

ESSENTIAL SERVICES COMMISSION

ASSESSING THE FINANCEABILITY OF VICTORIAN WATER BUSINESSES

COMMENTS FROM WESTERNPORT WATER

Executive Summary

Westernport Water appreciates the opportunity to provide comments on the specific questions raised by the Essential Services Commission (the Commission) on Assessing the Financeability of Victorian Water Business.

Whilst providing responses to the seven questions posed in the assessment we also provide comment as to future direction of the water industry in particular the increasing burden of debt. Although this assessment focuses on the ability of a corporation to service the debt our concern is the level of debt itself.

We note within the NERA report the following comment “financeability is not a major concern for the majority of Victorian water service providers”. We assume NERA have formed this perspective from applying various ratios across the industry. While many corporations within the industry are in no immediate financial threat, many are concerned about the long term financial viability of the water sector. If there is an over reliance on KPI’s to measure outcomes and less attention on how the industry perceives its future, we may miss the real opportunity to “assess the financeability of our water sector”.

The industry needs to set and agree KPI’s which allow current performance and possible future performance to be assessed. The trends from the KPI’s are the most important measure coming from the KPI’s not whether more measures should be added to the list. A poorly performing business is more likely to show unfavourable results in many of its financial measures. While further measures could be added to show more specific outcomes, such additions will unlikely change the overall financial assessment of the business.

Westernport Water therefore recommends no change to the mix of current indicators used by the Commission. Rather we would suggest tailoring the benchmarks of these indicators. Secondly we request further dialogue with the Commission in respect to our concerns about the level of debt and the long term financial viability of the water sector.

Responses to the Questions raised by the Commission

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.*

Government ownership places the business into a different operating environment than would otherwise be experienced by the private sector. While a government business has some attributes of the private sector ie independent Board, sub committees of the Board, ability to set strategic direction, required to operate profitably to be accountable and responsible for its actions.

Being government owned brings responsibility which are not present in the private sector and the Commission needs to consider:

- a) The additional reporting obligations and therefore cost. An example is SRIM.
- b) Higher community obligations than the private sector.
- c) Changes in the direction of government policy.
- d) Compliance with general government policy, an example could be FRD's.

The items listed above place a greater fixed cost onto the government business relative to that of a privately owned business. In our opinion the Commission should leave open the option to make allowances for government ownership on a case by case basis.

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.*

While we generally subscribe to the proposal that " price increases for viability in the near term should be paid back to customers through lower prices later", we believe the Commission should clarify it's position with regard to medium to longer term structural financial viability issues which may beset a water corporation.

We also agree with the principle of the Commission's comment "it is not the role to increase prices to rectify poor business decisions". This is justifiable in the case of short term financial constraints, but how is the Commission to react to a business which may have been poorly managed over a number of years and the solution to those problems may require long term corrective action. It is not clear how the Commission will respond to such challenges.

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.*

3.1 Current Indicators

In our opinion the current indicators provide the Commission and water businesses with an adequate basis to measure and determine the financial viability of the water sector. However we offer the following comments on how these measures could be better applied.

Primary Indicator: We acknowledge the FFO interest cover ratio removes the effect of non-recurrent revenue to place an emphasis on the real cash needs of the business. We also note the Commission has an objective for each water business to achieve an investment grade credit rating. These two objectives need to be drawn together. Credit ratings use Interest times cover ratios (cash flow basis) and have their own thresholds which identify whether an organization is performing above or below investment grade.

We would recommend the Commission set a benchmark minimum for this ratio which in the opinion of the Commission reflects the minimum which would equate to the water corporation achieving an investment grade credit rating. This would replace the current “Benchmark Range” of 1.5 to 3.0 times.

Secondary Indicator: Internal Financing Ratio (IFR). A deteriorating IFR is a future affordability indicator which may not initially manifest in a financial problem for a water corporation. For example a water business which is increasing the level of its external debt in an economic cycle of falling interest rates may not show the potential financial viability through measuring the Primary Indicator until either the debt has so substantially increased or the interest rate cycle changes to a rising interest rate environment.

We believe the Commission needs to re-evaluate the importance of this ratio and re-set its current “benchmark” of >35%. The build up of debt within the industry needs to be addressed and we concur with the findings of the Auditor General – see below. The setting of a higher benchmark will assist businesses to reshape their capital expenditure reform programs to a more financially sustainable level.

In support of our concerns the Victorian Auditor General provided the following comment in his 2012-13 annual report to the Parliament of Victoria.

Financial sustainability

Over the past five years, interest bearing liabilities have increased by \$10.3 billion, or 248 per cent, with finance costs now accounting for 21 per cent of the water industry's total operating costs each year. Accordingly, it is critical that water entities effectively manage interest rate risk. Servicing the growing debt and repaying that debt in the future are key challenges for the water entities. The ability of one metropolitan water entity to repay its debt is currently rated as low and another may encounter difficulties in repaying debt in the future.

Four entities were rated as having a high financial sustainability risk at 30 June 2013 due to the magnitude of their operating losses. This is an outcome of the pricing model that regulates the prices entities can charge their customers for water and services provided. This issue is one of a number of matters being considered by a Water Industry Financial Sustainability (WIFS) working group established during 2011–12.

The Auditor General notes that servicing the debt is only one measure of financial sustainability, the other measure being the ability of the water corporation to repay the debt. Much of the Victorian water sector debt is interest only, we are concerned the current financial viability tests may not appear to provide sufficient encouragement for water corporations to address the repayment of debt.

These comments provided by the Victorian Auditor General provide adequate warning of the financial health of the water sector. The IFR should form a Primary Indicator as recommended by the NERA report and the “Benchmark Range” should be lifted from >35% to a level which encourages water corporations to be less reliant on incurring more debt to fund their investment activities. We believe a higher IFR benchmark could stimulate water corporations to strive for efficiency gains and cost reductions to generate higher ‘cash flows from operating activities’ consistent with current ESC objectives.

3.2 Proposed NERA Indicators and Ranges

The proposed measures add little to the existing measures used by the Commission. Although the tighter “Benchmark Range” on the FFO Interest Cover is an improvement, as we noted above the “Range” should be replaced with a minimum only “Benchmark”.

We are not sure the new measure “Capital Adjusted Interest Cover” adds further value to the understanding of whether the water business has a financial viability issue. If a water business is at the low end of the “FFO” then it is likely to be scoring a low benchmark for the Capital Adjusted Interest Cover. The ‘trend’ the ratio or measure is registering should provide sufficient guidance as to whether the business is performing well or could potentially endure hardship. Adding a further measure which subtly refines the outcome of the FFO appears to have limited justification.

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.*

4.1 An interest cover ratio is required. It forms an essential management KPI for all businesses for both self-assessment and external review. While there are numerous interest cover ratios, the critical measure is not the absolute outcome but more importantly the direction over time to indicate whether a business has the capability to meet future obligations.

With that in mind the relative components of the numerator or denominator are of lesser importance than the trend. We do not recommend the Commission change from the current “FFO Interest Cover ratio”.

4.2 We do not concur with the establishment of weightings for indicators. The Commission has already set its objectives which are different to those of an external ratings agency which is

attempting to rank an organisation for credit worthiness. The credit agency is required to place rankings on both qualitative and quantitative measures to derive the credit rating outcome.

We believe the role of the ESC should not be one to rank the regulated water businesses by the use of the financeability assessment.

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?*

We do not propose to offer any profit measures to be included within the financeability assessment.

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?*

The Commission should assess a wider profile of measures as part of its consideration to movements in price. Of increasing importance to the customer base is the relative affordability of our customers to pay above the CPI on an ongoing basis. From our perspective there seems to be no direct link between the price and the profit in any one year. Corporations with special financial needs will continue to be assessed by the Commission on the relative merits impacting that entity. This may include an assessment of the items comprising the profit, but more likely the assessment of the entity's cash flow statement would have more relevance.

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

7.1 Operating leases

Given the nature of most operating leases, reflecting sundry office equipment etc being of low value, we would not recommend any adjustment. The Commission may consider adjustment necessary where the proportion of the annual obligations was material, to some agreed benchmark.

7.2 Superannuation Obligations

Outstanding commitments to unfunded defined benefit superannuation cannot be estimated by the water corporation, rather the water corporation is dependent upon the triennial actuarial assessment. If the corporation is required to make a contribution to the defined benefit fund it may not necessarily imply that any future contributions may be required. On this basis it does not indicate to us that it will determine a future financeability issue, therefore we do not recommend an adjustment.

7.3 Capitalised Interest

Under AASB 123 Borrowing Costs, Aus 8.1 A not-for-profit public sector entity may elect to recognise borrowing costs as an expense in the period in which they are incurred regardless of how the borrowings are applied.

Rural Regional Water corporations are likely to hold the “not for profit” status and elect not to capitalise borrowing costs.

We recommend the Commission not to request an adjustment for capitalised borrowing costs.