Response to the Independent Pricing and Regulatory Tribunal Issues Paper

Review of our Financeability Test

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1. Introduction

WaterNSW is pleased to provide this submission in response to the Independent Pricing and Regulatory Tribunal of NSW (IPART) *Review of our Financeability Test*, Issues Paper, May 2018 (the Issues Paper).

Our response references the individual questions posed in the Issues Paper, as set out section 2 below.

2. Response to Specific Matters

2.1 Objectives for the Review

2.1.1 Do you agree with our guiding objectives for the review? Are there other objectives we should consider?

At page 9 of the Issues Paper, IPART proposed the following objectives for the review:

1. *To ensure the financeability test effectively assesses the impact of our pricing decisions on the short-term financial sustainability of the regulated business.*
2. *That our 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 also stated:

To meet both objectives, a key question for the review is whether the financeability test should focus on how our pricing decisions affect the financial viability of:

1. *the benchmark efficient business (consistent with the approach taken for setting prices for the pricing review)*
2. *the actual business (the entity that needs to remain financially sustainable to continue providing services to customers), or*
3. *both.*

On balance, we consider that the objectives of the review are appropriate. It is important that the outcomes of a pricing determination are tested against real-world benchmarks for their impacts on the likely credit rating and ability to source capital from debt and equity providers. At the same time, financeability issues have impacts on customers through either service levels, capital investment decisions or, in worse case scenarios, going concern. The long-term interests of customers are best served when potential financeability issues are detected early and prevented.

2.2 Should we conduct a financeability test?

2.2.1 Do you agree that we should continue to conduct financeability tests?

Yes. We strongly agree that IPART should continue to conduct financeability tests.

2.2.2 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?

IPART's 2013 criteria for undertaking a financeability test is if:

- *the prices we regulate determine the revenues of the service provider, and*
- *the service provider is established as, or part of, an entity with a distinct capital structure.*[1]

We agree that this criteria remains appropriate.

[1] See page 14 of the Issues Paper.

2.3 Which businesses should we test?

2.3.1 Have we have applied the financeability test to the appropriate price reviews since the 2013 financeability review?

We agree that it has been appropriate, as part of good regulatory practice, to undertake financeability tests as part of the price reviews for regulated water utilities.

We accept that where an IPART regulated entity does not have a regulated asset base and a notional capital structure that it is difficult to apply a credit rating based financeability test. In such circumstances a different, more tailored/customised financeability test should apply, or it in such circumstance it may not be appropriate to undertake a financeability test.

2.4 What should the objectives of the test be?

2.4.1 Do you agree with our proposed objectives for the financeability test?

We support the objectives as proposed in the Issues Paper. That is, applying the financeability test to both the benchmark business and the actual business.

In respect to applying the test to the actual business, the business may wish for its financing arrangements to remain confidential which IPART should respect through the determination process.

2.5 How we implement the test

2.5.1 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?

We support conducting the financeability test to both the benchmark business and the actual business.

2.5.2 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?

Yes. The test should only apply to the portion of the business regulated by IPART and subject to the particular determination in question. For example, a financeability test on WaterNSW's Greater Sydney determination should only consider the inputs relating to that part of WaterNSW's business. Other regulated portions and unregulated portions should be excluded.

2.5.3 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?

As a default, the financeability test should apply to only the regulated portion in question. Testing the entire business may mask financeability issues and result in cross subsidisation.

2.6 How should we adjust the inputs for the financeability test?

2.6.1 Do you agree with the adjustments we make for operating lease expense and pension benefits?

We consider that IPART should use the same financial ratios that Moody's use in its 22 December 2015 Regulated Water ratings methodology. This would include adjustments for operating leases and unfunded superannuation liabilities.

2.6.2 Should we consider any other adjustments to the inputs we use to calculate our financial metrics?

No – see answer above.

2.6.3 Do you agree with our preliminary view that we should calculate a real cost of debt in the financeability test?

Yes. We agree with IPART's views set out in the Issues Paper at page 22 that a financeability problem should not be found through the test because of the way IPART compensates its regulated utilities for inflation (i.e. through RAB indexation). IPART is correct in its view that businesses can manage the inflation compensation timing mismatch.

This can be achieved through the use of financial instruments such as inflation swaps and low-coupon bonds. Through the use of these instruments it is possible to replicate a "real" rate debt portfolio, which results in the cashflows of the regulated utility being closer to that of "nominal" businesses. Note that the P&L interest expense will still be at the nominal rate, but with the cashflow statement and balance sheets differing through the resulting interest capitalisation.

Given that financial instruments are typically set at the "Break Even Inflation" (BEI) rate, we consider this to be an appropriate rate to use to deflate the nominal cost of debt.

However, for internal consistency, IPART may prefer to use the same inflation assumptions it has used elsewhere in the determination (i.e. in setting the WACC).

2.6.4 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?

We consider that the approach to estimating tax payments should be consistent with the test being applied. That is:

1. for the benchmark test, the approach should utilise, to the extent possible, the same assumptions underpinning the Notional Revenue Requirement (NRR) for the benchmark entity; and
2. for the actual test, the approach should utilise assumptions relevant and pertaining to the actual entity.

This is important to ensure the test achieves its objectives and a financeability issue is not masked in any way.

As a note, the Net Interest payments deduction assumption for the benchmark entity should be consistent with the benchmark gearing ratio over the course of the regulatory determination. A benchmark entity's shareholders would set a financial capital management policy which would set a target capital structure of the benchmark ratio, and distributions/equity injections would then follow to maintain the benchmark capital structure ratio.

2.7 We propose to focus our financeability assessment on the upcoming regulatory period

2.7.1 Do you agree with our preliminary view that we should continue to assess a business's financeability over the upcoming regulatory period?

Yes. The purpose of the financeability test is to ensure the regulated utility is financeable over the course of the regulatory period in question, and accordingly this is the appropriate period to assess.

2.8 We propose to focus on a quantitative assessment of financeability

2.8.1 Do you agree with our preliminary view that we should continue to use quantitative data to assess a business's financeability?

Yes. We agree that IPART's financeability test should focus on quantitative metrics only. The objectives of the financeability test are to assess the business' financial health, which are best assessed using financial data.

IPART should not attempt to assess qualitative factors, such as, for example, making assessments about the transparency and predictability of the regulatory environment. This would introduce conflicts of interest, is inherently subjective and may not best suited to IPART's functions and skill set. Unless IPART is specifically tasked to perform such a function by Government, in our view, this function is best left to the independent credit rating agencies such as Moody's.

The role of the financeability test should be as a check by the regulator to ensure, prior to making a pricing determination, that the revenue being provided to the regulated utility will leave it with sufficient financial strength, as measured through appropriate financial ratios, to obtain financing over the course of the regulatory period in question.

2.9 What target credit rating should we adopt?

2.9.1 Do you agree with our preliminary view to continue to use a BBB target credit rating across all industries?

Yes. This is consistent with the allowance provided in the WACC Methodology.

2.10 What financial metrics should we calculate?

2.10.1 Do you think the current metrics are appropriate?

We consider that

- FFO / Interest Cover,
- FFO / Net Debt and
- Net Debt / RAB

are appropriate and the most important financial ratios for assessing financeability.

2.10.2 Are there any additional metrics we should use, and if so why?

Whilst we do not consider it as important as the three ratios above, we also support the inclusion of **RCF / Net Debt** as this is also considered by Moody's in making credit rating assessments.

We also support the inclusion of metrics such as **Return on Capital Employed** and **Return on Regulated Equity** to test whether the benchmark entity would indeed be able to recover sufficient revenue under the proposed pricing determination to achieve the cost of capital assumed in the WACC Methodology. That is, this is a good way to check for "regulatory error". If the assumptions are consistent with the building block model, the differences should be zero.

2.11 What benchmark ratios should we adopt?

2.11.1 How should we refine the benchmark ratios for our financial metrics?

We support updating the benchmark ratios to be consistent with the "Baa" financial ratio ranges contained within the revised Moody's Regulated Water Utilities ratings methodology – 22 December 2015.

2.11.2 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?

Given IPART is, appropriately, not seeking to determine a credit rating as part of the financeability test, we agree that it is not appropriate to assign weightings to each particular financial ratio.

We support IPART's proposed approach in terms of assessing whether the business meets the benchmark ratio in each given year, and in cases where the business does not meet the benchmark ratios, looking for trends and deterioration that would indicate the presence of a financeability issue.

We support the ranking of the financial ratios. In particular, more emphasis should be placed on ratios that will indicate potential risk in terms of meeting interest obligations or liquidity and solvency concerns. To that end, we believe that more emphasis should be placed on the FFO / Interest ratio and the FFO / Net Debt ratio. We note that Moody's places more weighting on the FFO / Net Debt ratio than the Net Debt / RAB ratio.

2.11.3 Should we set out a step-by-step decision process to assess if a financeability problem exists?

We consider that a flow-chart or decision tree to show how a financeability concern will be identified would enhance transparency and predictability.

In circumstances where a potential financeability concern is identified, we agree that IPART should seek additional information from the business to check for evidence of a potential persisting financeability concern, before seeking to identify the source and potential remedy.

2.11.4 Are there any other factors we should consider when we analyse the financial ratios?

The equity component of RAB Indexation should be noted and adjusted for. For example, at the benchmark gearing ratio of 60% Net Debt / RAB, with the debt portfolio at 100% real rate, the cashflows will still be deflated for the 40% equity component. Unless the business "over-hedges" to fully convert the RAB Indexation to cash, cashflows will not be 100% nominal, and therefore they may not meet the Baa benchmark.

2.12 How do we identify the source of a financeability concern?

2.12.1 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?

Yes. In principle we agree that the three stages as proposed by IPART, at page 31 of the Issues Paper, are a logical sequence to conduct the financeability test.

However, we propose adjustments to the language of the first two stages (as set out in bold below) and we suggest a fourth source:

1. Regulated prices are set too low for even a benchmark efficient business to maintain an investment-grade credit rating over time **(i.e. insufficient for both the actual business and the benchmark business).** This could arise from an external shock applied to the business which is outside the control of management.

2. Regulated prices are sufficient for a benchmark efficient business but insufficient for the actual regulated business to maintain an investment-grade credit rating. This could be because:

    a. the business's owners have previously made imprudent or inefficient decisions. For example, the business may have previously engaged in inefficient spending which led to a higher gearing ratio and/or cost of debt **and/or lower Funds from Operations (FFO)**, or

b. an external shock is applied to the business which is outside of management's control.

3. Regulated prices are sufficient for the actual regulated business to maintain an investment-grade credit rating on average, but the timing of cash flows might create short-term financial problems from time to time.

4. **Regulated prices are set sufficiently for the actual business but insufficient for the benchmark business, because the business's owners have adjusted the business's gearing ratio downwards to avoid a financeability issue that would otherwise arise at the benchmark gearing ratio.**

2.12.2 Does our proposed financeability test capture the relevant temporary cash flow problems that might require a timing adjustment to regulated income?

We consider that there are several possible sources of a financeability problem:

- regulatory error
- a regulatory decision (not necessarily an error as such) such as WACC, Asset Lives, prudent and efficient operating costs
- timing issues – such as a temporarily large capital program
- the regulatory revenue model (i.e. "real" versus "nominal")
- legacy issues – such as the RAB being set well below historical cost, and maintenance capex being a larger burden relative to asset base than would otherwise be the case.

We consider that the financeability test will satisfactorily detect and diagnose the source of the financeability issue – supported by additional information, if necessary, from the regulated business.

2.13 What remedies should we consider?

2.13.1 Do you agree that our proposed remedies to address a financeability concern are appropriate?

Yes.

2.13.2 Are there other remedies that we should consider, and in what circumstances might it be appropriate to apply these remedies?

No.

2.13.3 Do you think that any NPV-neutral adjustments to prices should be limited to the upcoming regulatory period?

No. In some cases it may be beneficial to provide NPV-neutral adjustments over a longer period. For example this may require providing an NPV-positive adjustment in the upcoming regulatory period, with the expectation that a future Tribunal would review and potentially make offsetting adjustments to effect an NPV-neutral adjustment (noting that a Tribunal cannot bind future Tribunals).

The flexibility to provide NPV-neutral adjustments over longer time frames is likely to be valuable and necessary, given the relatively short length of current determination periods (4-5 years). If financeability adjustments are made to be NPV-neutral over a single regulatory determination period this may result in significant price volatility for customers.

2.14 What process should we follow to address a financeability concern?

2.14.1 Is our proposed process for addressing a financeability concern workable and reasonable?

Yes – however we would add a third stage, that if a financeability problem is found then remedies should not be confined to business management and shareholders –the remedy may also lie in a change in regulatory assumptions by IPART.