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VICTORIAN WATER
INDUSTRY ASSOCIATION INC.

20 February 2014

Water Team
Essential Services Commission
water@esc.vic.gov.au

Re: Assessing the Financeability of Victorian Water Businesses – VicWater submission

Thank you for the opportunity to provide comment on your consultation paper which considers the Essential Services Commission's (the Commission's) approach to assessing the financeability of Victoria's water businesses. This response represents the views of the Victorian Water Industry Association (VicWater), in particular that of Victoria's regional and rural businesses. VicWater is aware that a number of its members will be making separate submissions as they relate to their business, including the metropolitan businesses. We ask that you consider our submission in conjunction with these other submissions.

VicWater is the peak industry association for water businesses in Victoria and contributes to and influences the development and implementation of Government policies relating to water and wastewater services within Victoria. All 19 Government owned businesses are members of VicWater.

The following pages provide a general overview of responses from Industry to the questions provided in your consultation paper.

As is highlighted in our response to the questions, it is difficult to have a "one size fits all" or standardised approach. The most significant point of differentiation is the profit objective. Metropolitan water businesses are considered "for profit" for statutory reporting purposes whilst regional and rural businesses are considered "not for profit". The most significant impact in this area relates to asset valuation and asset accounting and depreciation. As a consequence, regional and rural water businesses carry asset values significantly higher than the Regulatory Accounting Base (RAB) whilst metropolitan water businesses have asset values that are more closely aligned to the RAB. This means that using statutory measures for the purpose of establishing performance metrics for financeability may be appropriate for metropolitan water businesses but are generally not appropriate for rural and regional water businesses.

Water corporation boards are accountable to the shareholder (the Victorian Government) for the performance of water corporations. This includes achieving the financial viability and performance requirements of the shareholder; and ensuring the business remain viable to meet long term commitments including the cost efficiency objectives of water businesses implicit in the regulatory framework of the Commission.

Any decision about financeability would be assisted by greater clarity from the Department of Treasury and Finance (DTF), as the shareholder, on appropriate levels of debt. There is an opportunity for DTF, as the agency responsible for the overall management of the state's debt and administering the annual borrowing approvals process, to establish clearer guidance to water businesses on expectations of financial performance where there are pricing and debt tradeoffs to be made in pricing decisions. This needs to be covered in the context of achieving long term price stability but also ensuring the state continues to achieve its overall objective of maintaining a AAA credit rating.

The Water Industry Regulatory Order (WIRO) and Statement of Obligations (SoO) should be amended to make clear the arrangements for assessing financial viability. Water businesses should then be responsible for submitting plans which include sufficient revenue to maintain viability.

VicWater would welcome further opportunities to assist the Commission with its engagement with water corporations on this work. Please feel free to contact me directly to discuss on (03) 9639 8868.

Yours sincerely

Tony Wright
Chief Executive Officer

RESPONSES TO ESC QUESTIONS

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

   The view of NERA is supported but there is a need to better understand the risk concepts that effect individual water businesses. If all businesses are not considered equal as to their potential impact on the 'investment grade of the state', this will need to be reflected in pricing decisions or otherwise reflected in moderated expectations of returns to shareholders.

   Some of the issues associated with rural risk in the water industry relate to the extent of investment that the regional water sector has had to make to meet compliance obligations (water quality in particular) that have not been fully funded.

   With this in mind, it is considered that any decision on whether to target a particular credit rating should be made by the Department of Treasury and Finance.

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.**

   The views across Industry were mixed:

   For some businesses, it was considered that unforeseen circumstances could arise from planning assumptions that were the subject of adjustments made by the ESC and/or its technical advisors; or from incorrect assumptions established in the calculation of the opening Regulatory Asset Base upon entry to independent price and service regulation

   Other businesses considered that any adjustments made for financial viability reasons should be applied on an NPV basis as this would provide for an equitable outcome.

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.**

   For "not-for-profit" entities, generally only the cash based indicators are relevant. However, the "For-Profit" entities support the proposal to include a profitability measure as part of a financial sustainability check.

   Profitability assessments are considered important in the privately owned utility sector. Water sector profitability measures are distorted in large part by differences between statutory and regulatory asset valuations – this can be mitigated by focussing on EBITDA profitability and return measures.

   FFO Interest Cover
   The focus on interest cover is appropriate and it is agreed that this needs to be the primary focus in regulatory decisions.

   However, it should be noted that, while FFO can be benchmarked, in the absence of real competition there can be little evidence to conclude that these benchmarks reflect efficient operations or the "recovery of efficient costs". For a measure of efficiency the industry would need to draw on some of the tools and techniques of management accounting such as standard costing and activity based accounting. The effect of these measures can be profound in relation to the determination of prices under the building block model.

   Capital Adjusted Interest Cover
   Capital Adjusted Interest Cover is a reasonable metric, however, given the impact of the implementation of regulation and low RAV's for some businesses, this metric may not accurately reflect the full replacement cost of assets

Net Debt / RAV (Gearing)
An appropriate metric, however, its explanatory power is limited for businesses which have significant other activities which incur debt. In addition the range suggested by NERA (85%-70%) appears to be high for not for profit businesses and we would consider the current ESC range of 65% to 45% to be more appropriate.

However, we note that the upper gearing ratio of 65% is inconsistent with the benchmark used to determine the weighted average cost of capital. Is this logical?

Internal Financing Ratio
Further investigation of the methodology used to calculate the internal financing percentage is required given that the regulator treats cash contributions from developers as both an operating cash flow (the numerator) and as an offset to capital expenditure (the denominator).

FFO/Net Debt
While providing an insight into a company's ability to repay its debts, it does not consider the impact where there is a significant capital program which will utilise cash flows and therefore the ability to repay debt.

Dividend Cover
This is only relevant to "For Profit" entities

The lack of a policy on debt management continues to be a problem. Given the expectation that water businesses are to be geared, there needs to be greater clarity from the shareholder through the Department of Treasury & Finance on what is a desirable interest cover ratio and an associated credit rating for water businesses to aspire to. The water industry has invested heavily over the past decade to augment water supplies and deliver on compliance obligations specific to improved water quality and environmental performance. This investment has impacted on the interest coverage ratios and generally diminished the strength of the balance sheets of the water industry.

In the free market economy gearing (or leveraging) is used to increase returns to shareholders where the cost of debt is lower than expected returns from the application of the debt. In the water sector, as we know, all but a few Corporations barely break even so there can be no financial benefit to the shareholder from gearing in these circumstances. Therefore debt can only be justified in the long term to support desirable capital development.

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.**

The Commission's focus on interest cover is appropriate but needs to take a long term view. The investment cycle of such long lived assets needs to be considered in any regulatory pricing decision.

Where a water business is faced with a large tranche of investment any decision needs to be considered in the context of long term price stability. A water business leading up to a large investment may want to substantially strengthen its balance sheet if prices are set to maintain a target price consistent with comparable benchmarks. Such a strategy will have the effect of improving the credit rating and potentially reducing the cost of debt for the lifecycle of the investment where this is internally financed.
The only other indicator of significance is the internal financing ratio as this indicator will determine the extent that a business is generating sufficient free funds from its operations to reinvest in the business to maintain service levels.

In order to comment on weighting, we'd need to understand how the weighting would be used in making a viability assessment. In the first instance, we'd expect that viability indicators reflect a pass or fail, and so weighting would not be necessary.

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?**

   Our understanding of the scope of this review is that it is concerned with assessing viability by reference to cashflow adequacy.

   Whilst the indicators currently applied are appropriate there is also a need to consider some form of profitability measure in addition to the existing cash based measures, In using these measures it is critical for the shareholder to understand that for some water corporations debt is increasing resulting in a different risk profile.

   A broader review of sustainable revenue would need to consider accrual accounting measures as indicators of medium to long term financial sustainability.

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?**

   Profit measures are not appropriate for water businesses that were established with zero or near zero RAV's, as they consistently produce losses before tax due to their large asset bases and high statutory depreciation relative to regulatory asset values and regulatory depreciation. In addition we acknowledge the impact of changes in accounting treatment on profit.

   Further there should be consideration of the treatment of cash and non-cash revenue (gifted assets) in the assessment of profit.

   Adjusting prices up and down in line with profitability would be inconsistent with the long term price stability objectives of the WIRO.

   Raising prices on an accruals (rather than cash) basis is a very different proposition to the current model, and requires much further review. In particular, we would need to determine how cash accumulations and deficits are reflected in pricing, and also recognise customer preference for price stability, which may mean maintaining prices above cost recovery for a period and offsetting the resulting surplus against future increases. At other times, we may transition to higher pricing over a number of years, which means accumulating deficits in the short term, and repaying those deficits from pricing above cost recovery in the longer term.

   In all cases however, it should be the responsibility of the water business to consult with customers on price paths.

7. **Should the Commission make adjustments for operating leases, superannuation obligations or capitalized interest in any financeability assessment? Please explain. Are there other adjustments that are worth our consideration and if so, what are these and why?**

   It is considered that this would add another level of complexity with limited or no benefits and therefore any such adjustments should only be considered if sufficiently material to affect financial viability.

   The only volatility in superannuation generally vests with defined benefits schemes that are assessed intermittently. The membership and associated liability will diminish over time as the number of active members diminishes. This could be offset where adverse economic conditions have the impact of increasing the exposure. Unfunded calls by superannuation funds should be recognised in the cost base of businesses where they are sufficiently material.

   Interest is generally not capitalised and any decision to enter into an operating lease should be premised on an efficient way of doing business.

   Further, these are indicators only and any individual business with financeability constraints will be working with the Commission to explore and resolve financeability constraints specific to that business.