

FACT SHEET

Final Decision - Financeability ratios

April 2015

We conduct a financeability test in price reviews where we use a building block model.¹ The purpose of the test is to assess the implications of our determinations for the financial sustainability of a utility. The financeability test allows us to identify instances where there may be financial sustainability issues.

The financeability test requires us to calculate three financial ratios:

- ▼ **Funds from operations (FFO) interest cover:** calculated as FFO plus interest expense divided by interest expense.² This is a coverage ratio and measures a utility's ability to service its debt.
- ▼ **Debt gearing (regulatory value):** calculated as debt divided by the regulatory value of fixed assets.³ This is a leverage ratio and measures a utility's ability to repay its debt.⁴
- ▼ **FFO over debt:** calculated as FFO divided by debt.⁵ This is a more dynamic measure of leverage than debt gearing and a useful indicator of a utility's ability to generate cash flows.

In December 2014 we released a Fact Sheet that set out changes to ratios we use in our financeability test. We received submissions in response to the Fact Sheet from Hunter Water Corporation (HWC) and Sydney Water Corporation (SWC). They supported all of our proposed changes except for the use of 100% of regulated and non-regulated revenue in our financeability test. The submissions also sought clarification on how we intend to calculate some of the input values used in our test.

Our final decision is to implement the changes outlined in our December 2014 Fact Sheet as set out in Table 1. This Fact Sheet also provides clarification on the issues raised in the submissions (Section 2).

¹ IPART, *Financeability tests in price regulation – Final Decision*, December 2013.

² We previously calculated this ratio as FFO plus net interest divided by net interest. FFO refers to adjusted FFO.

³ We previously calculated this ratio as net debt divided by the regulatory value of fixed assets plus working capital.

⁴ Moody's Investors Service, *Rating Methodology Global Regulated Water Utilities*, December 2009.

⁵ We previously calculated this ratio as FFO divided by net debt.

Table 1 Changes to financeability ratios⁶

Financeability testing parameters	IPART April 2014 template	Changes
Total revenue	Includes 50% of non-regulated revenue	Include 100% of non-regulated revenue
Cash Flow from Operations (CFO)	Receipts from customers less operating cost less tax paid less change in working capital	Exclude one-off gains or losses from sale of assets
FFO (unadjusted)	Pre-tax profit plus depreciation less tax	Use cash flow from operations prior to movements in working capital
Debt (last actual/historical financial year)	A hardcoded input value provided by utilities	Include all debt on balance sheet plus capitalised operating leases plus shortfall in defined benefit pension obligations
Debt (forecast) and debt roll-forward	Opening Debt plus or minus cash	Not to deduct cash from debt
Adjusted interest expense	Interest expense plus 1/3 operating lease expense	Use actual interest expense plus 1/3 of current year lease obligations plus interest rate times the shortfall on pension obligations
Adjusted net debt	Debt less cash plus operating lease debt plus superannuation adjustment	Not to deduct cash from debt
Net debt / (RAB plus working capital)	Adjusted net debt divided by adjusted RAB plus working capital	Exclude working capital and do not adjust the RAB
FFO to Debt	Adjusted FFO divided by adjusted net debt	Adjusted debt (excluding cash)

1 Clarification on input value calculations

In response to stakeholder submissions, we have clarified how some of the input values into our ratios will be calculated below.

Adjusted interest expense

What our stakeholders said

SWC requested clarification on how the actual interest expense and rate will be calculated.

⁶ IPART, *Fact Sheet - IPART financeability test ratio calculation*, December 2014.

Our response

We adjust the interest expense by adding one third of current year lease obligations plus pension shortfall expense (calculated as any shortfall in defined benefit pension schemes times the actual interest rate). This is consistent with the advice we obtained from our consultant Kanangra in 2014.⁷

We will require utilities to submit their forecast actual interest expense. We will calculate the actual interest rate by dividing the actual interest expense by total balance sheet debt.

Total revenue

What our stakeholders said

HWC disagreed with including 100% of non-regulated revenue because 50% is returned to customers through reduced revenue requirements. SWC asked us to ensure consistency by including revenue only to the extent that associated costs of generating that revenue are also included in the ratio calculation.

Our response

Our financeability test is based on the actual financial position of a utility, using the actual gearing level and the actual interest expense. To be consistent, we will include all revenue (both regulated and non-regulated) in ratio calculations.

Our standard practice is to include revenue only if the costs of generating that revenue are also included. We will continue to apply this principle.

Debt

What our stakeholders said

SWC asked us if our approach to calculating debt will change given our new approach to capitalising finance leases into the RAB

Our response

Debt will be calculated as total balance sheet debt (which includes the value of finance leases) plus the capitalised value of operating leases plus and any shortfall in defined benefit pension schemes. We believe that this provides us with the most accurate estimate of the actual level of gearing including finance leases over a regulatory period.

⁷ Kanangra Ratings Advisory Services, *Advice to IPART concerning the calculation of metrics*, November 2014.

Funds from operation (FFO)

What our stakeholders said

HWC and SWC noted that income tax paid on developer contributed assets is not included in IPART's calculation of FFO. For example, HWC notes that this is inconsistent with our tax building block model which includes tax paid by the utility on developer contributed assets.

Our response

We will include the income tax paid on all capital contributions⁸ to make the FFO consistent with our tax building block model.

However, we note that the effective tax rate for utilities is generally lower than the statutory tax rate of 30%. We may consider using a benchmark effective tax rate for FFO calculations in the financeability test in the future.

2 Updated financeability and tax calculations in IPART's website model template

The updated IPART cost building block model template on our website reflects our modified approach to calculating the financial ratios.⁹

The updated model template includes two changes to the building block tax allowance. The changes are:

- ▼ The WACC inflation is used for all tax calculations instead of the inflation rate used to escalate costs and prices.
- ▼ Tax on the share of profits from disposals that is shared with customers is included.

⁸ This includes cash developer contributions, assets free of charge and grants.

⁹ http://www.ipart.nsw.gov.au/Home/Industries/Research/Reviews/Financial_Models/IPART_cost_building_block_and_pricing_model