

Submission to the Independent Pricing  
and Regulatory Tribunal's draft  
decision

## **Financeability tests in price regulation**



**WATER SERVICES**  
ASSOCIATION OF AUSTRALIA

## **OVERVIEW OF WSAA**

### **WSAA IS THE INDUSTRY BODY THAT SUPPORTS THE AUSTRALIAN URBAN WATER INDUSTRY**

Its members and associate members provide water and wastewater services to approximately 17 million Australians and many of Australia's largest industrial and commercial enterprises.

The Association facilitates collaboration, knowledge sharing, networking and cooperation within the urban water industry. It is proud of the collegiate attitude of its members which has led to industry-wide approaches to national water issues.

WSAA can demonstrate success in the standardisation of industry performance monitoring and benchmarking, as well as many research outcomes of national significance. The Executive of the Association retain strong links with policy makers and legislative bodies to monitor emerging issues of importance to the urban water industry. WSAA is regularly consulted and its advice sought by decision makers when developing strategic directions for the water industry.

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## WSAA submission to IPART's review of financeability tests in price regulation

### Key messages

- A financial viability or financeability test is a vital element of the regulatory framework, and one that is underdeveloped in the regulation of water utilities in Australia.
- Most water regulators have considerable discretion over the approach to setting prices and in determining the cost of capital.
- This is particularly the case for IPART which is required under its act to balance a wide range of factors.
- As such the role of the financeability test is as a cross check that the regulatory approach provides long term financial viability for an efficient utility
- IPART's short term focus for the financeability test is not in the interests of customers. Financial viability problems take time to emerge and time to solve. A short term focus risks price shocks, or reduced service levels to customers.
- Similarly, the benchmarks in IPART's draft decision suggest that it would not address financeability issues until financial problems have already emerged. A utility just meeting the benchmarks is likely to need to borrow just to fund replacement capital expenditure, let alone fund new growth, meet water security requirements or pay dividends.
- IPART's approach should not be seen as a precedent for other regulators.
- A better approach is to address problems before a utility risks losing investment grade status.
- This could be achieved if IPART set benchmarks that are consistent with a minimum BAA1 (Moody's) or BBB+ (S&P) credit rating.

### 1.0 Introduction

The Water Services Association of Australia welcomes the opportunity to comment on the IPART's draft decision on financeability tests in price regulation.

WSAA is the industry body which supports the Australian urban water industry. Our members include the largest water utilities in Australia, providing urban water services to around 17 million Australians. The Association facilitates collaboration, knowledge sharing, networking and cooperation within the urban water industry. We also provide a forum for debate on issues important to the industry and a voice for communicating the members' views.

WSAA makes submissions to state reviews where they have national implications or raise issues of particular interest to the wider membership. Financial viability is a key issue for the industry and IPART's draft decision is the first detailed discussion of the issue from an economic regulator. Throughout this submission WSAA uses the term financeability interchangeably with financial viability.

Water utilities in most parts of Australia have followed a common path over the last ten years, underpinned by the need to respond to the millennium drought. Utilities undertook significant capital expenditure on desalination, recycling, stormwater harvesting and dams to

improve the level of water security. This necessitated significant price rises. In conjunction with energy price rises there is a significant level of community concern with the affordability of services.

Affordability has been a key theme in recent price determinations handed down by economic regulators. For a number of utilities price rises have been below the inflation rate. However, the combination of higher borrowings, permanently lower demand for water and low price outcomes has raised the issue of securing a long term price path that provides for financial viability.

It is pleasing that IPART is recognising the need for a clear position on this issue. However, WSAA has two major concerns with the draft decision.

- Firstly, it suggests the financeability test is a narrow short term test, rather than being primarily concerned with long-term financial performance.
- Secondly, the numerical benchmarks IPART adopts in the draft decision are not appropriate measures of financial viability.

WSAA's purpose in providing a submission is twofold: to seek changes to IPART's final decision; but also to set out why the draft should not be viewed as a precedent in other jurisdictions or adopted by other economic regulators.

## 2.0 The role of the financeability test

WSAA considers that the prime role of the financeability test is to ensure that an efficient utility is financially viable in the long term, rather than the short term focus ascribed to the test by IPART. IPART's approach is unlikely to serve the long term interests of consumers

IPART argues that the objective of the financeability test is to assess whether the business can continue to borrow funds in financial markets in the short term — the next four to five years. It says:

The purpose of our financeability test is to assess if a utility could obtain additional financing in financial markets based on their current actual financial position, consistent with an investment grade firm. This is a short term test, for the next 4-5 years of a determination period.

The critical issue this raises is 'what is there to ensure long term viability'. IPART claims that its approach to pricing ensures long term viability.

Our approach to setting prices ensures that utilities are financially sustainable for the long term. Under the building block model, we set prices to cover the efficient costs of a benchmark business. This includes a market-based return for equity and debt holders.

This characterisation is a significant oversimplification of how IPART, and other economic regulators set prices.

First, the building block model is not a mechanical or deterministic formula. It allows significant discretion as to how the model is applied, and in the choice of the parameters for the key variables. The parameters comprising the Weighted Average Cost of Capital are only the most obvious: the treatment of tax, the process for indexation and the degree of

risk sharing within the framework all involve significant judgement. There is no guarantee that the adoption of a building block model per se will provide long term financial viability.

More fundamentally, IPART has oversimplified how it approaches the regulatory task. In its inquiry into urban water, the Productivity Commission drew attention to the mixed objectives that a number of economic regulators are required to follow. The PC report cited the Queensland Competition Commission as an example, but it could have equally cited IPART or other regulators.

In making determinations IPART is required to take account of the matters listed in section 15 of its act (see box 1). IPART is required to weigh up a number of competing factors and strike a balance. The implications of this were set out by a tribunal member (now former member) in a speech to IPART's 2010 conference.

In addition to the tension between many of the section 15 matters, it is important to note the residual discretion given to IPART, to have regard to "any other matters" the Tribunal considers relevant. And so we balance the need for cost reflective pricing against the protection of consumers from excessive price shocks, and we balance the need of State utilities to be rated BBB+ against the need for consumers to adjust to price increases which are individually manageable but cumulatively difficult, and we balance the need for State utilities to invest capital expenditure in big lumps against the needs of consumers to have prices glide upwards rather than step upwards, and we balance the interests of those who benefit from capital projects now against those who will benefit from them in the future.<sup>1</sup>

In determinations, IPART will often provide the notional revenue requirement — the output from its building block model — and a different target revenue which reflects how IPART has balanced the factors in its act.

#### **Box 1: Matters IPART has regard to when making determinations**

In making determinations and recommendations, the Tribunal is to have regard to the following matters (in addition to any other matters the Tribunal considers relevant):

- a. the cost of providing the services concerned,
- b. the protection of consumers from abuses of monopoly power in terms of prices, pricing policies and standard of services,
- c. the appropriate rate of return on public sector assets, including appropriate payment of dividends to the Government for the benefit of the people of New South Wales,
- d. the effect on general price inflation over the medium term,
- e. the need for greater efficiency in the supply of services so as to reduce costs for the benefit of consumers and taxpayers,
- f. the need to maintain ecologically sustainable development by appropriate pricing policies that take account of all the feasible options available to protect the environment,
- g. the impact on pricing policies of borrowing, capital and dividend requirements of the government agency concerned and, in particular, the impact of any need to renew or increase relevant assets,
- h. the impact on pricing policies of any arrangements that the government agency concerned has entered into for the exercise of its functions by some other person or body,
- i. the need to promote competition in the supply of the services concerned,
- j. considerations of demand management (including levels of demand) and least cost planning,
- k. the social impact of the determinations and recommendations,
- l. standards of quality, reliability and safety of the services concerned (whether those standards are specified by legislation, agreement or otherwise).

<sup>1</sup> Downloaded IPART website 15 October 2010, p. 7

<http://www.ipart.nsw.gov.au/Home/Quicklinks/Speeches/Speech - IPART Conference - 7 May 2010 - Sibylle Krieger>

Given this approach, IPART’s statement in the draft decision that long term financial viability is automatically taken care of cannot be sustained. It follows that a financeability/financial viability test has a critical role. The test provides a vital check to ensure that economic regulators strike the right balance between short term benefits and the longer term interests of customers in having a financially viable service provider with the capacity to continue to invest in and maintain essential assets.

A narrowly focussed short-term test is not in the interests of consumers. Financeability problems take time to emerge and time to resolve. If they are not identified until they become critical, the only options would be price and bill shocks, or impacts on service quality.

On the other hand if problems are addressed early, smooth long-term price paths — that give consumers time to adjust gradually — can address financeability concerns.

**Table 1: Credit rating grades**

S&P	Moody's	Grade
AAA	Aaa	Investment grade
AA+	Aa1	
AA	Aa2	
AA-	Aa3	
A+	A1	
A	A2	
A-	A3	
BBB+	Baa1	
BBB	Baa2	
BBB-	Baa3	
BB+	Ba1	Non-investment
BB	Ba2	
BB-	Ba3	
CCC	Caa	
CC	Ca	
D	C	

Previous stakeholder submission to this review strongly supported the use of notional gearing ratios as part of the test, as well as actuals. WSAA recommendation that the financial viability test should be a long term test and cross check is consistent with this approach.

### 3.0 What are the benchmarks to test for financial viability

Most governments explicitly require their state owned corporations to maintain an investment grade credit rating. The financeability test provides a set of financial ratios to judge whether that criteria is being met. The financial ratios chosen by IPART are standard ratios used by credit ratings agencies and are not controversial.

However, the key issue is what benchmarks against each of the ratios are appropriate for the water industry to maintain an appropriate investment grade credit rating.

IPART’s draft decision is to adopt benchmarks consistent with a Baa3 credit rating — the lowest investment grade rating possible (table 1). Based on a consultant’s report the draft decision adopts the benchmarks set out in table 2.

**Table 2 IPART’s draft decision, financial ratios and benchmarks**

Ratio	Benchmark consistent with Baa3 credit rating
<b>FFO/interest</b>	1.4/1.5 – 1.7 times
<b>Debt/Rab</b>	90% to 100%
<b>FFO/Debt</b>	5% – 8%

WSAA disagrees with the targets set by IPART. Under the Moody’s rating system Baa3 is the minimum rating consistent with investment grade. This is equivalent to BBB- under the Standards and Poors’ rating.

Urban water is an essential service, with very long asset lives. It is also asset intensive. Returns in the industry should be relatively stable, which should enable the industry to access capital to invest at relatively low cost to provide efficient services. It is not consistent with the characteristics of the industry to suggest that credit metrics at the bottom of the lowest investment grade rating – bordering on speculative -- is an acceptable outcome for an urban water utility over time.

Box 2 sets provides an illustrative example of what it would mean for a water business if it had an FFO to interest ratio of 1.5 times. It shows that under reasonable assumptions, the business would not be generating sufficient funds to fund its replacement capital expenditure. It would need to increase borrowings to maintain existing service standards. It also follows that it would need to borrow to:

- Fund growth or other capital expenditure such as for water security
- Pay a dividend to its shareholder.
- Meet any unanticipated shocks to revenue or expenditure.

**Box 1: What does an FFO to interest ratio of 1.5 times mean for a water business**

A simple example illustrates the level of funds that would be available to a business if were to have an FFO to interest ratio of 1.5.

If we assume a company has assets of \$1000, we can use IPART (and other regulators) standard gearing assumption (60% debt and 40% equity) and an interest rate assumption to calculate the level of funds available to the business (FFO).

Category	Value	Comment
Assets	\$ 1,000	Assumption
Debt	\$ 600	IPART WACC assumption
Equity	\$ 400	IPART WACC assumption
Interest rate	6%	IPART Hunter Water Determination
Interest	\$ 36	Calculation
FFO to interest	1.5	IPART's draft decision benchmark
<b>Calculated FFO</b>	<b>\$ 18</b>	Calculation using FFO to interest formula
Replacement capex - 70 year		
life	\$ 14 to \$ 30	

This simple calculation shows that at an FFO to interest ratio of 1.5 the Funds from operation would be \$18. In this example, this is not sufficient to fund replacement capital expenditure to maintain existing service standards. If average asset lives were 70 years, an absolute minimum of \$14 would be needed to fund replacement capex. However, it is common in the water industry for the replacement value of assets to be much higher than the value used for regulatory purposes, and consequently the level of expenditure required to maintain the system is higher than that implied by the regulatory asset value. This is the case for both Sydney Water and Hunter Water, and implies that the amount necessary to replace assets would significantly exceed the funds from operation at a ratio of 1.5.



Under such a scenario debt would increase, in both quantity and costs, without the necessary capacity to fund it. WSAA does not consider that in any reasonable or plain English sense does this represent long-term financial viability. It would necessitate cuts to service standards, or significant price and bill increases.

#### **What should the benchmarks be?**

IPART has traditionally referred to the need for water utilities to have financial ratios consistent with a BBB+ (Standard and Poors) credit rating. The equivalent Moody's rating is BAA1, two notches higher than the IPART draft decision.

Financeability is originally a term imported from the UK, where it has been part of the regulatory framework for many years. Ofwat the UK water regulator applies the financeability test to ensure that utilities can maintain an investment grade credit rating. In its 2009 price determination it specified an FFO to interest ratio of around 3.0 and an FFO to debt ratio of around 13%. These are double the values contained in IPART's draft decision.

WSAA considers that benchmarks consistent with a minimum investment grade rating of BBB+ (S&P), or BAA1 (Moody's) is appropriate for the Australian water industry.

## **4.0 Conclusion**

While WSAA welcomes IPART's focus on the important issue of the financeability test in price regulation we consider that it should amend its final decision.

IPART's current short term focus in the financeability test is not in the interests of consumers. It could result in price shocks to address financial issues that have been addressed too late or inappropriate cuts to service levels. In its current form it does not provide an appropriate precedent for the urban water industry in Australia.

The final decision should recognise that there is no guarantee in the building block regulatory approach that a utility will achieve long term financial viability. To a greater or lesser extent all economic regulators have a degree of discretion. The financeability test is an important cross check to ensure that the right balance between short term benefits to consumers, the long term interests of consumers and the viability of the utility is achieved.