdly, the adoption of a real cost of debt appears to be a more complicated issue and one on which there should be further discussion among key stakeholders before the final report and decision are released. At this stage we are not convinced that the added complexity of adopting a real cost of debt will deliver additional insight into financeability concerns to make it worthwhile to depart from the practices of credit ratings agencies.

More broadly, in the draft report and in submissions from stakeholders there is considerable discussion of what form of debt utilities should use. The financeability test should be consistent with a range of debt raising strategies. We are not sure that it is consistent with the purpose of the financeability test for it to actively drive debt raising practices of utilities (rather than being a more passive check on financeability). For example, as pointed out in Sydney Water's submission, utilities more commonly utilise nominal debt and would find it difficult to replicate a real cost of debt assumption because of the thinness of the market for inflation-indexed bonds and swaps. A decision to continue with a real cost of debt as part of an adjusted set of actual inputs could place pressure on businesses to replicate that approach to debt raising because there is no mechanism for the regulator to detect financeability issues in an environment of nominal debt.

Finally, WSAA understands that, in practice, some ratios and indicators may be considered more important than others, however, we are concerned with IPART's more rigid approach to the ranking of parameters in order of importance. Each of the suggested ratios has its own role to play, and WSAA would prefer to see the financeability test adopt them as a suite of indicators that would be considered together in forming a view about the overall financial picture of a business.

4.0 Conclusion

In conclusion, WSAA commends IPART on its approach to the financeability test, which is a significant step forward in terms of transparency and regulatory certainty.

We would, however, recommend that IPART adopt as far as possible the existing quantitative metrics developed and used by credit ratings agencies to apply the test. This would reduce the risk of regulatory error and avoid distorting utility commercial behaviour.

5.0 Contact Details

WSAA welcomes the opportunity to discuss this submission further.

If there are any details you wish to follow up on please contact:

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