ASSESSING THE FINANCIAL VIABILITY OF VICTORIAN WATER BUSINESSES

Summary of views and proposed new indicator

June 2014

An appropriate citation for this paper is:

Essential Services Commission 2014, *Assessing the financial viability of Victorian water businesses: Summary of views and proposed new indicator*, June.

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1 BACKGROUND

In December 2013, we released a consultation paper considering the Essential Services Commission's (the Commission's) approach to assessing the financial viability of Victoria's water businesses.

We established our approach to financial viability tests in Victoria's water industry when we started regulating the sectors prices in 2004. Since then, we have approved prices meeting the financial viability objectives set out in the *Essential Services Commission Act* (2001) – see Box 1, *the Water Industry Regulatory Order,* and the Australian Competition and Consumer Commission's *Water Charge Infrastructure Rules*.[1]

It is possible that the prices estimated via a building block methodology (the approach to establishing prices used by the Commission in past price reviews) may not provide a business with sufficient cash flow to remain viable in the short-term. This may reflect a number of factors, such as the use of benchmark finance costs in establishing prices.[2] Prices established via other incentive based approaches to pricing (for example, benchmarking or index based approaches) can also lead to prices being set at a level inconsistent with financial viability. A financial viability test allows us to make a 'safety net' adjustment to prices if the regulatory pricing model results in prices that would leave a water business financially unviable.

It is in the long term interests of customers that a business is financially viable so it can provide services desired by customers. A business should be in a position to do so when expected revenues enable an efficient water business to pay its bills as they fall due, and undertake its forecast capital program in order to deliver services.

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1 Note that from 2012, the Commission was accredit by the ACCC to regulate the prices for rural infrastructure services delivered by Goulburn Murray Water and Lower Murray Water.

2 For further details see: NERA Economic Consulting 2013, *Assessing the Financeability of Regulated Water Service Providers – A report for the Essential Services Commission*, October, p.4-5.

BOX 1 ESC ACT AND WIRO IN RELATION TO FINANCIAL VIABILITY

Section 8 of the *Essential Services Commission Act* (ESC Act) 2001 states the Commission's objective:

> *(1) In performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers.*
>
> *(2) Without derogating from subsection (1), in performing its functions and exercising its powers in relation to essential services, the Commission must in seeking to achieve the objective specified in subsection (1) have regard to the price, quality and reliability of essential services.*[3]

Section 8A of the ESC Act specifies that the Commission must have regard for the financial viability of the industry:

> *(1) In seeking to achieve the objective specified in section 8, the Commission must have regard to the following matters to the extent that they are relevant in any particular case— …*
>
> > *(b) the financial viability of the industry*

Section 14 of the *Water Industry Regulatory Order* outlines regulatory principles, including the need for the Commission to be satisfied prices provide for a sustainable revenue stream:

> *(1) In order to be satisfied that prices, or the manner in which such prices are to be calculated or otherwise determined, comply with the Regulatory Principles, as required by this Order, the Commission must:*
>
> > *(a) be satisfied that the prices contained in the Water Plan which the regulated entity proposes it be permitted to charge for prescribed services over the term of the Water Plan, or the manner in which the Water Plan proposes that such prices are to be calculated or otherwise determined, are such as to:*
> >
> > > *(i) provide for a sustainable revenue stream to the regulated entity that nonetheless does not reflect monopoly rents or inefficient expenditure by the regulated entity*

The financial viability test is not an alternative means of establishing prices and does not displace normal approaches. The financial viability test acts as a filter to identify any potential financial viability issues. Further, the Commission does not determine the financial policies of the water businesses – this is an issue for business management and their owners.

The maximum prices we approved in the 2013 price review provided for the financial viability of all 19 water businesses. Further, we note that only one business has sought an adjustment to prices based on viability concerns since we began regulating the prices of the water industry in 2004. Nevertheless, we want to test whether we need to

[3] *Essential Services Commission Act* 2001, Section 8.

make any changes for future price reviews given that economic, financial and industry conditions have changed since commencing our price determination role.

The nature of the financial viability test currently used by the Commission is set out in our December 2013 consultation paper. The main features of our current approach are:

- We base our approach on that taken by private sector credit ratings agencies. This is because the quantitative ratios used by the rating agencies provide a useful reference point due to their wide currency, and reflect accumulated experience on the key ratios that provide a guide to financial viability.

- The Commission uses four quantitative indicators to assess the financial viability of water businesses. These are set out below (along with definitions):

TABLE 1.1 CURRENT FINANCIAL INDICATORS USED

Indicator	Calculation	Benchmark Range	Description
Primary indicator			
FFO interest cover	(FFO + net interest) / net interest	1.5 to 3.0 times	Measures the extent of the cash flow buffer a business has to meet its debt obligations.
Secondary indicators			
Net Debt / Regulatory Asset Value (%) (Gearing)	(Interest bearing liabilities – cash) / RAV	65 to 45 per cent	Measures the debt component of the regulatory capital structure.
FFO / Net debt (%)	FFO / (Interest bearing liabilities – cash)	>10 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
Internal financing ratio (%)	(FFO – dividends) / net capital expenditure	>35 per cent	Measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after dividends.

Notes: FFO refers to ‘funds from operations’, and RAV refers to the ‘regulatory asset value’.

- We incorporate the indicators and benchmark ranges into the financial templates we provide to water businesses as part of our price reviews.

- Three of the four indicators above are cash based indicators. We have preferred cash-related indicators as they are not influenced by a business’s accounting policies, and therefore provide a more reliable view of a business’s underlying financial position.

- The financial viability test is based on whether a business meets an investment grade credit rating, based on outcomes for ratios for the indicators above. We use investment grade as the benchmark for the financial viability test. If a business meets investment grade, an efficiently run business should be in a position to pay its bills as they fall due, and undertake its forecast capital program in order to deliver services.

- We have not weighted the individual indicators in financial viability assessments. However, we have prioritised interest cover in our assessments as it gives the best indication of a business's ability to meet finance and other payment obligations.
- The Commission uses actual data (including historic data and forecasts) for its financial viability tests, as opposed to notional data. Notional data uses benchmarks (such as for gearing), so does not provide a true indication of a business's financial position.

2 FEEDBACK ON OUR CONSULTATION PAPER

In December 2013, the Commission's consultation paper sought feedback on our current approach to financial viability tests, and on the recommendations in a report prepared for us by NERA Economic Consulting (NERA). We commissioned NERA to prepare a paper to inform our future approach.[4] Drawing on our existing approach and NERA's recommendations, our consultation paper sought feedback on seven questions. The Commission received nine submissions in response to our December 2013 consultation paper, had discussions with ratings agencies, and engaged in one-on-one meetings with individual water businesses.

This chapter summarises feedback to each question in our consultation paper. For each question, we provide an initial view as outlined in our consultation paper, key issues raised by stakeholders, and our updated view.

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4 NERA Economic Consulting 2013, *Assessing the Financeability of Regulated Water Service Providers – A report for the Essential Services Commission*, October

CONSULTATION PAPER Q1

Do stakeholders agree with NERA's view that there should be no adjustments to the financial viability assessment to account for government ownership of the Victorian water businesses?

OUR INITIAL VIEWS

Consistent with our past approach and NERA's recommendations, our view was that we should continue to test whether a business meets the equivalent of an investment grade credit rating in order to determine whether a financial viability adjustment to prices is required. If a water business meets investment grade, an efficiently run business should be in a position to pay its bills as they fall due, and undertake its forecast capital program in order to deliver services.

However, we sought feedback from stakeholders on whether the threshold of investment grade should account for government ownership of the water businesses. Adjusting for government ownership would make it easier for an entity to meet an investment grade rating, relative to an (otherwise) equivalent private sector entity.

SUMMARY OF RESPONSES TO OUR CONSULTATION PAPER

Almost all submissions supported the Commission's current approach that assesses whether a water business meets the equivalent of an investment grade credit rating. VicWater considered that any decision to target a credit rating should be made by the Department of Treasury and Finance (DTF).

The majority of submissions agreed with NERA that the threshold of investment grade used in our financial viability tests should not take into account government ownership of the water businesses. Goulburn Valley Water, in supporting this approach, noted that the water businesses are Government Business Enterprises required to trade independent of government. Outlining an alternative view, South East Water believed government ownership should be taken into account when determining benchmarks for financial viability, given this is usual practice for private ratings agencies.

COMMISSION VIEW

We confirm our initial view that we should continue to test whether a business meets the equivalent of an investment grade credit rating in order to determine whether a financial viability adjustment to prices is required. This approach is supported by submissions.

The Commission does not agree with VicWater that DTF should be responsible for determining a target credit rating for the purposes of our financial viability tests. This would confuse the roles of owner/shareholder and the economic regulator. As noted earlier, the financial targets used internally by a business are a matter for its management and owner. DTF would be likely to set a higher threshold based on its objective for financial management of such entities – not a target for price intervention.

We note that in undertaking assessments of credit ratings, private ratings agencies take into account government ownership. For example, Moody's assessment of the credit rating of Sydney Water Corporation included a four-notch credit rating uplift to account for the high likelihood of State support should the business encounter viability issues.[5]

The Commission believes the approaches taken by private sector ratings agencies provide a sound basis for our financial viability assessments. We will continue to base financial viability tests on the approaches taken by private ratings agencies (i.e. taking into account government ownership), and reflect government ownership implicitly within the benchmark ranges we adopt for our viability indicators.

[5] https://www.moodys.com/research/Moodys-assigns-A1-rating-to-Sydney-Water-Corporation-Outlook-stable--PR_263959 - accessed 19/5/2014

CONSULTATION PAPER Q2

<u>Do stakeholders agree with NERA's proposition that any adjustment to prices (for financial viability reasons) should be implemented on an NPV neutral basis?</u>

OUR INITIAL VIEWS

Our initial view was that any adjustment to prices based on financial viability grounds should be implemented subject to NPV neutrality (that is, price increases for viability in the near term should be paid pack to customers later through lower prices). This would mean that over the long run a business would recover no more than efficient costs via customer prices. We have not previously considered making price increases for viability subject to NPV neutrality.

SUMMARY OF RESPONSES TO OUR CONSULTATION PAPER

The majority of submissions supported our initial view that any adjustment to prices based on financial viability grounds should be implemented subject to NPV neutrality. Lower Murray Water (LMW) supported the principle of NPV neutrality, albeit noting that the rebalancing of prices should occur over a reasonable time period so a business does not re-enter an unviable financial position.

The VicWater submission noted that views were mixed across the sector. VicWater considered that our adjustments to the pricing proposals of water businesses during price reviews, and/or incorrect assumptions used to establish the opening regulatory asset base (RAB) for each business, could influence financial viability.

COMMISSION VIEW

We confirm our initial view that any adjustment to prices based on financial viability grounds should be implemented subject to NPV neutrality. The Commission notes the weight of responses to our consultation paper in favour of NPV neutrality. This will help to ensure that a business will recover (via customer prices) only its efficient costs.

The Commission agrees with LMW that in deciding the timeframe over which funds are to be paid back to customers, consideration will need to be given to the financial position of the business. A return of funds to customers may need to occur over multiple years. The speed at which any water business would return funds would be assessed on a case-by-case basis by the Commission, having regard for forecast outcomes for the ratios used in our viability tests.

VicWater identified two possible influences[6] on financial viability. The price setting methodology accounts for such influences – not the viability assessment. The financial viability assessment occurs only after the application of the price setting methodology, meaning it is a true 'safety net'.

6 The first matter – Commission adjustments to pricing proposals – is made after advice from external consultants and public consultation. The second matter – opening RAB – is a once only (or 'line in the sand') decision by the Minister.

CONSULTATION PAPER Q3

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

OUR INITIAL VIEWS

Our initial view was that a continued focus on cash flow based indicators of financial viability, similar to those currently used by the Commission, ratings agencies, other regulators and as recommended by NERA, is appropriate.

We sought views from stakeholders about whether we should modify the indicators and ranges we use to conduct our financial viability tests.

Table 2.1 compares the indicators and ranges currently used by the Commission with NERA's recommendations. NERA recommended a set of primary indicators that would form the basis of our financial viability assessments—the same as those currently adopted by the Commission—and two new secondary measures—capital adjusted interest cover and dividend cover.[7] Relative to the Commission's current ranges, NERA recommended an increase in the benchmark used for interest cover, gearing and the internal financing ratio. NERA's recommendation for FFO / net debt was not much different to our current benchmark.

TABLE 2.1 INDICATORS AND RANGES

Indicator	NERA's proposed	ESC's current
	Primary indicators	**Primary indicator**
FFO interest cover	1.8 to 2.5 times	1.5 to 3.0 times
Capital adjusted interest cover[8]	1.2 to 1.5 times	Indicator not currently used
		Secondary indicators
Net Debt / RAV (%)	85 to 70 per cent	65 to 45 per cent
FFO / Net debt (%)	10 to 6 per cent	>10 per cent
Internal financing ratio (%)	100 to 50 per cent	>35 per cent
	Secondary indicator	
Dividend cover[9]	More than 100 per cent	Indicator not currently used

7 Capital adjusted interest cover is an alternative specification of interest cover, which looks at the cash flow buffer a business has to meet its debt obligations.

8 Capital adjusted interest cover = (FFO + interest expense – nominal RAV depreciation) / interest expense.

SUMMARY OF RESPONSES TO OUR CONSULTATION PAPER

Indicators

The majority of submissions supported retaining the existing set of indicators used by the Commission in its financial viability tests.

In terms of NERA's proposed dividend cover indicator, some businesses such as Yarra Valley Water supported inclusion of the measure on the basis that metropolitan water businesses pay a commercial level of dividend, and the indicator may be useful in identifying financial viability issues. Others including Melbourne Water and South East Water questioned the value the dividend cover indicator would add to the financial viability test.

A number of submissions however, supported the addition of a new measure that focused on profitability or a measure of the return on assets achieved by a water business (which was seen as relevant for the water businesses classified as 'for profit' entities). We explore a new measure focusing on returns later in the paper.

Indicator benchmarks

Most submissions also indicated a preference for the current ranges used by the Commission for each indicator, albeit Yarra Valley Water and Melbourne Water supported the relaxation of the ranges for interest cover and the internal financing ratio. Yarra Valley Water and VicWater suggested that NERA's proposed range for gearing was too high. Southern Rural Water queried the relevance of upper (or lower) limits for each indicator.

It was evident in our consultation that some confusion existed in relation to the benchmarks we apply for our viability tests. For the avoidance of doubt, the benchmarks we apply are not targets for either the businesses or the Commission.

We use these lower threshold benchmarks to assess a business's financial viability, and whether regulatory intervention is warranted. For example, we do not set targets for a business's mix of debt and equity or its level of debt. Instead, we use benchmark ranges that rest at the margin of investment grade status.

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[9] Dividend cover = Earnings per share / Dividends per share = Earnings / Dividends. We would need to assume a proxy for the numerator and denominator to be applicable to water businesses.

Businesses' management and boards set financial targets in consultation with the Department of Treasury and Finance; in practice, we would expect to find that their targets would differ from threshold benchmarks adopted by the Commission.

COMMISSION VIEW

We intend to maintain the current set of indicators we use in our financial viability tests. We note the strong support in submissions for the indicators we currently use. Further, it is desirable to maintain consistency with the indicators used by ratings agencies.

Drawing on comments from Southern Rural Water regarding the relevance of benchmark ranges for the financial indicators, we propose to identify a point estimate for each financial indicator that will input to our financial viability assessments.

In terms of each of the indicators:

Interest cover

We propose to maintain the current (lower) benchmark of 1.5 times. However, taking into account NERA's views and those of some businesses, we will use 1.8 times as a threshold to where we will flag a caution in any of our price decisions or performance reporting about the financial position of a water business. We will also focus on interest cover to assess the magnitude and timing of any necessary financial viability adjustment (and the timing of the return of funds to customers via lower prices).

Gearing

Taking into account NERA's recommendation and the significantly higher ranges adopted by ratings agencies for gearing (compared with our existing ranges), we believe there is merit in lifting the gearing indicator's benchmark from its current level.

Noting industry concerns about using a higher gearing benchmark, we propose to use a point estimate of 70 per cent for gearing (consistent with NERA's proposed lower bound), up slightly from the current upper bound of 65 per cent used by the Commission.

Note however, that gearing can also be an indicator of business decisions about the appropriate finance mix. As noted in our consultation paper, we do not believe a financial viability adjustment to prices should be made if the viability issue reflects management decisions. Therefore, if a business exceeds the gearing benchmark used in our financial viability test, and it can be demonstrated that the business had not exhausted alternative solutions to a financial viability issue, we may not make an adjustment to prices based on this indicator.

Internal financing ratio

The Commission did not receive many comments from stakeholders on the internal financing ratio. We believe there is limited merit to changing the benchmark range for the indicator from the current level of greater than 35 per cent.[10]

FFO/Net debt

The Commission received limited comments in relation to the indicator. We propose to leave the measure unchanged with a benchmark range of more than 10 per cent.

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[10] VicWater and South East Water raised the treatment of customer contributions in the internal financing ratio. In certain instances customer contributions do not fully cover growth capital expenditure, which can require a business to take on greater debt. We will consider this when undertaking our financial viability assessments. We also note South East Water's query in relation to new customer contributions being included in the denominator and numerator of the internal financing ratio. We believe using net capital expenditure (which removes customer contributions from the denominator) addresses the matter.

CONSULTATION PAPER Q4

<u>Is the Commission's focus on interest cover appropriate? Should the Commission weight or prioritise the indicators for the purposes of financial viability assessments? Explain, and if applicable, outline weightings or the order of priority for indicators.</u>

OUR INITIAL VIEWS

Our consultation paper noted that we have not provided specific weightings to the individual indicators in financial viability assessments. However, we have used interest cover as the primary indicator for our financial viability assessments. This is largely based on the observation that interest cover gives the best indication of a business' ability to meet cash obligations (for example, operating payments and financing costs).

SUMMARY OF RESPONSES TO OUR CONSULTATION PAPER

The majority of submissions outlined support for the Commission's focus on interest cover for financial viability assessments, albeit most stated that we should continue to consider other measures of financial viability in addition to interest cover.

South East Water noted that there should be a strong focus on interest cover along with other measures that are useful in assessing financial viability. Goulburn Valley Water believed that the weighting of the various ratios is not required because they all need to be considered, and different circumstances may change the emphasis on various ratios over time. Only Yarra Valley Water thought we should specify a weighting for each indicator.

COMMISSION VIEW

Consistent with the majority of submissions and NERA's recommendations, we will not specify numeric weightings for each indicator that we use in our financial viability tests. We agree with Goulburn Valley Water that flexibility is needed in undertaking financial viability assessments.

However, for transparency, we think there is merit in ranking the indicators in order of importance to our financial viability tests. This will allow us to focus on the ratios that are most relevant for us when assessing the likely financial viability of a business.

The Commission will continue to prioritise interest cover in our assessments of financial viability. We note the support in submissions for an ongoing focus on interest cover in our financial viability tests. In terms of rankings, we will then consider gearing. FFO / net debt, our new proposed indicator, and the internal financing ratio will be given the lowest priority in our viability tests.

CONSULTATION PAPER Q5 AND Q6

<u>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?</u>

<u>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?</u>

OUR INITIAL VIEWS

Our initial view was that statutory profit is not an appropriate indicator for viability assessments because:

- it is influenced by a business' accounting policies and their interpretation, both of which can change over time. Therefore, statutory profit may not be easily compared across businesses or across different years for an individual business.
- it may not provide a reasonable indication of a businesses' ability to pay bills as they fall due or finance capital investments (which is critical to financial viability tests).
- its calculation includes transactions related to activities that are not covered by the regulatory framework.

While we did not think statutory profit should be considered in our financial viability tests, we sought stakeholder views on other profitability measures that could be useful.

SUMMARY OF RESPONSES TO OUR CONSULTATION PAPER

Submissions from the metropolitan businesses supported the addition of an indicator of profitability or returns to the suite of indicators we use for financial viability tests. VicWater noted that such a measure would be relevant for 'for profit' entities only.

Submissions also acknowledged that accounting treatments affect the calculation of statutory profits, and that the financial viability assessment should focus on cash-based indicators. Melbourne Water believed a measure of statutory profit (or something equivalent) is necessary, noting that ongoing losses were inconsistent with good commercial practice.

In addition, Pawsey and Crase 2014 highlighted comparability issues exist within the financial statements of Victorian water businesses – issues stemming from Victorian water businesses' application of different asset valuation techniques, different assumed useful asset lives and the impact of revaluations on financial results.[11]

In terms of profit-related measures, VicWater and South East Water proposed an approach based on EBITDA, which removes allowances for capital-related and financing items from the calculation of earnings, giving an indication of profitability/returns.

Submissions gave some, but limited, support to adopting an approach that adjusts prices down when profits are high and up when profits are low – which Yarra Valley Water's submission referred to as 'profit smoothing'.

COMMISSION VIEW

In relation to the Commission adopting a symmetric (or 'profit smoothing') approach that adjusts prices for high/low profits, we do not propose to adopt such an approach because we are not adopting a specific measure of profit.

The Commission retains its view that statutory profit is not an appropriate indicator for our financial viability assessments for the reasons listed above. However, we believe that there may be merit in adding a new indicator focusing on earnings that is relevant to all businesses not just 'for profit' entities.

Below, we outline a proposed new indicator for further feedback. Note we believe that any new measure should be useful, calculable from the existing regulatory templates, and not place any further reporting burden on businesses. We believe the new indicator meets these criteria. We refer to the new indicator as 'Proportion of Discretionary Revenue (PDR)'.

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[11] Nicholas Pawsey and Lin Crase 2014, Review of the Statutory Asset Values of Victorian Water Businesses, January 2014 p31.

Proposed 'Proportion of Discretionary Revenue' Indicator

The 'Proportion of Discretionary Revenue' indicator compares "discretionary" earnings against total revenue over time.

The formula for the indicator is:

PDR = (R – O – T – I) / R, where

R = Regulated Revenue

O = Operating Expenditure

T = Actual Tax Payments

I = Actual Interest Payments

The indicator is based on inputs used for our price determinations, and will be updated for historic actuals at each price review. The new indicator reflects the proportion of regulated revenue earned that is available for a business (and its shareholder) to allocate at their discretion. A business can use these discretionary fund capital works, reduce debt, lower prices and/or pay dividends.

The size of the margin would indicate the degree of discretion available to a business; and if the margin was negative on an ongoing basis, it may reflect the business is not financially viable and/or faces significant financial stress. The capacity for a business to meet any unexpected payment obligations should be greater when the ratio is higher.

We do not think a specific benchmark range for the PDR indicator is appropriate. Instead, the trend across price periods and overtime would provide useful contextual information to our viability assessments.

We seek feedback from businesses in relation to the proposed new indicator.

CONSULTATION PAPER Q7

<u>Should the Commission make adjustments for operating leases, superannuation obligations, or capitalised interest in any financial viability assessment? Please explain. Are there other adjustments that are worth our consideration and if so, what are these and why?</u>

OUR INITIAL VIEWS

The question in our consultation paper was part of a broader discussion on the nature of the inputs that we should use to conduct our financial viability tests. The main issue in financial viability tests is whether to use estimates of actual financial data rather than notional financial data—notional financial data uses benchmarks of key inputs such as gearing to assess the financial position of a water business.

The Commission's consultation paper noted our view that estimates of actual rather than notional financial data should be used to estimate financial ratios, consistent with our current practice. We agree with NERA that the use of notional data is unlikely to provide an understanding of a water business' actual financial position, which is critical for a financial viability assessment.

We sought feedback on the merits of NERA's proposed adjustments to the input data used to calculate financial indicators. For most businesses, the adjustments proposed by NERA would not be relevant and/or would not have a material impact on the calculation of viability indicators.

SUMMARY OF RESPONSES TO OUR CONSULTATION PAPER

Some submissions recommended making adjustments was appropriate, but a key theme was that adjustments needed to be material.

> VicWater: *"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."*

> Yarra Valley Water: *"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 financial viability assessment."

COMMISSION VIEW

The Commission will continue to use estimates of actual rather than notional financial data to estimate financial ratios – consistent with our current practice. We agree with NERA that the use of notional data is unlikely to provide an understanding of a water business' actual financial position, which is critical for a financial viability assessment.

We propose to assess any business proposals to make adjustments for leases or other financial adjustments on a case by case basis—that is, any changes to the cash model used by the Commission need to be substantiated by water businesses. Substantiation could include the recommended approach to financial adjustments (such as for finance leases) provided by ratings agencies to the relevant business.

3 SUMMARY OF OUR PROPOSED FUTURE APPROACH

In our future financial viability assessments, we propose to:

- Use the five quantitative indicators outlined in table 3.1. These indicators focus mainly on cash flow, which we believe gives us the best indication of a business's underlying financial position.
- For interest cover, gearing, FFO / net debt, and the internal financing ratio, assess whether a business meets an investment grade credit rating based on outcomes for ratios for each of the indicators. The ratios we propose to use are provided in table 3.1.
- Rank estimates for interest cover highest in terms of importance in conducting our financial viability assessments, with gearing ranked second. FFO / net debt, internal financing ratio, and the PDR indicator will be ranked the lowest in terms of the importance to our financial viability assessments.
- Make any future viability adjustments on a NPV neutral basis. Note while price increases for financial viability usually occur over one pricing period, we would likely smooth the return of funds to customers through lower prices over a number of years to ensure a business does not re-enter a financially vulnerable position.
- Not increase customer prices to rectify business decisions – for example, if a business chose to take on high gearing and had no extenuating circumstances. Where business decisions threaten a business's financial viability, primary responsibility rests with a business's management and board to address the issue.
- Use historic and forecast actual data for financial viability tests as opposed to notional data.
- Consider adjustments proposed by businesses to the inputs used in our tests (such as for leases) on a case-by-case basis, allowing only material adjustments proposed and substantiated by businesses.

TABLE 3.1 PROPOSED FINANCIAL INDICATORS

Indicator	Calculation	Benchmark Range	Description
Primary indicator – used to determine size of adjustments			
FFO interest cover	(FFO + net interest) / net interest	> 1.5 times < 1.8 times used as a caution	Measures the extent of the cash flow buffer a business has to meet its debt obligations.
Secondary indicators – used only as contextual information to determine whether an adjustment is necessary			
Net Debt / Regulatory Asset Value (%) (Gearing)	(Interest bearing liabilities – cash) / RAV	< 70 per cent	Measures the debt component of the regulatory capital structure.
FFO / Net debt (%)	FFO / (Interest bearing liabilities – cash)	> 10 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
Internal financing ratio (%)	(FFO – dividends) / net capital expenditure	> 35 per cent	Measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after making dividends.
Proportion of Discretionary Revenue (PDR)	(Regulatory Revenue – Operating Expenditure – Actual Tax – Actual Interest) / (Regulatory Revenue)	No benchmark range	This indicator gives a reflection of an entity's earnings and discretionary funds available – discretionary funds that can be used to give a return to the shareholder, reduce debt, lower prices, reinvest in an entity's assets, and manage unexpected cashflow constraints.

Notes: FFO refers to 'funds from operations', and RAV refers to the 'regulatory asset value'.

4 NEXT STEPS

Stakeholders may wish to provide feedback before we finalise our approach to our future financial viability tests in July to August 2014. In particular, we are seeking feedback on the proposed new indicator. Written comments are due by 25 July 2014.

We would prefer to receive written comments by email to water@esc.vic.gov.au.

If you have any queries, please contact Matt Donoghue on 03 9032 1330.

You can also send comments by mail to:

Water Team

Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

The Commission's normal practice is to make all submissions publicly available on its website. If you do not wish us to disclose information publicly, please provide a confidential version and a version that is suitable for publication.