REVIEW OF IPART'S FINANCEABILITY TEST

SUBMISSION TO DRAFT REPORT

SEPTEMBER 2018

HUNTER WATER

Version 1.0 – 14 September 2018

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ISSN: 1836-3253

ABN: 46228513446

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EXECUTIVE SUMMARY

The Independent Pricing and Regulatory Tribunal (IPART) is reviewing its financeability test which it uses to assess whether pricing decisions are likely to impact a business's financial stability and in particular its capacity to raise funds to manage activities over a regulatory pricing period.

Hunter Water appreciates this further opportunity to comment on IPART's test.

We agree with IPART that it should continue to target the achievement of a BBB investment-grade credit rating. Hunter Water's view is that the financeability test needs to closely align with Moody's credit rating metrics, as our BBB credit rating is dependent on performance against those specific metrics.

Accordingly, Hunter Water proposed the following amendments to the financeability test in our response to IPART's earlier issues paper (June 2018):

- Continuing to use the nominal cost of debt in the actual business financeability test unless a business's rating agency is using cash interest in which case IPART should adopt that value
- Adding retained cash flow (RCF) over debt to the three financial ratios currently used in the financeability test
- Adopting Moody's financial ratio weightings as reproduced in the issues paper's table 5.3
- Including some consideration of qualitative factors, and
- Using Moody's financial ratio benchmarks as reproduced in the issues paper's table 5.2.

Hunter Water observes that IPART's draft report decisions are generally inconsistent with our proposed amendments, and those of most other stakeholders.

Hunter Water is concerned that the proposed financeability test is now only directly comparable to 10 per cent of Moody's rating criteria as applied to us (see section 2.1.2). We therefore question the test's capacity to accurately assess the impact of proposed pricing decisions on our credit rating. We again note that any reduction in Hunter Water's current credit rating would have adverse consequences for the business, its shareholders and our customers.

Hunter Water therefore encourages IPART to carefully consider the above amendments prior to finalising its financeability test.

This submission provides additional comments on the draft report's proposed financial ratios and benchmark targets. We also provide further comments on IPART's proposed use of the real cost of debt which is a fundamental issue responsible for a significant proportion of the difference between the proposed financeability test and our credit rating metrics.

1 INTRODUCTION

Hunter Water welcomes the opportunity to respond to the Independent Pricing and Regulatory Tribunal's (IPART's) Draft Report *Review of our financeability test*.

Hunter Water provided a detailed response to IPART's issues paper and our positions provided on key issues remain largely unchanged.[1] This submission focusses on IPART's draft decisions and associated adjustments to the extent that they were not detailed in the earlier issues paper.

The submission is structured as follows:

Introduction	
Financial ratios	Comments on IPART's proposed selection of financial ratios as well as the associated weightings and targets. Also provides our views on IPART's proposed cost of debt inputs for its benchmark and actual financeability tests.
Assessing and Addressing financeability concerns	Comments on IPART's proposed assessment process and remedies for addressing financeability concerns.

Hunter Water's positions on each of the 24 draft decisions contained in IPART's draft report are listed in Appendix A.

[1] Hunter Water, June 2018.

2 FINANCIAL RATIOS

IPART propose the following draft decisions:

> *15 That we would calculate the following ratios for the benchmark and actual tests:*
>
> *– The Adjusted Interest Coverage Ratio (AICR).*
>
> *– An Adjusted Funds From Operations (FFO) divided by debt ratio.*
>
> *– The debt divided by RAB, or gearing, ratio (which is fixed for the benchmark test).*
>
> *16 That we would calculate the Interest Coverage Ratio (ICR) and the (unadjusted) FFO over debt for the actual test as a diagnostic tool only.*
>
> *17 That we would rank the financial metrics to place more weight on the AICR and adjusted FFO over debt ratios, and to place less emphasis on the gearing ratio.*[2]

2.1 Hunter Water's comments on IPART's proposed financial ratios

2.1.1 Real cost of debt

IPART proposes to replace its current interest cover ratio (ICR) with an adjusted interest cover ratio (AICR). The draft report notes that the AICR ratio differs from the ICR in that it assumes a real cost of debt in the calculation. In addition IPART note that in calculating the adjusted FFO over debt ratio, it would assume a real interest expense in both the benchmark and the actual test.[3]

The draft report goes on to state:

> *"For the actual test, we would also calculate the unadjusted ICR and FFO over debt ratio (ie, assuming a nominal interest expense). Calculating these metrics on both a real and nominal basis would assist us to diagnose the source of any financeability issues and identify the impact of issuing nominal debt on the business's financeability."* [4]

[2] IPART, 2018, page 34
[3] Ibid, page 35
[4] IPART, 2018, page 35

IPART also state that:

> *"When we calculate the financial ratios, we have retained our preliminary decision to use a real cost of debt. This is because our real WACC framework compensates a business for inflation over future periods through the RAB. Our decision to use a real cost of debt ensures that:*
>
> - *We do not overstate the financeability concerns of the business (due to double counting of inflation).*
> - *We adopt a consistent approach to assess financeability across different businesses. In practice, businesses operate with a wide variety of financing strategies, and their interest expense may include a blend of nominal and real debt.*
> - *The actual financing strategy of the business does not influence our pricing decisions and therefore customer bills."* [5]

Most stakeholders, as noted by IPART,[6] disagreed with its preliminary position to calculate a financeability test using a real cost of debt and strongly argued for the use of a nominal cost of debt.

Stakeholders argued in support of IPART continuing to use the nominal cost of debt for a number of reasons:

- Consistency with Moody's credit rating reviews of NSW water utilities[7,8]
- The market for inflation-indexed corporate bonds in Australia (for private issuers of debt, such as business in the circumstances of Sydney Desalination Plant) is extremely thin.[9]
- Australian utilities, including Sydney Water, primarily use nominal bond debt funding. Nominal bond debt with a standard coupon remains the most common source of debt issued in the Australian bond market, and is generally the most liquid.[10]
- All historical credit metrics have used inputs based on nominal figures. Treasury expressed concerned about calibrating the credit metrics to use real figures.[11]

The draft report states that Moody's (a global ratings company) preferred approach is to consider the AICR ratio for regulated water utilities where its revenue is determined using a building block approach.[12] However, Moody's do not apply the AICR to their assessment of NSW water utilities. Instead, Moody's use the traditional ICR. This indicates that Moody's do not consider the AICR relevant to their assessment of NSW water utilities, consistent with the stakeholder arguments noted above.

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[5] Ibid
[6] IPART, 2018, page 36
[7] Hunter Water 2018, page 9
[8] Sydney Desalination Plant, page 6
[9] Sydney Desalination Plant, 2018, page 6
[10] Sydney Water, 2018a, page 2
[11] NSW Treasury, 2018, page 2
[12] IPART, 2018, page 37

The draft report notes that:

> *A business's credit rating using the AICR will always be better (when inflation is positive) because*
>
> - *The calculated ratio is higher, and*
> - *Moody's benchmark AICR is lower than the comparable ICR.*[13]

Accordingly, IPART propose that the benchmark ratios for the AICR and ICR be the same, because it is a more conservative approach that minimises the differences between the two tests.[14]

Hunter Water also notes IPART's draft decision (No. 16) to calculate the Interest Coverage Ratio (ICR) and the (unadjusted) FFO over debt for the actual test as a diagnostic tool only.

Hunter Water, questions the efficiency and transparency of IPART's proposals to adjust ratios and conduct additional diagnostic testing rather than simply using existing credit rating metrics.

Hunter Water maintains the position in its submission to the issues paper that IPART should continue to use the nominal cost of debt in the financeability test – in line with the assessment practice that is actually being used by a business's rating agency.

2.1.2 Proposed ratios

The following table shows IPART's proposed ratios and Hunter Water's preferred ratios.

[13] Ibid, page 38
[14] Ibid

Table 1: Financeability test ratios

IPART's Draft Report	Hunter Water
Adjusted Interest Cover Ratio (AICR)	ICR
Adjusted Funds From Operations (AFFO) divided by debt ratio	FFO divided by debt ratio
Debt divided by RAB	Debt divided by RAB ratio
	Retained Cash Flow (RCF) over debt ratio

The main differences between IPART and Hunter Water's preferred ratios are the treatment of the cost of debt in the first two ratios and the fact that IPART have chosen not to adopt Moody's fourth financial ratio (i.e. Retained Cash Flow/Debt).

Hunter Water notes that the main components of IPART's proposed financeability test now differ significantly from those used in our credit rating assessment process (see Table 2).

Table 2: Moody's rating grid for regulated water utilities

Rating Factors	Factor Weighting	Sub-Factors	Sub-Factor Weighting
BUSINESS PROFILE	50%	Stability and Predictability of Regulatory Environment	15%
		Asset Ownership Model	5%
		Cost and Investment Recovery (Ability & Timeliness)	15%
		Revenue Risk	5%
		Scale and Complexity of Capital Programme & Asset Condition Risk	10%
FINANCIAL POLICY	10%	Financial Policy	10%
LEVERAGE AND COVERAGE	40%	Adjusted Interest Coverage OR FFO Interest Coverage	12.5%
		Net Debt / Regulated Asset Base OR Debt/Capitalisation	10%
		FFO / Net Debt	12.5%
		RCF / Net Debt	5%
Total	100%	Total	100%
UPLIFT FOR STRUCTURAL CONSIDERATIONS		Up to 3 notches	

The proposed financeability test is now only directly comparable to 10 per cent of Moody's rating criteria as applied to Hunter Water (i.e. the Debt/RAB ratio). We therefore question the test's capacity to accurately assess the impact of proposed pricing decisions on our credit rating.

2.1.3 Target ratios

IPART's draft report contains the following table that outlines proposed target ratios and how they compare against the credit rating agencies.

Table 3: Target metrics versus 2013 metrics used by IPART and credit rating agencies

	Adjusted interest coverage ratio	FFO interest coverage	FFO / debt	Debt / RAB
	Higher is better	*Higher is better*	*Higher is better*	*Lower is better*
IPART (Draft decision)	**>1.8x**	**>1.8x**	**>6%**	**<70%**
IPART (2013)[a]	NA	1.4-2.9x	5-10%	60-100%
Moody's (Baa) – Water[b]	1.5-2.5x	2.5-4.5x	10-15%	55-70%
Moody's (Ba) – Water[b]	1.2-1.5x	1.8-2.5x	6-10%	70-85%
Moody's (Baa) – Energy networks[c]	1.4-2x	2.8-4x	11-18%	60-75%
S&P Global (Significant)[d]	NA	2-3x	9-13%	NA
S&P Global (Aggressive)[d]	NA	1.5-2x	6-9%	NA
Fitch Ratings (BBB)[e]	NA	1.5x	5.5%	70%

a IPART, *Financeability tests in price regulation – Final Decision*, December 2013, p 10.
b Moody's Investors Service, *Rating methodology – Regulated Water Utilities*, June 2018, p 21.
c Moody's Investors Service, *Rating methodology – Regulated Electric and Gas Networks*, March 2017, p 19.
d S&P Global Ratings RatingsDirect, *Corporate Methodology*, November 2013, p 35. The credit rating that S&P Global Ratings assigns a business is dependent on their financial metrics and their risk profile. The 'Significant' and 'Aggressive' ratios in this table correspond to a BBB benchmark.
e FitchRatings Australian *Regulated Network Utilities: Ratings Navigator Companion* April 2018, pp 9 & 11.

Hunter Water supports IPART's logic in proposing to set single target ratios for each metric. We agree that it is the bottom (or top) of the current credit rating bands that provide the relevant and true threshold. The following table provides our comments on IPART's proposed target ratios.

Table 4: Hunter Water's comments on IPART's proposed target ratios

Ratio	IPART target	Hunter Water's comments
Adjusted interest cover ratio (AICR)	>1.8x	We do not support the use of this ratio as noted previously. We note that setting the target commensurate with FFO interest coverage does not negate the fact that the AICR will be higher than the ICR if inflation is positive.
FFO interest coverage (ICR)	>1.8x	Supported on the basis that this is consistent with Moody's approach.
FFO/debt	>6%	Hunter Water support a higher rate of >10% consistent with Moody's approach.
Debt/RAB	<70%	Supported on the basis that this is consistent with Moody's approach

Hunter Water also proposes a target ratio of >6 per cent for retained cash flow over debt, consistent with our position that this ratio should be used in the financeability test. The target is based on Moody's range of 6-10 per cent for a Baa rating for water utilities.[15]

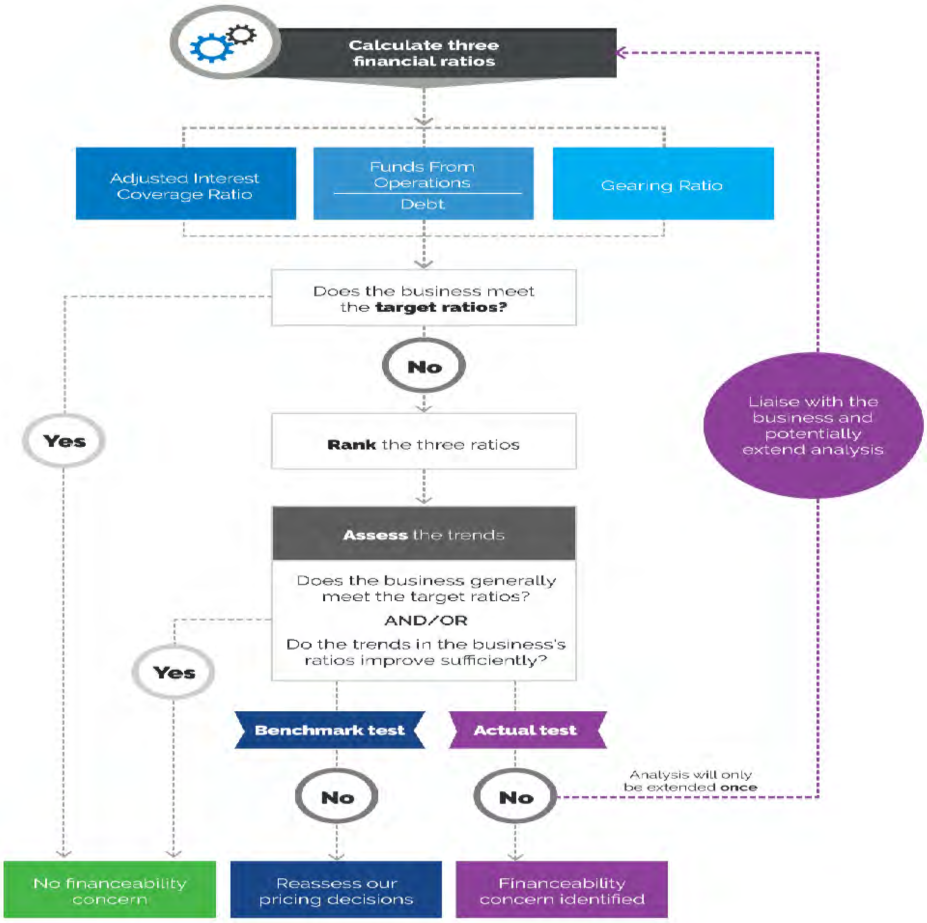
[15] Moody's page 23

3 ASSESSING AND ADDRESSING FINANCEABILITY CONCERNS

3.1.1 Assessing financeability concerns

Hunter Water appreciates IPART's efforts to setting out a clearer process to identify whether a financeability concern exists as summarised below:

Figure 1: IPART's process for identifying a financeability concern



Source: IPART, 2018, page 48

The draft report indicates that IPART, when calculating the three financial ratios, would also calculate the FFO interest coverage ratio (which assumes a nominal interest expense), but that this would not influence its initial assessment of the business's financeability.[16] Hunter Water is concerned that potentially significant financeability issues could be overlooked if the nominal interest cover ratio is not taken into account in IPART's initial financeability assessment.

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[16] IPART, 2018, page 49

3.1.2 Addressing financeability concerns

IPART's draft decisions set out remedies for addressing financeability concerns:

> *21 That, if the source of a concern is due to a regulatory setting, we would correct the regulatory setting by reassessing our pricing decision.*
>
> *22 That, if the source of a 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.*
>
> *23 That, if the source of a concern is due to temporary cash flow problems, we could consider an NPV-neutral adjustment to prices.*
>
> *24 That, if we consider an NPV-neutral adjustment is appropriate:*
>
> - *First, we would consider whether it is appropriate to implement this adjustment over the regulatory period under review.*
> - *Second, if we do not consider this adjustment should be restricted to the regulatory period under review, we could consider:*
>   - *whether it is appropriate to implement an adjustment by allowing a higher depreciation allowance in the period under review in order to increase prices in the next regulatory period, or*
>   - *an explicit adjustment to the pricing path over the regulatory period. If we made such an adjustment, we would publish the value of this adjustment in present value terms. This would allow a future Tribunal to consider this adjustment in a future regulatory period.*[17]

We note that at each price review IPART's expenditure consultants review a utility's proposed operating and capital expenditure to ensure that it is prudent and efficient. We therefore assume that IPART's draft decision 22 refers to an ex-post review of the prior price path that identifies imprudent and/or inefficient business decisions that were not allowed for within the relevant determination. The final report could clarify this.

We support IPART's draft decision 24 recognising that in some cases remedies may need to extend beyond one regulatory period. However, adjusting depreciation rates in one period and resetting them in the next does not constitute an appropriate remedy. Depreciation rates should be set objectively to reflect asset lives and support long-term financial stability. We would support IPART's second proposed remedy option of explicit NPV adjustments in relation to shorter term cash flow issues.

[17] IPART, 2018, pages 53-54

4 REFERENCES

Hunter Water Corporation, 2018, *Hunter Water Submission Review of Financeability Test 2018, Response to Issues Paper*, Newcastle, June.

Sydney Water, 2018a, *Submission to IPART's financeability test issues paper*, Sydney, June

Sydney Water, 2018b, Dr Tom Hird, Competition Economists Group, *IPART review of financeability test*, Sydney, June

Sydney Desalination Plant, 2018, *Review of financeability tests – Response to Issues Paper*, Sydney, June

NSW Treasury, 2018, *Response to request for submissions on IPART's issues paper, "Review of our Financeability Test"*, Sydney, June.

Moody's Investors Service, 2015, Rating Methodology Regulated Water Utilities, December.

APPENDIX A: HUNTER WATER RESPONSE TO IPART'S DRAFT DECISIONS

THE FINANCEABILITY TEST FRAMEWORK

1. That we would continue to conduct financeability tests.

Support consistent with our response to the issues paper.

2. That the objectives of the 2018 financeability test are to:

- **ensure our pricing decisions would allow an efficient investment-grade rated business to raise finance and remain financeable during the regulatory period (benchmark test), and**
- **assess whether the actual business would be financeable during the regulatory period (actual test).**

Support consistent with our response to the issues paper.

3. That we would continue to use the criteria in the 2013 test and conduct a financeability test if:

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

Support consistent with our response to the issues paper.

4. That we would continue to use quantitative data to assess a business's financeability.

As detailed in section 3.5 of our response to the issues paper we consider that the financeability test should have some regard to relevant and material qualitative data.

IMPLEMENTING THE TEST

5. That we would conduct separate financeability tests, using the inputs for a benchmark efficient business and for the actual business.

Support consistent with our response to the issues paper.

6. For the benchmark test, we would use the real cost of debt and gearing ratio in the WACC and include the allowance for inflation indexation over the regulatory period.

Hunter Water supports use of the nominal cost of debt see section 2.1.1.

7. For the actual test, as a default we would use the business's current debt outstanding, forecast interest expense and dividend payments. If the business's interest expense is on a nominal basis, we would not include the inflation indexation component in the interest expense.

Support apart from the proposed exclusion of the inflation indexation component in the interest expense.

8. That we would use the tax allowance from the building block as the tax expense for the benchmark test.

Hunter Water supports.

9. That we would calculate the tax expense for the actual test using the process outlined in Table 4.3.

Hunter Water supports.

10. That we would make adjustments for operating lease expense, superannuation net liabilities and inflation accretion in the actual test only.

Support apart from the proposed inflation accretion adjustment (see 2.1.1).

11. That, as a default, we would conduct both financeability tests on the portion of the business for which we are setting prices.

Support consistent with our response to the issues paper.

12. That we would consider on a case-by-case basis whether to conduct the actual test using financial data for the whole business.

Support consistent with our response to the issues paper.

13. That we would assess a business's financeability over the upcoming regulatory period unless a financeability concern arises.

Hunter Water, as outlined in section 3.4 of our response to IPART's issues paper, considers that five years is a reasonable forecast period. We agree that this could be extended if a financeability issue is identified subject to data availability.

FINANCEABILITY ASSESSMENT

14. That we would continue to use a BBB target credit rating across all industries.

Support consistent with our response to the issues paper.

15. That we would calculate the following ratios for the benchmark and actual tests:

- **The Adjusted Interest Coverage Ratio (AICR).**
- **An adjusted Funds From Operations (FFO) divided by Debt ratio.**
- **The Debt divided by RAB, or Gearing, ratio (which is fixed for the benchmark test).**

Hunter Water considers that IPART should not replace the current ICR with the AICR and that FFO should not be adjusted to remove inflation (see section 2.1.2). We also consider that the ratios should include Retained Cash Flow (RCF) over debt.

16. That we would calculate the Interest Coverage Ratio (ICR) and the (unadjusted) FFO/Debt for the actual test as a diagnostic tool only.

Hunter Water considers that both of these ratios should continue to be formally included in the financeability test (see section 2.1.2).

17. That we would rank the financial metrics to place more weight on the AICR and adjusted FFO/Debt ratios, and to place less emphasis on the Gearing ratio.

Support – in line with retention of the established ICR approach.

18. **That we would adopt the following target ratios:**

- **An Adjusted Interest Coverage Ratio and an Interest Coverage Ratio of greater than 1.8 times.**
- **A FFO over debt ratio greater than 6%.**
- **A debt to RAB gearing ratio less than 70%.**

Hunter Water's comments on these ratios are provided in table 4.

19. **That we would adopt the process in Figure 5.1 to identify whether a financeability concern exists.**

Hunter Water supports.

ADDRESSING A FINANCEABILITY CONCERN

20. **That, if we identify a financeability concern, we would separately test whether this concern is due to:**

- **setting the regulatory allowance too low**
- **the business is taking imprudent or inefficient decisions, and/or**
- **the timing of cash flows.**

Support consistent with our response to the issues paper.

21. **That, if the source of a concern is due to regulatory error, we would correct the regulatory error by reassessing our pricing decision.**

Support consistent with our response to the issues paper.

22. **That, if the source of a 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.**

Support – see further comment in section 3.1.2.

23. **That, if the source of a concern is due to temporary cash flow problems, the Tribunal could consider an NPV-neutral adjustment to prices.**

Hunter Water supports.

24. That, if the Tribunal considers an NPV-neutral adjustment is appropriate:

- **First, it would consider whether it is appropriate to implement this adjustment over the regulatory period under review.**
- **Second, if it does not consider this adjustment should be restricted to the regulatory period under review, it could consider:**
  - **whether it is appropriate to implement an adjustment by allowing a higher depreciation allowance in the period under review in order to increase prices in the next regulatory period, or**
  - **an explicit adjustment to the pricing path over the next regulatory period. If it made such an adjustment, we would publish the value of this adjustment in present value terms. This would allow a future Tribunal to consider this adjustment in a future regulatory period.**

Support. However we do not support the proposed option to increase depreciation rates in one regulatory period and then reset them in the next (see section 3.1.2).