

14 February 2014

Water Team
Essential Services Commission
Level 37, 2 Lonsdale Street
MELBOURNE VIC 3000

Dear Sir/Madam,

Re: Assessing the financeability of Victorian water businesses consultation paper

We welcome the Commission's release of the consultation paper on assessing the financeability of Victorian water businesses including the accompanying NERA report. It is important that the Commission continues to undertake robust financeability assessment as part of price reviews including, if necessary, adjustments to pricing outcomes. Our response to the Commission's questions are detailed below:

- 1. Do stakeholders agree with NERA's view that there should be no adjustments to the financeability assessments to account for government ownership of the Victorian water businesses? Please explain the reasons for your view.**

We agree with NERA's view that the Commission's financeability assessment of the Victorian water businesses should be consistent with the principle of competitive neutrality.

Yarra Valley Water, like other Victorian Government Businesses under competitive neutrality principles, is subject to:

- a tax equivalent regime; and
- a financial accommodation levy that recognises the implied cost of the Government guarantee to ensure borrowings are at commercial rates of interest. Like all Victorian water businesses, we borrow through the Treasury Corporation of Victoria (TCV) and interest is charged at commercial rates through a combination of TCV rates, reflecting the State Government borrowing rate, and a financial accommodation levy based on our "standalone credit rating".

The pricing principles in the Water Industry Regulatory Order (WIRO) also support the view that the Commission should undertake financeability assessments of Victorian water businesses on a standalone basis. Under the first pricing principle in the WIRO, the Commission is required to "provide a sustainable revenue stream for a regulated entity.....". Given this requirement, it is expected that, if a water business is experiencing financeability issues, it would be appropriate

for the Commission to provide a revenue stream that allows the business to be financially sustainable irrespective of the ownership structure of the business.

- 2. Do stakeholders agree with NERA's proposition that any adjustment to prices (for financial viability reasons) should be implemented on an NPV neutral basis? Please explain.**

We agree with NERA's proposition that any adjustments to prices should be implemented on a NPV neutral basis. Over the medium to long term, water businesses or customers should not be advantaged or disadvantaged by financial viability issues. A key consideration will be the length of time the adjustment is required to ensure financial viability. While it is important to minimise the amount of the adjustment and the length of time for the support received by a business, any adjustment needs to be sufficient to address the financeability issues rather than having an ongoing issue.

- 3. Are the indicators and ranges we currently apply, or those proposed by NERA, appropriate for financeability assessments for water businesses? Please explain and/or identify any alternative indicators and ranges.**

We agree with NERA that a financeability assessment of a regulated water business should be focused on maintaining an "investment grade rating". Rating agencies – Moody's, Standard and Poor's and Fitch – determine whether companies have "investment grade" credit ratings and it is appropriate to use their metrics in defining the appropriate indicators and ranges for water businesses given the competitive neutrality arrangements .

NERA used the Moody's financial metrics in its paper. The financial indicators and ranges recommended by Moody's for a Baa or higher rating are appropriate in most cases for the ESC to make its own financeability assessments. We do, however, have concerns about the adoption of a ratio of greater than 70% for the Net Debt/RAV indicator. Our experience and modelling would suggest that Australian water businesses may experience financial stress at a Net Debt/RAV ratio of 70% or greater.

We also support the adoption of a dividend cover ratio. The metropolitan water businesses do pay a commercial level of dividend, that takes into account the amount tax paid. The inability of a water business to maintain its dividend policy would signal financeability issues. This metric could be a secondary measure as recommended by NERA.

- 4. Is the Commission's focus on interest cover appropriate? Should the Commission weight or prioritise the indicators for the purposes of financeability assessments? Explain, and if applicable, outline weightings or the order of priority for indicators.**

Interest cover is a critical measure in determining the financeability of a water business. Adverse positions in other measures such as Debt/RAV would also be reflected in a low interest rate cover.

For a more complete financeability assessment, we recommend the adoption of the weightings in Moody's quantitative assessment rankings. It is important that any financeability assessment undertaken by the Commission be consistent with assessments that would be undertaken by the credit ratings agencies.

5. **Are there any profit measures (other than statutory profit) that are not beholden to individual businesses' accounting policies or different application of the accounting policies between businesses?**
6. **If the Commission were to consider using profit, should the approach be symmetric, potentially increasing prices where profits are low and decreasing prices where profits are high?**

We do not believe it is necessary to use a profit measure, other than statutory profit measure used in a dividend cover metric. Ratings agencies' quantitative assessments are cash focussed. It is our view that any profit measures would be of limited value.

We do not support the Commission using a strategy of increasing prices where profits are low and decreasing prices where profits are high. We support NERA's proposition that any adjustments to prices should be implemented on a NPV neutral basis. It is likely that such adjustment may have the effect of increasing prices where profits are low and decreasing prices where profits are high. For financeability purposes, it is not necessary, or appropriate, for the Commission to undertake a profit smoothing exercise.

7. **Should the Commission make adjustments for operating leases, superannuation obligations, or capitalised interest in any financeability assessment? Please explain.**

We support the Commission making the same adjustments that Moody's makes to the financial statement to reflect the underlying economics of transactions – these adjustments will better reflect the cash flows of the business. For Yarra Valley Water, these items are not material but for other Victorian water businesses these adjustments may change the outcome of a financeability assessment.

Should you have any queries in regard to this submission please do not hesitate to contact Brett Mathieson, Manager Regulation and Planning, on 9872 2441.

Yours faithfully



Pat McCafferty
General Manager, Strategy and Communications

