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Our Ref: Doc10/11979, 101012 Submission on Independent
Pricing and Regulatory Tribunal Discussion Paper -
Financeability tests and their role in price regulation

Financeability Tests
Independent Pricing and Regulatory
Tribunal
PO Box Q290
QVB Post Office NSW 1230

12 October 2010

Dear Mr Cox

Submission on Discussion Paper - Financeability tests and their role in price regulation

State Water welcomes the opportunity to comment on the financeability discussion paper. State Water's major issues of concern are detailed in the attached submission.

If you wish to discuss the State Water submission further please contact Joseph Caruana, regulatory analyst on 02 9354 1074, or joseph.caruana@statewater.com.au.

Yours sincerely

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Submission on Discussion Paper - Financeability tests and their role in price regulation

Introduction

State Water welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal's (IPART's) Discussion paper - *Financeability tests and their role in price regulation*. The long-term financial sustainability of State Water is a key regulatory outcome for all stakeholders, including shareholders and customers. It is important that State Water has the financial capacity to invest in required bulk water infrastructure and undertake appropriate operating and maintenance expenditure. It is also important that State Water has the capacity to meet its debt obligations and provide a commercial return to equity holders; otherwise incentives for new investment are weakened.

State Water supports IPART's interpretation of legislation that it is obliged to consider whether pricing decisions are likely to adversely affect the financeability of a prudent, efficient business. A firms' stand-alone credit rating is the key indicator of credit worthiness and financial viability and NSW Treasury requires Government owned businesses to maintain an appropriate investment grade credit rating. State Water supports the current financeability tests adopted by IPART as they provide an objective, transparent and relatively simple assessment of credit rating.

However, State Water believes that the financeability tests undertaken in State Water's 2010 pricing determination highlight a 'disconnect' between projected debt gearing and credit rating outcomes relative to the benchmarks adopted in the determination of the weighted average cost of capital (WACC). IPART's analysis shows State Water's credit rating falling well below investment grade over the course of the 2010 Determination (to BB in 2013-14), despite projected gearing levels remaining well below the target 60 per cent benchmark

State Water contends that the provision of an appropriate risk adjusted revenue allowance should facilitate achievement of an investment grade credit rating at gearing levels up to the target benchmark. In this regard, the financeability test provides an important input into the determination of gearing levels that support investment grade credit rating outcomes.

In the 2010 determination, IPART concluded that State Water's financial viability issues were best managed by the business and its shareholders through additional equity funding:

> *'Our view is that a company susceptible to drought and operating in a competitive market would not simultaneously significantly increase its level of gearing, expenditure and returns to shareholders without compromising its credit rating.'*

State Water agrees in principle that higher levels of equity funding may be required in order for State Water to retain an investment grade rating. However it is inconsistent for IPART to determine that 60 per cent gearing is an efficient capital structure for the purposes of determining State Water's WACC, but then effectively require State Water to limit gearing levels to below 40 per cent or otherwise accept below investment grade credit rating outcomes. State Water contends that a company 'susceptible to drought and operating in a competitive market' would not adopt high levels of financial risk as reflected in IPART's benchmark gearing level of 60 per cent. IPART's financeability test clearly supports this conclusion.

The projected deterioration in State Water's credit rating is due to a combination of both high business risk and high financial risk. State Water does not benefit from stable and predictable regulated cash flows. Resultant higher business risk means that State Water cannot afford the same level of financial leverage typical of lower risk metropolitan water utilities. State Water's higher business risk is recognised by IPART in the financial viability analysis through the adoption of a higher risk business profile relative to other NSW water businesses. However, IPART does not recognise State Water's higher business risk in the WACC through the adoption of lower gearing and/or higher equity beta assumptions.

State Water's initial submission proposed a debt gearing benchmark of 30 per cent, consistent with State Water's business risk profile and a BBB+ credit rating. Had the final determination adopted a 30 per cent debt gearing benchmark, it would be appropriate for IPART to undertake financeability tests based on this benchmark, with the onus falling on the business and its owners to manage capital structure outcomes around this benchmark. However, under current determination outcomes, State Water is exposed to sub-investment grade credit rating outcomes at gearing levels well below the target 60 per cent benchmark, and is not compensated for the resultant higher cost of debt.

IPART's discussion paper states 'in making our 2010 determination for State Water, we decided that the short-term financeability issues we identified were best managed by the business and its shareholders, rather than by us'. In response, State Water argues that State Water's financeability issues are not 'short-term' but rather reflect an inconsistency between input WACC parameters and pricing determination outcomes. The determination of WACC assumed 60 per cent debt gearing and a debt margin based on a BBB to BBB+ credit rating benchmark. In contrast, the financeability test determined a BB credit rating outcome based on actual gearing levels of 45 per cent. State Water notes that credit rating outcomes would have been far worse under notional 60 per cent debt gearing assumptions.

State Water believes that an appropriate regulatory response would have been to reduce the 'notional' debt gearing benchmark to a level that supported investment grade credit rating outcomes based on State Water's underlying business risk profile. This would have necessitated a target debt gearing benchmark of between 30 to 40 per cent, with a corresponding increase in the WACC to reflect revised capital structure assumptions. Under such assumptions, State Water would achieve investment grade credit rating outcomes, consistent with the BBB to BBB+ credit rating benchmark used to derive the cost of debt.

Issues on which IPART is seeking comments

1. Should we continue to use the current four financial ratios to project the likely credit rating? If not, what ratios should we use?
State Water supports the four financial ratios currently used by IPART to project likely credit rating outcomes. These ratios are consistent with that adopted by NSW Treasury and rating agencies when assessing the credit rating of regulated utilities.

The financial ratios currently used should only be changed if there is clear evidence of alternative ratios being used by NSW Treasury and credit rating agencies. Alternative ratios should only be used if there is transparent and objective data available (i.e. ratio ranges) to facilitate assessment of credit rating within each business profile.

2. Should we consider other factors in addition to these financial ratios in projecting credit rating? If so, what factors should we consider, and why?
State Water believes that the financial ratios currently used provide a transparent and objective methodology for assessing financial viability. The qualitative factors listed in Table 4.1 of IPART's discussion paper (including regulatory environment, operating characteristics and stability of business model), contribute towards the assessment of business profile. Of these factors, stability and predictability of regulated cash flows is the primary determinant of business profile.

The assessment of business profile is a key input to the determination of credit rating. Regulated businesses with lower risk business profiles can afford to adopt higher levels of financial risk and still maintain an investment grade credit rating. In contrast, regulated businesses with average to high-risk business profiles (such as State Water) require higher levels of financial protection (i.e. lower gearing) in order to achieve an equivalent rating. NSW Treasury should provide input to IPART's assessment of business profile, based on information from the annual stand-alone credit rating assessments of Government owned businesses.

3. *Should we continue to use a credit rating of BBB+ or BBB as the benchmark for passing the financeability test? If not, what benchmark should we use?*
State Water supports the continued use of the BBB to BBB+ credit rating benchmark. This is consistent with the credit rating range adopted by other Australian regulators and with the benchmark credit rating used in IPART's estimation of the cost of debt. It is also consistent with the minimum investment grade credit rating required by NSW Treasury.

4. Should we use the actual gearing ratio in assessing financeability, or a notional gearing ratio of 60% (as we do in calculating the WACC)?

State Water strongly supports the use of notional, rather than actual, gearing levels for the purposes of assessing financial viability. However, the notional debt gearing benchmark should not automatically be 60 per cent for all businesses.

When determining the level of gearing used to calculate the WACC, IPART adopts a benchmark capital structure, rather than the actual financial structure, to ensure that customers will not bear the cost associated with an inefficient financing structure. Similarly, IPART should adopt a benchmark capital structure in undertaking analysis of financial strength. It is inconsistent to adopt benchmark debt gearing for the purposes of determining WACC and actual gearing for the purposes of determining the impact of regulatory decisions (including WACC) on financial viability.

The adoption of notional gearing assumptions removes financing decisions (including capital structure and dividend payout policy) from the revenue determination process. These are essentially decisions for the business and their owners, and should not directly impact on regulatory outcomes.

Under IPART's building block framework, regulated revenue requirements should be the same regardless of whether a business is geared at 0 per cent or 100 per cent. The adoption of actual gearing ratios when assessing financeability, will potentially lead to customers funding inefficient capital structure decisions. Such outcomes may create a perverse incentive for shareholders to increase gearing levels to inefficient levels in order to maximise revenue requirements.

The financeability tests should provide important input to the determination of the benchmark debt gearing, to ensure that determination outcomes are consistent with the achievement of the BBB to BBB+ credit rating outcome used to derive the debt margin. Should a business fail the financeability test under notional (i.e. benchmark) capital structure assumptions, this would indicate the need for a lower debt gearing benchmark.

5. How should IPART respond when a business fails the financeability test?

State Water supports the basic premise that if an appropriate risk adjusted rate of return is provided, regulated businesses should be able to maintain an investment grade credit rating at debt levels consistent with the target 'benchmark' capital structure used to determine the WACC. There should be no need for an IPART response unless a business fails the financeability test based on notional gearing assumptions.

Financeability test outcomes are more significantly impacted by decisions relating to capital structure rather than determination outcomes. In most cases, the failing of financeability tests are due to unreasonably high debt levels (i.e. high financial risk) rather than inadequate regulated revenue. However concerns relating to actual debt levels are removed if notional debt gearing assumptions are adopted, thereby separating financeability issues relating to revenue adequacy from those relating to capital structure. As previously discussed, State Water believes that decisions relating to actual capital structure should be left to the business and its shareholders, and should be outside the scope of IPART's determination.

However, if a business fails the financeability test based on notional (i.e. benchmark) gearing assumptions, this indicates that assumed financial risk is too high relative to the firm's underlying business profile. Under such circumstances, 'notional' gearing assumptions should be lowered to reflect financial risk assumptions that are consistent with the underlying business profile. To ensure consistency within the determination, the WACC should also be adjusted to reflect amended capital structure assumptions.

6. Should responsibility for addressing short-term financial viability issues rest with the business and its shareholders, not the regulator?

Under 'notional' debt gearing assumptions, short-term financial viability issues should not arise, as 'notional' gearing assumptions are not impacted by short-term fluctuations in cash flows and gearing levels

To the extent that short-term viability issues relate to actual gearing levels exceeding the notional benchmark, such concerns should rest with the business and its shareholders. This may necessitate flexibility in capital structure and dividend policies to accommodate short-term fluctuations in debt levels resulting from lumpy capital expenditure etc.

7. If a regulator finds that additional equity raisings are necessary to ensure financeability, should it include an allowance for this in its building block calculations?

State Water's position is that issues relating to capital structure, including requirements for equity raisings, should be left to the business and its owners. If financeability tests are based on the notional gearing benchmark, there should be no need for allowances relating to equity raisings in the building block calculations.

8. Is it appropriate for the regulator to mandate a specific funding strategy to address short-term financial viability issues? If so, in what circumstances?

State Water believes it is not appropriate for regulators to mandate specific funding strategies. Decisions relating to funding strategies should be left to the business and its owners and will not impact on financeability tests if notional gearing assumptions are adopted.

9. In what circumstances might it be appropriate for IPART to make adjustments to the building block model to address financeability concerns?

As previously discussed, State Water believes that financeability tests based on notional gearing assumptions provide important information relating to the internal consistency of determination outcomes. If a business fails the financeability test based on notional gearing assumptions, then the benchmark gearing assumption adopted for the WACC should be lowered to enable the achievement of BBB to BBB+ credit rating outcomes, consistent with the determination of debt margin. Otherwise the debt margin in the WACC should be adjusted upwards to reflect projected credit rating outcomes.

10. What form should any regulatory adjustment to address financeability concerns take?

State Water believes that adjustments should be made to the WACC to ensure internal consistency between input WACC parameters and determination outcomes.

11. Should any adjustments to address financeability concerns be NPV-neutral?

The extent to revenue adjustments relate to changes in the WACC, by definition such changes will be NPV neutral (i.e. in NPV terms, any increase in the return on capital arising from a higher WACC will be offset by the higher WACC used to discount such return on capital increases).

Comments on IPART's Preliminary Views

Based on IPART's preliminary views, the discussion paper identifies the following steps that would be undertaken during the normal course of a pricing determination:

1. use a notional gearing level in the WACC and actual or notional gearing level in the financial ratio analysis
2. determine the appropriate business risk profile
3. compute financial ratios based on cash flows
4. compute the notional credit rating on an annual basis over the determination period
5. identify whether there are any potential financeability issues, based on years where the credit rating falls below BBB

. identify the reasons for the deterioration in the credit rating

7. assess whether any change in the capital structure would be able to lift the credit rating back up to investment grade
8. quantify the options available to the business and shareholders without making any direct adjustments to any of the building block inputs.

State Water supports this approach subject to the following conditions:

- Step 1 - Notional (not actual) gearing should be used in the financial ratio analysis for consistency with the determination of WACC.

- Step 7 - Any changes to capital structure in the financial analysis should also be reflected in the notional gearing used to determine WACC.

- Step 8 – Advice on options available to the business and shareholders should be limited to the extent that actual gearing levels exceed the notional benchmark. If a notional gearing benchmark is used, there should be no need to advise the business and shareholders on financing decisions relating to capital structure and dividend policy.

Application of Proposed Methodology to State Water's 2010 Pricing Determination

State Water's 2010 pricing determination provided a BB credit rating outcome in 2013-14 based on projected 'actual' gearing levels of 45 per cent. State Water's modelling demonstrates that credit rating outcomes would have been significantly lower assuming notional debt gearing of 60 per cent (consistent with gearing assumptions used to determine State Water's WACC):

State Water Credit Rating Outcomes - 2010 Pricing Determination

	10/11	**11/12**	**12/13**	**13/14**
Actual Gearing	34%	41%	45%	45%
Credit Rating (Actual gearing)	BBB+	BBB	BB+	BB
Notional Gearing (60%)	60%	60%	60%	60%
Credit Rating (60% gearing)	B+	B+	B+	B+

Based on Step 7 listed above, such outcomes should have led to a review of capital structure assumptions, in order to lift the credit rating back up to investment grade. State Water's modelling indicates that a notional gearing level of between 30 per cent and 40 per cent is consistent with the achievement of a BBB to BBB+ credit rating:

State Water Credit Rating Outcomes - Based on Lower Notional Gearing

	10/11	**11/12**	**12/13**	**13/14**
Credit Rating (30% gearing)	BBB+	BBB+	BBB+	BBB+
Credit Rating (40% gearing)	BBB	BBB	BBB	BBB

Having determined notional debt gearing assumptions consistent with the benchmark credit rating, the WACC should have been revised to reflect amended capital structure assumptions. Alternatively, the cost of debt should have been increased to reflect the debt margin applicable to the B+ credit rating outcome under 60% notional gearing assumptions.