6 Revenue Requirements and Financial Metrics

Central Coast Council

This paper discusses:

- IPART's 2019 revenue requirements for the 2019-22 period
- The target total notional revenue requirement of $873.4 million calculated over four years (2022-26)
- The lower WACC estimate (3.31% post tax real WACC) resulting in a lower return on capital
- The disaggregation of the asset base by asset class which increases the return of capital (regulatory depreciation)

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1 Building block components

Central Coast Council (Council) has calculated target revenues required over the four-year period to 30 June 2026 using IPART's building block approach. The building block approach allows a utility to charge prices that recover efficient costs through the calculation of an annual 'notional revenue requirement' that reflects these costs. The notional revenue requirement is the sum of the following cost allowances:

- Operating expenditure
- An allowance for a return on capital investment in the business - Regulatory Asset Base (RAB) multiplied by the weighted average cost of capital (WACC)
- An allowance for a return of capital (depreciation)
- A working capital allowance
- A tax allowances

The calculation of the notional revenue requirements is shown in Figure 1

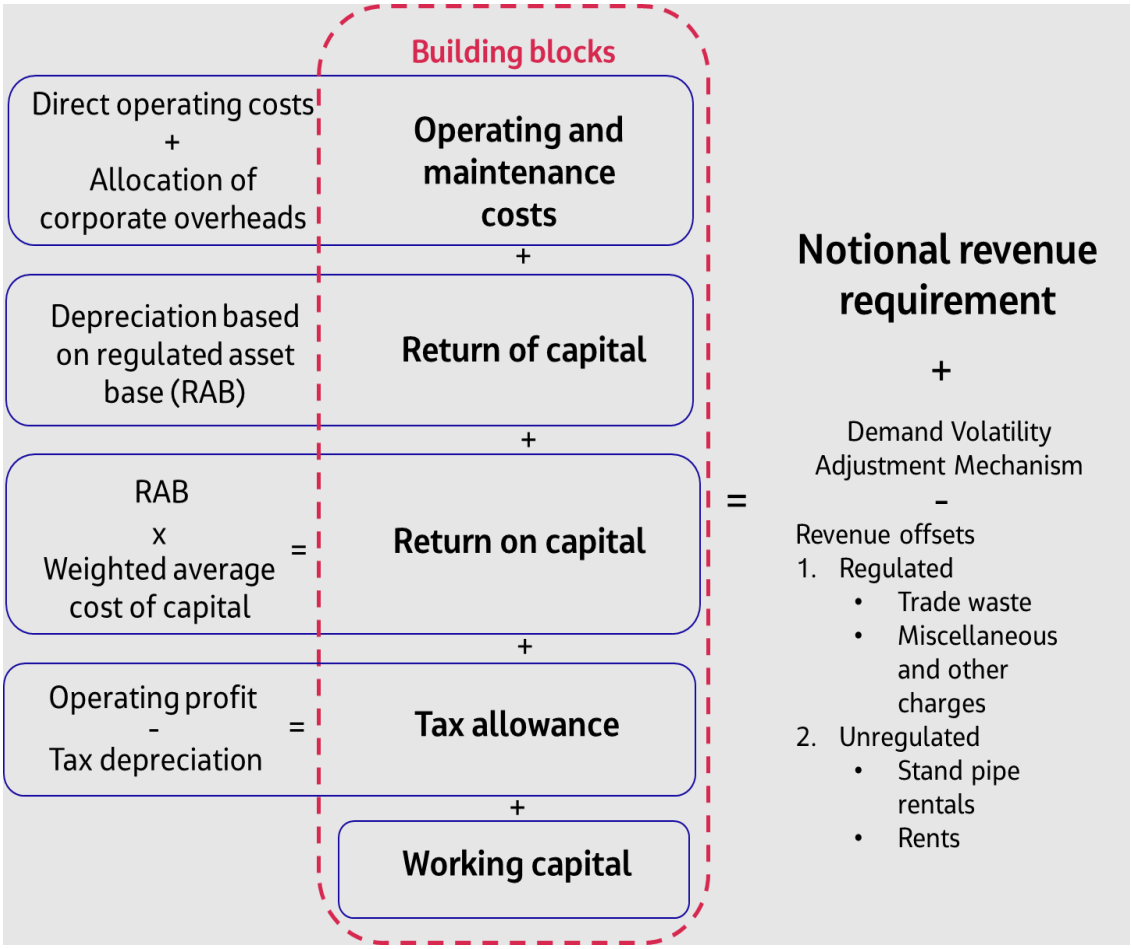


Figure 1: Notional revenue requirement calculation process

Each of the elements of the building blocks are explained in Section 3.

IPART adopts a post-tax building block methodology. The rate of return applied to the Regulatory Asset Base (RAB) excludes tax, and the tax allowance is calculated separately.

When setting prices, IPART considers revenue that can be generated outside of that recovered through water, sewerage and stormwater drainage service and usage charges.

This Technical Paper sets out Council's water, sewer and stormwater drainage proposed notional revenue requirement and target revenue by product for a five-year period from July 2022 to 30 June 2027. Whilst the requested determination period is for four years, 1 July 2022 to 30 June 2026, IPART guidelines state that an additional year of information be included in the pricing submission. The paper explains the calculation of each of the building block allowances for the price period. Regulated revenues over the current regulatory period are also documented.

2 Regulated revenue over the current price period

In the 2019 Determination, IPART calculated a target revenue for Council water, sewer and stormwater drainage for each year of the 2019-2022 regulatory period. Key building block assumptions which underpin target revenue included:

- A post tax WACC of 4% which was attributed to a reduction in the risk-free rate and debt margin
- Return of capital (regulatory depreciation) was based on one weighted average life for all asset classes

The average life for existing assets were:

- Water - 77 years
- Sewerage - 77.2 years for Wyong and 71.2 years for Gosford
- Stormwater drainage - 80.8 years

For new assets:

- Water and sewerage - 75 years
- Drainage - 95 years

The majority of Council's revenue for its water, sewer and stormwater drainage businesses come from both residential and commercial customers.

The revenue split for water, sewer and stormwater drainage from the 2019 IPART Final Report is shown in Table 1, Table 2 shows the information in $nominal.

Table 1 IPART revenue allowance ($2018-19)

$M	2019-20	2020-21	2021-22	Totals ($2018-19)
Water IPART revenue	72.2	72.2	73.9	218.3
Sewer IPART revenue	72.6	72.5	72.8	217.9
Stormwater drainage IPART revenue	14.8	15.0	15.3	45.1
Total	159.6	159.7	162	481.3

Table 2 Water, sewer and stormwater drainage IPART revenue ($nominal)

$M	2019-20	2020-21	2021-22	Total ($nominal)
Water Actuals	68.8	69.1	71.0	208.9
Water IPART allowance	72.0	73.7	76.7	222.4
Sewer Actuals	71.2	74.4	77.3	222.9
Sewer IPART allowance	72.3	74.0	76.1	222.4
Stormwater drainage actuals	14.4	15.0	15.5	44.9
Stormwater drainage IPART allowance	14.7	15.3	16.0	46.0

Note: CPI used for nominal$ are as per IPART SIP of 2019 -0.3% 2020 2.4% & 2021 2.5%

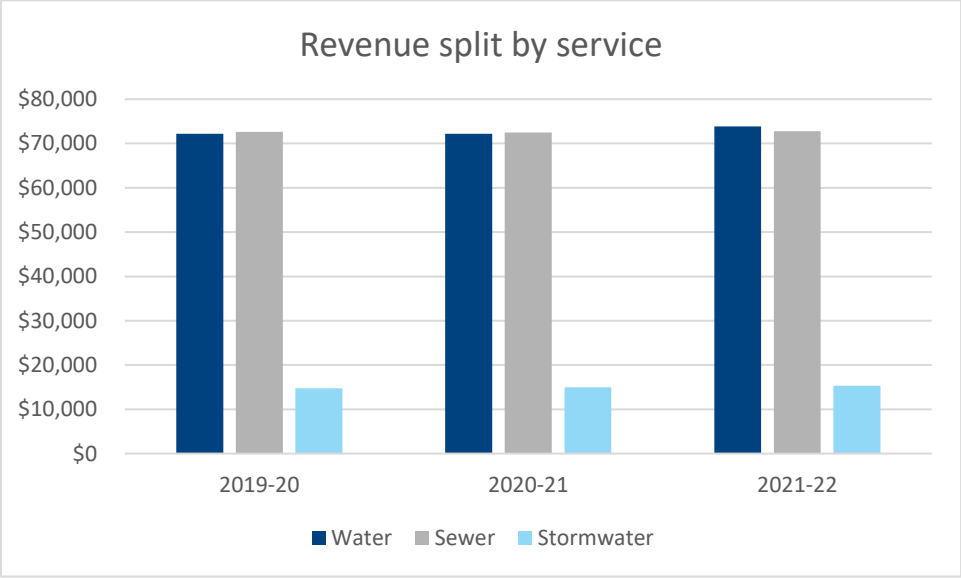


Figure 2: Revenue split by service 2019-2022 ($2018-19) $000s

2.1 Water

Water revenue is predominantly recovered via usage charges which account for approximately 74% of the target revenue for water. Revenue outcomes are variable and dependent on climatic conditions throughout the regulatory period.

Table 3: Water actuals /forecast $nominal

$M	2019-20 Actual	2020-21 Actual	2021-22 Forecast
Water Fund			
Water Availability Charges			
- Residential	11.2	11.6	11,8

$M	2019-20 Actual	2020-21 Actual	2021-22 Forecast
- Non-Residential	1.2	1.2	1.2
Total	**12.4**	**12.8**	**13.0**
Water Usage Charges	55.9	55.3	56.8
Total	**55.9**	**55.3**	**56.8**
Other Fees and Charges	1.6	1.8	1.9
Pensioner Rebates	(2.1)	(2.1)	(2.1)
Pensioner Reimbursements	1.0	1.2	1.3
Total	**(1.1)**	**(.84)**	**(.80)**
Total Regulated Income ($nominal)	**68.8**	**69.1**	**71.0**

The variance can predominantly be explained by the lower than forecast water sales which were 2,157ML less than the IPART allowance.

2.2 Sewer

Sewer revenue is predominantly recovered via service charges which account for 80% of the target revenue.

Table 4: Sewer actual/forecast $nominal

$M	2019-20 Actual	2020-21 Actual	2021-22 Forecast
Sewer			
Sewerage availability charges			
- Residential	48.8	50.3	50.7
- Non-Residential	4.6	5.0	5.2
Total	**53.3**	**55.2**	**57.8**
Sewer usage charges			
- Residential	12.5	13.0	13.1
- Non-Residential	2.9	3.2	3.3
Total	**15.4**	**16.2**	**16.4**
Trade Waste	2.6	2.6	2.6

$M	2019-20 Actual	2020-21 Actual	2021-22 Forecast
Other Fees and Charges	0.87	1.2	1.2
Total	**3.4**	**3.8**	**3.8**
Pensioner Rebates	(2.1)	(2.1)	(2.1)
Pensioner Reimbursements	1.0	1.3	1.3
	(1,1)	**(823)**	**(.80)**
TOTAL Regulated Income	**71.2**	**74.4**	**77.3**

The 2021-22 forecast is higher due to the additional $1.8M ($2021-22) for the IPART clarification notice No.1 of 2021.

2.3 Stormwater

Stormwater is recovered through fixed charges which account for 91% of the target revenue.

Table 5: Stormwater drainage actuals/forecast $nominal

$M	2019-20 Actual	2020-21 Actual (Draft)	2021-22 Forecast
Stormwater Drainage			
Annual Charges			
- Residential	13.7	14.0	14.3
- Non-Residential	0.7	0.98	1.2
	14.4	**15.0**	**15.5**
TOTAL Regulated Income	**14.4**	**15.0**	**15.5**

The historical revenue requirement for the 2019 determination period compared to the IPART determined revenue requirement is shown in Figure 3.

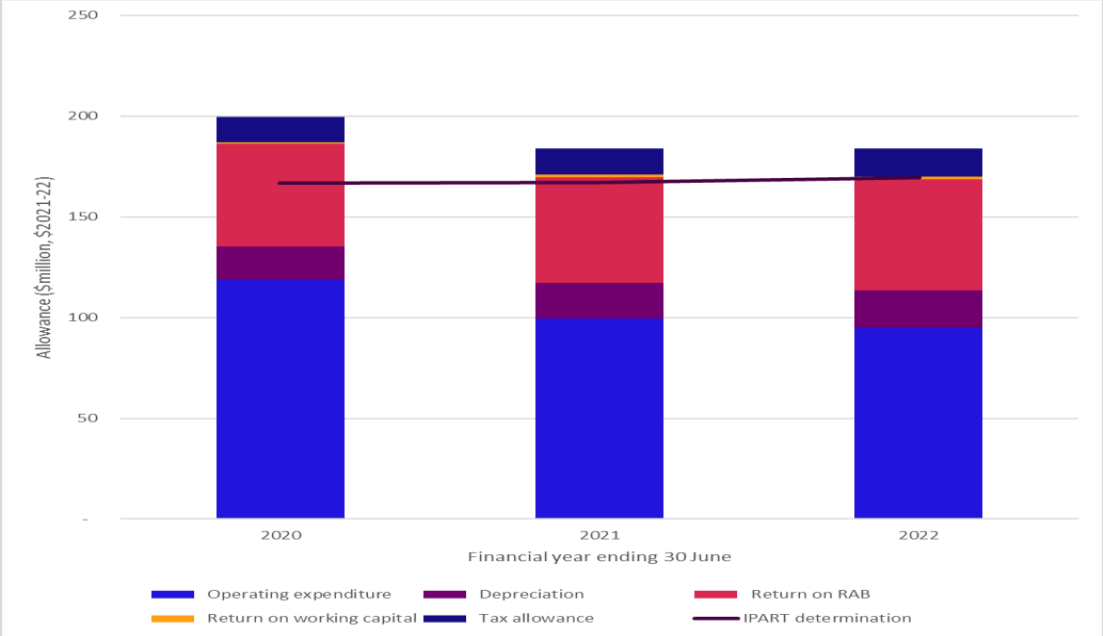


Figure 3: Historical revenue requirements vs IPART determination

The actual revenue requirement for the 2019 determination was higher than the IPART determined requirement due to higher operating costs. The reasons for this difference were detailed in the Operating Cost Technical Paper 5.

3 Forecast revenue over the proposed price period

3.1 Operating and maintenance costs

Operating and maintenance costs for water, sewerage and stormwater drainage are shown in Figure 4.

There is an increase in materials, consultants, full time employees (FTE's) and hire and contracts. The increase to these expenditure categories is required to support Council's regulatory obligations and asset maintenance strategies. The detail of which can be found in the individual business cases to support the operational expenditure.

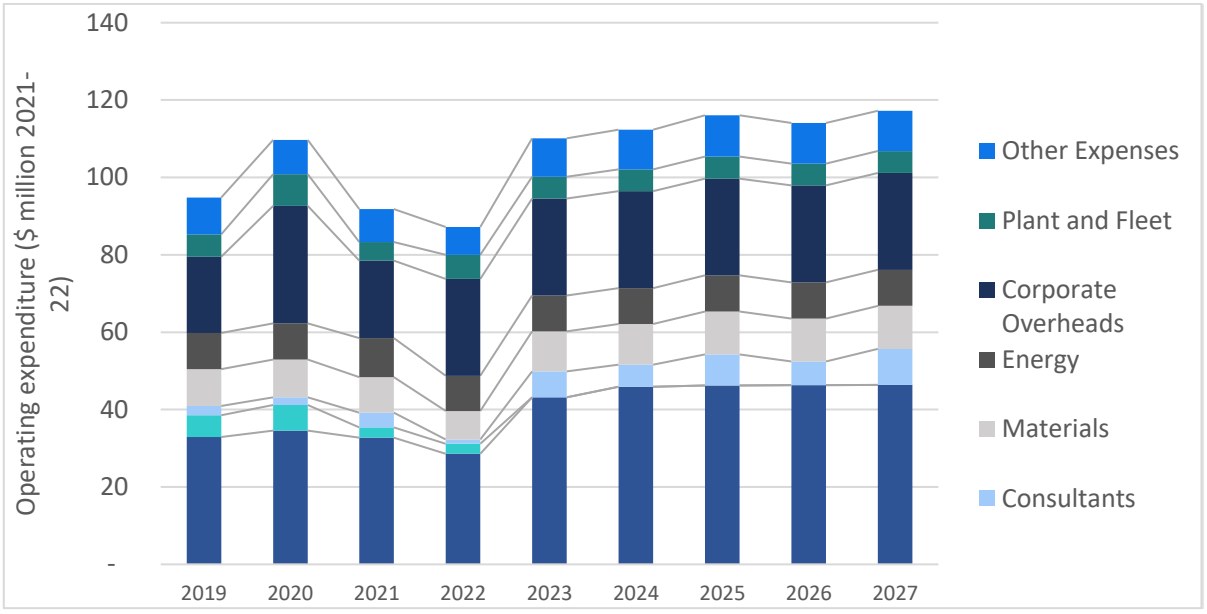


Figure 4: Operating and maintenance costs

3.2 Return of Capital

The return of capital (depreciation) building block is shown in Figure 5

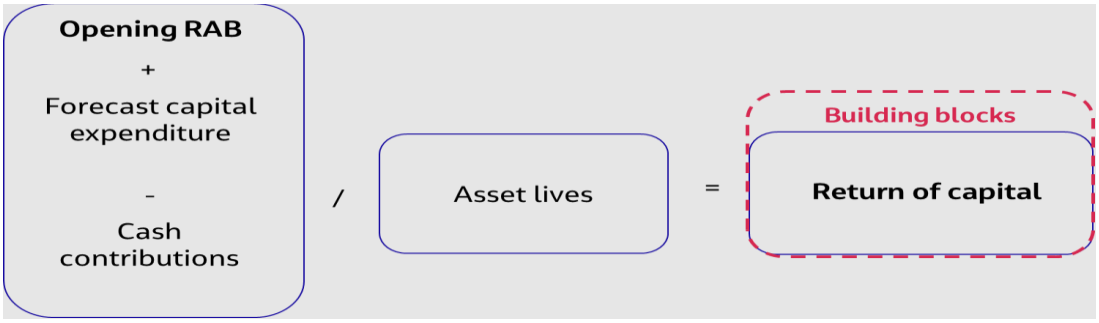


Figure 5: Return of Capital (depreciation) building block

The Regulatory Asset Base (RAB) determines the return of and return on capital. The opening and closing RAB for the next price determination period are shown in Table 6.

Table 6: Opening and closing RAB ($million, $nominal)

TOTAL ($M)	2022-23	2023-24	2024-25	2025-26	2026-27
Opening RAB	1,444.9	-	-	-	-
Opening value	1,444.9	1,461.8	1,496.7	1,533.2	1,574.3
Capital expenditure	77.8	79.0	77.9	78.2	129.2
Cash capital contributions	33.0	14.2	9.5	4.0	11.4
Disposals	0.0	0.0	0.0	0.0	0.0
Return of capital (Depreciation)	27.9	29.9	31.9	33.2	34.5
Indexation	0.0	0.0	0.0	0.0	0.0
Closing value	1,461.8	1,496.7	1,533.2	1,574.3	1,657.5

The RAB is then divided by the asset life relevant to the asset class to generate an annual return of capital (depreciation). In 2020, Council undertook an asset disaggregation following what was done by both Hunter Water and Sydney Water. The resulting disaggregation resulted in a lower weighted average life of Council's assets. The new weighted average life, calculated based on the asset lives of the different asset classes, has been used in the return of capital calculation for the 2022 determination. The total in return of capital is shown in Figure 6 where there is an increase over the regulatory period.

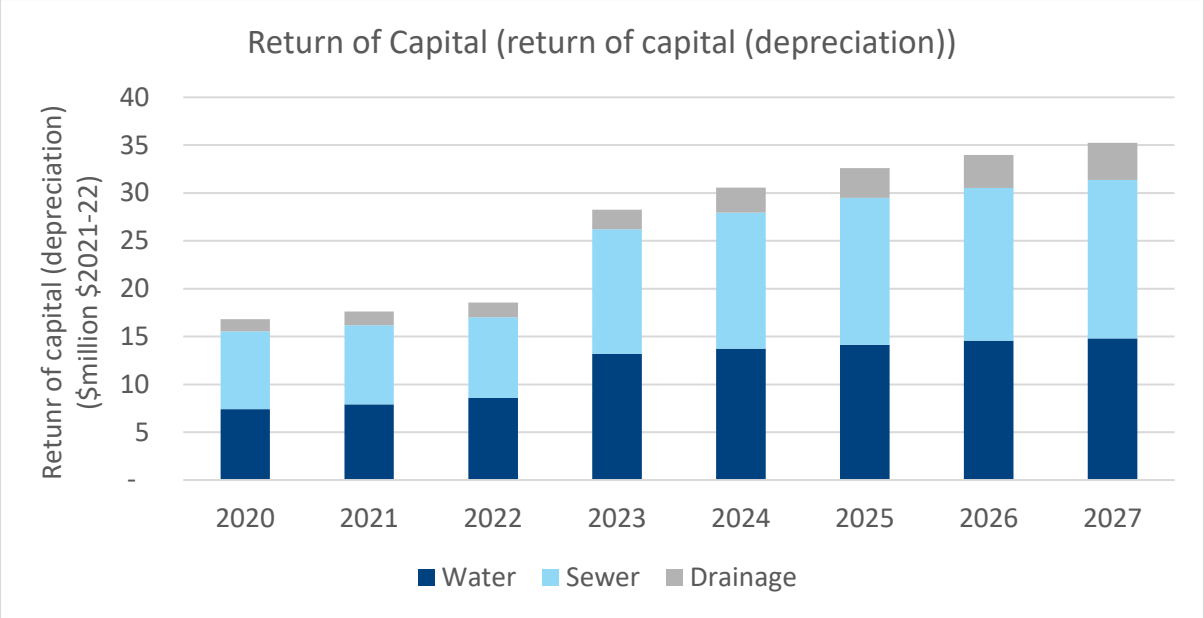


Figure 6: Previous (IPART determined) and forecast return of capital (depreciation)

3.3 Return on Capital

The return on capital uses the same RAB as the return of capital (depreciation) calculation multiplied by the weighted average cost of capital (WACC) as shown in Figure 7.

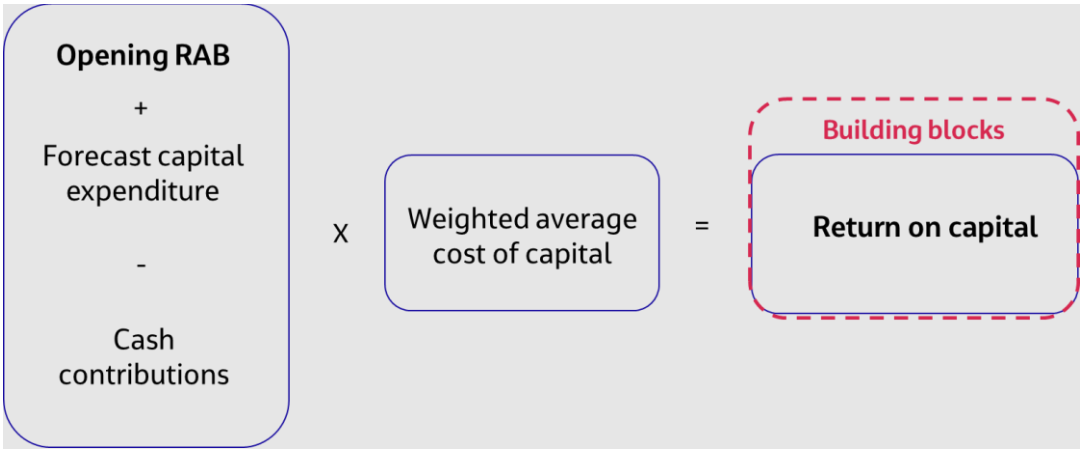


Figure 7: Return on capital building block

The WACC is provided by IPART. The current WACC components, dated February 2021, are show in Table 7.

Table 7: WACC components

WACC components – February 2021	
Debt funding	60%
Cost of debt (nominal pre-tax)	4.45%
Corporate tax rate	30.00%
Gamma	25.00%
Low WACC	2.70%
Medium WACC	3.31%
High WACC	4.00%
Post-tax real WACC	3.31%
Post-tax nominal WACC	5.81%

The post-tax real WACC is applied to the RAB to calculate a return on capital. The historical and forecast return on capital is shown in Figure 8.

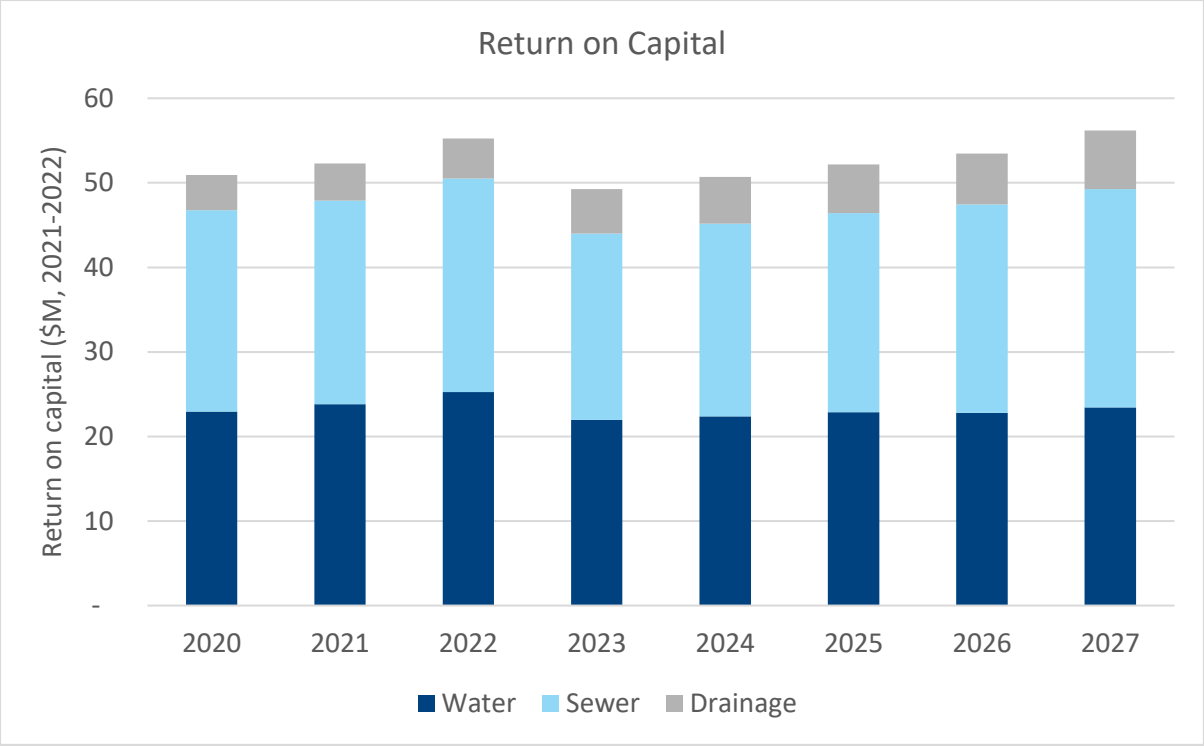


Figure 8: Historical and forecast return on capital

The WACC has decreased from the last determination period, driven by a lower cost of debt. Forecast return on capital is lower than the current calculated return on capital.

3.4 Tax allowance

Tax is calculated as a separate allowance in the notional revenue requirement, consistent with the use of a post-tax WACC. The commercially based tax allowance is a separate building block that replicates the tax liability of a similar, well-managed privately-owned business. The reason for this allowance is described by IPART in the commentary below:

Our tax allowance is not intended to recover the Council's actual tax liability over the determination period. Rather, it reflects the liability that a comparable commercial business would be subject to. Including this allowance is consistent with our aim is to set prices that reflect the full efficient costs a utility would incur if it were operating in a competitive market (including if it were privately owned). It is also consistent with the principle of competitive neutrality, that is, that a government business should compete with private business on an equal footing and not have a competitive advantage due to its public ownership.

Source IPART Final report Review of Central Coast Councils Water, sewerage and stormwater prices May 2019

The forecast tax allowance for the next determination period is shown in Table 8

Table 8: Tax allowance ($millions $2021-22)

Financial year ending 30 June $M	2023	2024	2025	2026	2027
Tax allowance	3.8	4.7	5.7	6.5	7.4

3.5 Working capital

Working capital allowance is the notional revenue requirement to allow Council to recover the costs it incurs due to delays between it delivering services and receiving payment for those goods or services (net of any benefits it receives due to delays between it receiving goods or services and paying for those good or services). It also provides funds to service debts.

A return on working capital, using a nominal post-tax WACC, is added to the building blocks to recover the interest associated with the working capital facility.

The return on working capital for the next determination period is shown in Table 9.

Table 9: Return on working capital ($million $2021-22)

Financial year ending 30 June $M	2023	2024	2025	2026	2027
Return on working capital	1.5	1.3	1.4	1.4	1.2

3.6 Notional revenue requirement

The notional revenue requirement for the FY2022 to 2026 (with the additional 2027 year) is shown in Table 10.

Table 10: Notional revenue requirement ($millions) ($2021-22) unsmoothed

Financial year ending 30 June $M	2023	2024	2025	2026	2027
Operating expenditure	126.1	130.4	135.1	132.6	134.5
Return of capital (depreciation)	27.9	29.9	31.9	33.2	34.5
Return on RAB	48.2	49.4	50.8	52.0	54.7
Return on working capital	1.5	1.3	1.4	1.4	1.2
Tax allowance	3.8	4.7	5.7	6.5	7.4
TOTAL	**207.5**	**215.6**	**224.9**	**225.7**	**232.3**

The total revenue requirement, compared to the previous determination and the average increase in the proposed notional revenue requirement, is shown in Table 11.

Table 11: Cumulative notional revenue requirement ($millions)($2021-22)

Category $M	Total 2020 to 2022	Total 2023 to 2027	Annual average 2020 to 2022	Annual average 2023 to 2027
Operating expenditure	313.2	524.2	104.4	131.0
Return of capital (depreciation)	54.2	122.9	17.6	30.7
Return on RAB	158.3	200.3	52.7	50.1
Return on working capital	3.4	5.5	1.1	1.4
Tax allowance	39.9	20.7	13.3	5.1
TOTAL	**569.1**	**873.6**	**189.1**	**218.3**

3.7 Revenue from tariffs

The amount that will be collected via tariff is then calculated based on the notional revenue requirement and adjustments due to:

- Revenue offsets including Demand Volatility Adjustment Mechanism (DVAM) and WACC true-up
- Regulated revenues
- Trade waste
- Miscellaneous and other charges

- Unregulated revenues
- Standpipe rentals
- Rents

Table 12: Adjustments for revenue required from tariffs ($2021-22)

Financial year ending 30 June $M ($2021-22)	2023	2024	2025	2026	2027
Notional revenue requirement (NRR)	**207.5**	**215.6**	**224.9**	**225.7**	**232.3**
Profit/loss on asset sales	0.0	0.0	0.0	0.0	0.0
Net revenue offsets	6.1	0.0	0.0	0.0	0.0
Non-regulated revenue	0.0	0.0	0.0	0.0	0.0
Trade waste	2.5	2.5	2.5	2.5	2.5
Other regulatory revenue	3.0	3.0	3.0	3.0	3.0
Pensioner rebates	-1.9	-1.9	-1.9	-1.9	-1.9
Revenue required from tariffs	**197.7**	**212.0**	**221.3**	**222.1**	**228.7**

Table 13: Revenue from tariffs by service ($2021-22) unsmoothed

Financial year ending 30 June $M ($2021-22)	2023	2024	2025	2026	Total $2021-22)	4-year average	2027
Water	90.7	94.1	100	98.8	383.6	95.9	102.8
Sewer	83.7	92.6	95.1	96.1	367.5	91.2	97.1
Stormwater drainage	23.3	25.4	26.2	27.0	101.9	25.5	28.8
Total	**197.7**	**212.1**	**221.3**	**221.9**	**853.0**	**212.6**	**228.7**

Note The revenue for water will be split 76% water usage and 24% service charges. Sewer will be split 21% sewer usage and 79% for service charges. Total may not add due to rounding.*

The net revenue offsets are comprised of the Demand Volatility Allowance Mechanism (DVAM) and WACC true-up. The DVAM accounts for the difference in the determined sales volume and actual sales volume over the 2019 determination period. Council sold less water than was forecast in the 2019 determination period as shown in Table 14.

Table 14: Determination and actual sales volumes ML

Financial year ending 30 June	Units	2020	2021	2022 forecast
Determination sales volume	ML	28,645	29,149	29,340
Actual sales volume	ML	26,695	27,168	27,183
Difference	**ML**	**1,752**	**2,110**	**2,157**
Sum of discounted adjustment	**$M**			**3.48**

The revenue associated with the lower actual sales volume can be collected in the next determination period. Council uses a constant WACC over the determination period and then undertakes a WACC true-up to account for the actual WACC during the determination period.

The WACC true-up is shown in Table 15.

Table 15: WACC adjustment true up

Financial year ending 30 June	$M
Water	7.5
Sewer	7.5
Drainage	1.4

3.8 Notional revenue requirement

The revenue requirements are presented in Table 16 as unsmoothed revenue. Meaning that the expenditure/allowance occurs in the year as indicated.

3.8.1 Water notional revenue requirements

Table 16: Water Notional Revenue Requirement ($2021-22)

Financial year ending 30 June $M	2023	2024	2025	2026	2027
Water					
Operating expenditure	55.9	57.2	61.7	60.1	62.8
Return of capital (depreciation)	13.1	13.5	13.9	14.3	14.6
Return on RAB	21.6	22.0	22.5	22.5	23.1
Return on working capital	.6	.6	.6	.6	.6
Tax allowance	1.8	2.1	2.5	2.6	2.9
Notional revenue requirement (NRR)	**93.0**	**95.4**	**101.3**	**100.2**	**104.1**

Note Totals may not agree due to rounding*

3.8.2 Sewer notional revenue requirement

Table 17: Sewer Notional Revenue Requirement ($2021-22)

Sewerage South $M	2023	2024	2025	2026	2027
Operating expenditure	53.2	56.0	56.4	55.3	54.4
Return of capital (depreciation)	8.4	8.9	9.5	9.7	10.1
Return on RAB	14.1	14.1	14.3	14.8	15.3
Return on working capital	.5	.5	.4	.5	.4
Tax allowance	.1	.2	.4	.7	.9
Notional revenue requirement (NRR)	**76.2**	**79.8**	**81.0**	**81.0**	**81.1**
Sewer North $M	**2023**	**2024**	**2025**	**2026**	**2027**

Operating expenditure	0	0	0	0	0
Return of capital (depreciation)	4.5	5.0	5.6	6.0	6.2
Return on RAB	7.7	7.9	8.4	9.0	9.7
Return on working capital	.1	.1	.1	.1	.1
Tax allowance	1.8	2.0	2.2	2.4	2.4
Notional revenue requirement (NRR)	**14.1**	**15.0**	**16.2**	**17.4**	**18.3**

Note Totals may not agree due to rounding*

3.8.3 Stormwater drainage notional revenue requirement

Table 18: Stormwater drainage Notional Revenue Requirement $million ($2021-22)

Stormwater $M	**2023**	**2024**	**2025**	**2026**	**2027**
Operating expenditure	17.0	17.2	17.1	17.2	17.2
Return of capital (depreciation)	1.9	2.4	2.9	3.2	3.6
Return on RAB	4.8	5.3	5.5	5.7	6.6
Return on working capital	0.1	0.1	0.2	0.2	0.2
Tax allowance	0.1	0.3	0.6	0.7	1.1
Notional revenue requirement (NRR)	**24.0**	**25.4**	**26.2**	**27.0**	**28.8**

Note Totals may not agree due to rounding*

4 Disaggregation of the RAB

The regulatory return of capital (regulatory depreciation) building block allows the initial investment in a regulated asset to be recovered from customers over the asset's useful life. A key consideration in the calculation of this allowance is the determination of appropriate useful lives at which to depreciate the assets in the RAB. Regulatory depreciation should be based on the economic lives of assets.

Council considers this promotes efficient planning and investment in assets over time. Ensuring the assets lives are correct should also ensure intergenerational equity, such that today's customers only pay for those assets used in the provision of services - not for past investments in assets that are no longer in productive use (assets that are replaced, decommissioned, renewed, or scrapped).

IPART's 2019 Draft Report on the Review of Central Coast Water, sewer and stormwater drainage prices commented on the Council's current used of a weighted average useful life:

Our analysis suggests the Council's RAB could be better disaggregated into asset classes that more closely reflect the underlying economic lives of its actual water, sewerage and stormwater assets. A more accurate disaggregation would promote more cost-reflective prices and support the Council's financial sustainability over time

Council has recognised that by applying the asset lives shown in Table 20, it is under-recovering revenue related to return of capital (regulatory depreciation).

Table 19: Asset lives for both new and existing assets for water, sewer and stormwater drainage

	Water	Sewer Gosford	Sewer Wyong	Stormwater drainage
Average existing asset lives @ 30/06/2019	77	77.2	71.2	80.8
New Asset to be created in the current determination	75	75	75	95

The useful life of an asset is the period over which the fixed asset is expected to provide service or economic benefit to the Central Coast. Similarly, return of capital (regulatory depreciation) is calculated on a straight-line basis over an asset's useful life.

4.1 Disaggregating the asset base by class

For this determination, Council has reviewed the current regulated asset base regarding the disaggregation of its water, sewer, and stormwater drainage assets.

The result is that the value of the opening Regulated Asset Base (RAB) will not change but will be apportioned against lower-level asset categories, which in turn will impact return of capital (regulated depreciation)
Regulated depreciation uses straight line depreciation and the asset lives in the current determination are based only on the categories of water, sewer, and stormwater drainage (as explained above).
Based on how IPART disaggregated the RAB for Hunter Water and Sydney Water, Council has also created new categories with reference to the weighted average asset lives (WAUL) in the Fixed Asset Register (FAR).

To understand the impacts, the current formula to calculate the weighted average asset life for water, sewer, and stormwater drainage assets (both new and existing assets) in the FAR needs to be understood.

- **New assets** are those assets created post 1 July 2000 and are included in the RAB at full value.
- **Existing assets** are those assets created pre-1 July 2000 and are included in the RAB at a discounted value (43% of gross replacement cost).

Weighted Average Useful Life (WAUL) is calculated as a portion of each asset contributed to the combined useful life for either new or existing assets.

RAB categories
In determining the maximum fee chargeable, IPART set the price based on:

- Existing operating costs
- Return on capital
- Return of capital (regulatory depreciation)
- Tax
- Return of weighted capital.

In calculating the return of capital - depreciation component of this calculation, the RAB is divided by the economic life of those assets within each category. Currently Council has four categories being:

- Stormwater drainage
- Water supply
- Sewerage north
- Sewerage south

It is proposed as part of the disaggregation that the assets be disaggregated into the following categories:

Stormwater drainage

- Non-depreciating
- Mechanical/electrical
- Civil
- Equipment

Water supply

- Buildings
- Mechanical/electrical
- Civil
- Equipment/telemetry

Sewerage north

- Non-depreciating (sewer gravity mains only)
- Buildings
- Mechanical/electrical
- Civil
- Equipment/telemetry

Sewerage south

- Non-depreciating (sewer gravity mains only)
- Buildings
- Mechanical/electrical
- Civil
- Equipment/telemetry

Whenever working with useful lives of assets, it is essential that the adopted life accurately reflects the loss of value or the consumption of the asset over time. From an organisational perspective, if asset life is too short then an organisation will appear to be unsustainable when this is not the case, or customers will overpay for them. If asset lives are too long the organisation may appear sustainable when in fact it's not, or from a customer perspective, future generations will have to pay for assets that they receive no economic benefit from. Council has an extensive asset register which includes all its depreciable and non-depreciable assets. The following tables outline Council's adopted asset hierarchy for its regulated asset base. Council believes this asset hierarchy is appropriate and provides a better representation of Council's stormwater, water and sewer portfolios.

Table 20: Asset hierarchy for stormwater drainage asset lives by asset type

RAB category	Asset Type	New Asset lives	Existing Asset lives
Stormwater drainage			
Non-depreciable	Non depreciable portion of basins and levees	-	-
Mechanical/electrical	Hydrometric station including flood warning system, rain gauges, water level sensors	20	9.32
Civil	Pipes, culverts, channels, pits, headwalls, basins, levees, floodgates	71.82	54.48
Equipment	GPTs, stormwater quality improvement devices (SQID)	23.87	7.94

Table 21: Asset hierarchy for regulated asset base – water asset lives by asset class

RAB category	Asset type	New Asset lives	Existing Asset lives
Water			
Buildings	Water Supply Buildings	96.77	68.84
Mechanical/electrical	Water pump stations/network assets/elec/mech general can be from other areas	42.46	29.32
Civil	Dams and weirs, tunnels, raw water, water mains, water reservoirs, water treatment plants, ground water	71.82	54.48
Equipment	Telemetry towers, SCADA/ICT, control instrumentation, water meters, equipment	23.87	7.94

Table 22: Asset hierarchy for regulated asset base – sewer Asset lives by Asset class

RAB category	Asset type	New Asset lives	Existing Asset lives
Sewer North			
Non-Depreciating	Non – Depreciable portion of Gravity Mains	-	-
Buildings	Sewerage buildings	54.06	27.56
Mechanical/electrical	Sewage pump stations, network assets	32.50	13.04
Civil	Outfalls, sewer mains, sewage treatment plants, low pressure systems	63.69	49.95
Equipment	Telemetry towers, SCADA/ICT, control instrumentation	16.79	9.26
Sewer South			
Non-Depreciating	Non – Depreciable portion of Gravity Mains	-	-
Buildings	Sewerage buildings	55.23	42.64
Mechanical/electrical	Sewage pump stations, network assets	33.69	18.39
Civil	Outfalls, sewer mains, sewage treatment plants, low pressure systems	57.10	48.24
Equipment	Telemetry towers, SCADA/ICT, control instrumentation	17.03	10.67

5 Financeability

IPART undertakes financeability tests to:

- Ensure its pricing decisions allow an efficient investment-grade rated Council to raise finance and remain financeable during the regulatory period (benchmark test)
- Assess whether the actual Council would be financeable during the regulatory period (actual test)

IPART conducts a financeability test if:

- The prices IPART regulates determine the revenues of the service provider
- The provider is established as, or part of, an entity with a distinct capital structure.

The financeability test is comprised of benchmark and actual calculation of the following ratios:

1. Interest Coverage – This is calculated as Funds From Operations (FFO) plus interest expense divided by interest expense. This ratio measures a Council's ability to service its debt burden using the Council's cash flows.
2. Debt gearing (gearing) – This is calculated as debt divided by the regulatory value of fixed assets, i.e., the RAB. It measures a Council's leverage.
3. FFO divided by Debt– This is a more dynamic measure of leverage than debt gearing because it measures a Council's ability to generate cash flows to service and repay debt.

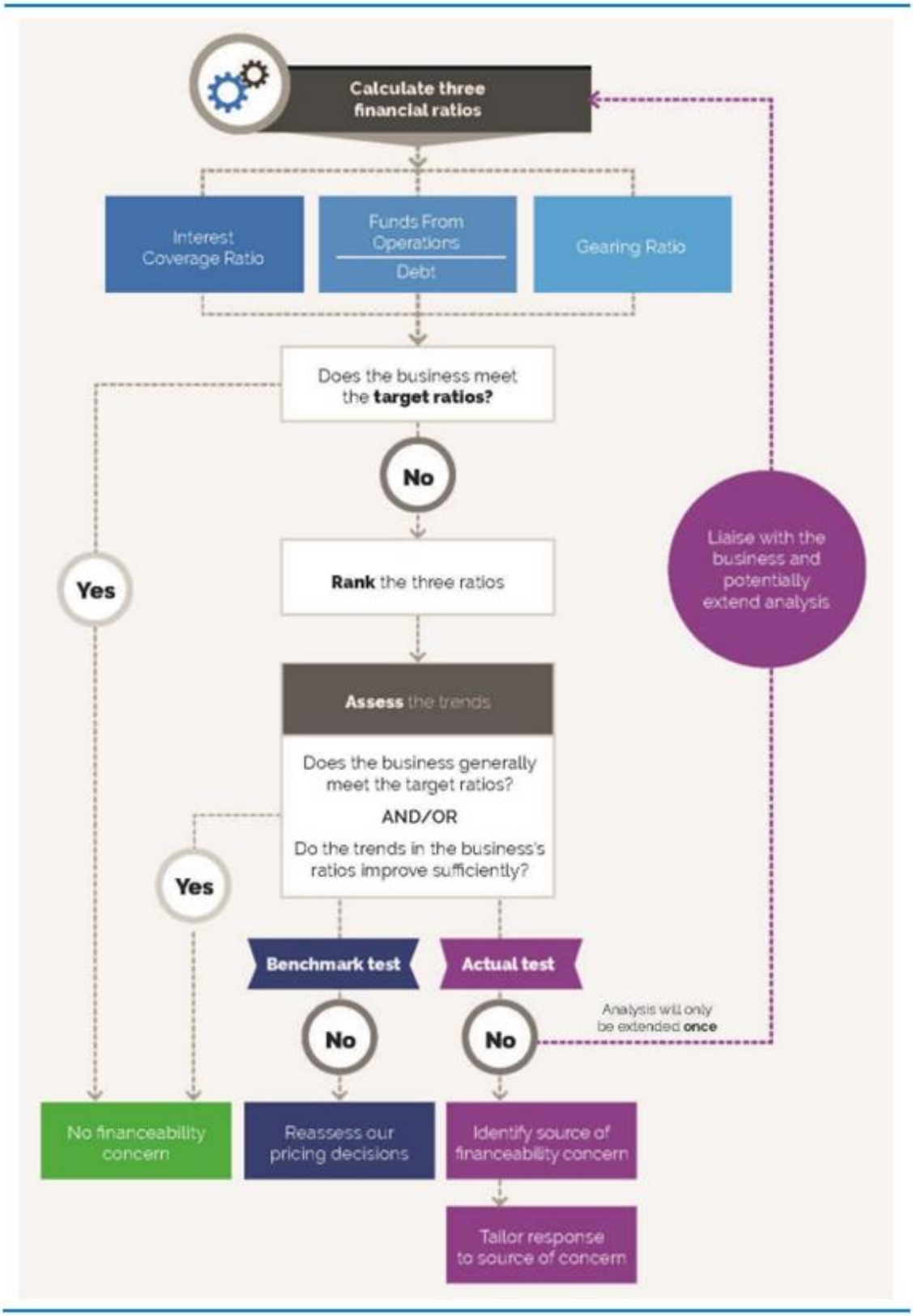
The ratios are then compared to IPART's targets shown in Table 23.

Table 23: IPART ratio targets

Ratio	Benchmark test	Actual test
Interest cover	>2.2	>1.8
Gearing	>7.0%	>6.0%
FFO over debt	<70%	<70%

Source: IPART, Final Report - Review of our financeability test - November 2018

The process of determining the financeability and then subsequent response from IPART is shown in the following flow diagram.



Source: IPART, Final Report - Review of our financeability test - November 2018

Figure 9 IPART process identifying financeability concern for the benchmark and actual tests

The process shows that there is recourse to reconsider pricing decisions where benchmark ratios are not met while not meeting actual ratios results in an extension of analysis as well as potential responses to the source of concern.

5.1 Historical financeability

In the 2019 determination, IPART used the results of a 2018 financeability assessment of the Council. The results were provided for:

- Benchmark test ratios
- Actual rest ratios

The Council was forecast to outperform two of the ratios, Interest Cover Ratio and Gearing, with the FFO over debt was not considered sufficient to warrant a change in pricing decision.

Table 24: 2019 Financeability benchmark ratios

Ratio	Target	2019-20	2020-21	2021-22
Interest cover	>2.2	3.0	3.1	3.1
Gearing	>7.0%	5.8%	6.1%	6.2%
FFO over debt	<70%	60%	60%	60%

Source: IPART, Final report - Review of Central Coast Council water sewerage and stormwater prices - May 2019

The results of the actual test suggested that Council would substantially exceed the ratios.

Table 25: 2019 Financeability actual ratios

Ratio	Target	2019-20	2020-21	2021-22
Interest cover	>1.8	3.4	3.6	3.3
Gearing	>6.0%	16.2%	15.7%	15.0%
FFO over debt	<70%	20%	21%	22%

Source: IPART, Final report - Review of Central Coast council water sewerage and stormwater prices - May 2019

5.2 Council funds

The Council has restricted funds, which can only be used for the purpose that the funds are raised. This restricts the council's financial flexibility, compared with other water businesses regulated by IPART.

Council manages three separate funds:

- Water
- Sewer
- Stormwater

Council is only able to move funds between the three funds with Ministerial approval. As a result, the debt levels and cash flow issues faced by the Council require careful management within this regulatory review.

5.3 Forecast financeability

The forecast financeability of the Council over the next determination period has been undertaken for:

- Water, sewer and stormwater
- Water only

5.3.1 Water, sewer and stormwater drainage

The benchmark test ratios for water, sewer and stormwater drainage are shown below.

Table 26: Forecast financeability - benchmark test ratios

Benchmark test ratio	IPART	2022-23	2023-24	2024-25	2025-26
Interest cover	>2.2x	4.23	4.31	4.37	4.39
Gearing	<70%	60%	60%	60%	60%
FFO over debt	>7%	6.5%	6.6%	6.7%	6.8%

Source: Council data

Similar to the 2019 pricing proposal, Council is forecast to outperform two of the ratios, Interest Cover Ratio and Gearing. The FFO over debt continues to be lower than the target, even with the reduced asset lives following the asset disaggregation. IPART should examine and then consider the benchmark test ratio results in its broader consideration of the pricing proposal as Council seeks to improve its efficiency.

The results of the actual test ratios are shown below.

Table 27: Forecast financeability – actual test ratios

Actual test ratio	IPART	2022-23	2023-24	2024-25	2025-26
Interest cover	>1.8x	8.66	9.92	11.47	13.36
Gearing	<70%	11%	10%	8%	6%
FFO over debt	>6%	34.9%	41.0%	48.6%	63.8%

Source: Council data

The Council outperforms the actual test ratios and is well-placed from its actual Council position in the next period under the current pricing proposal.

While the proposal allows the council to achieve its financial outcomes, any reduction in revenue imposed by IPART could create cash flow issues within the water (but not sewer) business.

5.3.2 Water

The water fund has been assessed separately to highlight the relative difference in financeability, particularly given the inability to pool funds across water, sewer and stormwater. The benchmark test ratios for water are shown below.

Table 28: Forecast water financeability - benchmark test ratios

Benchmark test ratio	IPART	2022-23	2023-24	2024-25	2025-26
Interest cover	>2.2x	4.30	4.33	4.35	4.40
Gearing	<70%	60%	60%	60%	60%
FFO over debt	>7%	6.6%	6.7%	6.7%	6.8%

Source: Council data

The water fund has similar performance across the ratios to the entire business and is also underperforming on the FFO over debt. The actual test ratios for water are shown below.

Table 29: Forecast water financeability - actual test ratios

Actual test ratio	IPART	2022-23	2023-24	2024-25	2025-26
Interest cover	>1.8x	5.23	5.89	6.72	7.67
Gearing	<70%	19%	16%	14%	11%
FFO over debt	>6%	21.4%	24.6%	28.7%	38.1%

Source: Council data

In the actual test, the water fund still outperforms the ratios set by IPART but has lower outperformance than the entire business ratios. The water business ratios are forecast to improve over the next determination period based on the current proposal.

6 Abbreviations

DVAM	Demand Volatility Allowance Mechanism
FFO	Funds From Operations
IPART	Independent Pricing and Regulatory Tribunal
RAB	Regulated Asset Base
WACC	Weighted Average Cost of Capital
WAUL	Weighted Average Useful Life

7 References

IPART Review of Central Coast Council's water, sewerage and stormwater prices to apply from 1 July 2019, May 2019