

# Embedding Financial Viability and Sustainability

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The purpose of this paper is to review the RIC's approach in the first price review towards assessing financeability, to determine whether this approach remains valid and to discuss how the RIC will respond to potential financeability issues in the future.

Summary  
Document

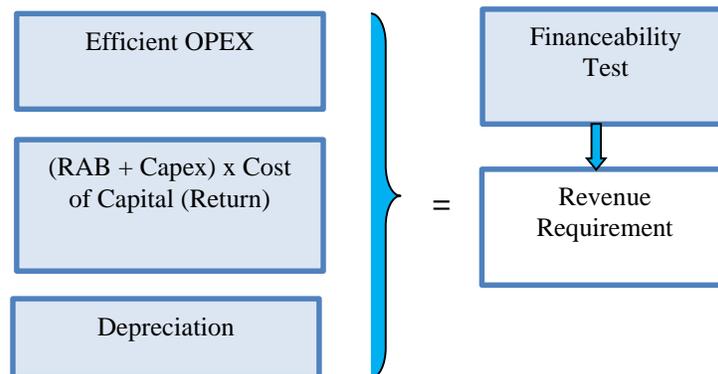
## Background

The Regulated Industries Commission (RIC) is mandated by legislation to ensure that the service providers under its purview remain financially viable. The RIC is also required under its Act to set price controls every five years, which is a process whereby an assessment of the service provider's revenue requirement is made by the regulator, and tariffs are set to levels that will enable financial viability and sustainability of the service provider's operations.

## Approach to Ensuring Financial Viability and Sustainability

In its first regulatory control period 2006-2011, the RIC utilised the building block methodology to establish the revenue requirement for T&TEC. The methodology, as illustrated in Figure 1, shows that the total allowed revenue requirement includes all efficient operating and maintenance (Opex) costs, plus allowances for "return on" (cost of capital) and "return of" (depreciation) T&TEC's regulatory asset base.

**Figure 1 - Overview of the Revenue Requirement Calculation**



The due diligence exacted in calculating the revenue requirement ensures that only efficient costs are allowed for cost recovery. These efficient costs form the basis upon which an appropriate tariff structure is designed. For the 2021-2026 regulatory control period, the RIC intends to continue to use the building block methodology to provide the means for T&TEC to remain financially viable over the regulatory control period.

## Challenges in Regulating for Financial Viability and Sustainability

**Building-block Approach** - As long as the cost of capital and other variables/factors are estimated correctly, the building-block method should ensure long-term financial viability of the service provider with the use of benchmarking or comparative efficiency assessments.

**Notional or Actual Gearing Ratio** - the gearing ratio feeds into the building-block model and the financeability assessment. Some regulators used notional gearing while others use actual gearing ratio of the service provider. There are advantages and disadvantages to either approach. The RIC utilised notional gearing for the last price review and intends to continue with this approach.

**Cost of Debt and Capital** - In the first determination, the RIC discussed approaches to calculating the cost of capital, including whether to use the true WACC (i.e. as a Government-owned entity) or to use a private sector surrogate. The RIC considered that a combination of a forward-looking cost of capital, and an allowance for embedded fixed rate debt, provided a more reasonable approach than the traditional WACC approach.

**Anticipatory Investment** - a significant amount of investment in renewable generation will be required based on government targets and much of this may occur at locations currently not equipped for the transmission of such energy. How investments made on an anticipatory basis should be regulated is an issue, as there is the risk that the provision made for anticipatory investment may not be fully utilized.

## Assessing Financeability in the Second Price Review

The RIC will assess the financeability of T&TEC by undertaking the following steps:

- i. Forecasting cash flows over the determination period;
- ii. Projecting financial statements from the forecast cash flows; and
- iii. Computing financial ratios from the financial statements.

The RIC will calculate five financial ratios as part of the financeability test and measure those ratios against the indicated target:

Ratio	Formula	Target
• Funds Flow Interest Cover (times)	$(\text{FFO} + \text{Net Interest}) / \text{Net Interest}$	Between 2 to 3
• Debt Payback Period (years)	$\text{Net Debt} / \text{FFO}$	Between 5 to 7
• Funds Flow/Net Debt (times)	$\text{FFO} / \text{Net Debt}$	Between 0.15 to 0.2
• Internal Financing Ratio (%)	$(\text{FFO} - \text{Dividends}) / \text{Net Capex}$	Minimum 40
• Debt as a proportion of the RAB (%)	$\text{Net Debt} / \text{RAB}$	Below 65

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