Barwon Water

21 February 2014

Mr Marcus Crudden
Acting Director Regulation, Water
Essential Services Commission
Level 37, 50 Lonsdale Street
Melbourne 3000

Dear Marcus,

Re: Assessing the Financeability of Victorian Water Businesses - Consultation Paper

I am writing to you in response to the Commission's *Financeability Indicator Review* consultation paper released in December 2013.

Barwon Water's responses to the Commissions queries in the consultation paper are provided in Attachment 1.

Barwon Water appreciates having the opportunity to provide feedback to you on this matter.

Yours sincerely,

Michael Watson.

Michael Watson
General Manager Busienss Services

Attachment 1 - Barwon Water Response to 'Assessing the Financeability of Victorian Water Businesses'

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Attachment 1 – Barwon Water Response to 'Assessing the Financeability of Victorian Water Businesses'

Commission seeking comment on:	Barwon Water Response
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.	**Barwon Water's view is that, if the primary purpose of the assessment is to measure and potentially re-open or adjust prices to prevent financial stress, then making no adjustment for government ownership provides a stronger signals than including an allowance, if each business is treated as an independent entity.** Both options have advantages and disadvantages and ultimately depends on what the main objective of measuring the businesses financial sustainability and viability is. Including an allowance results in a better credit rating for businesses and therefore, could hide an underlying issue which would otherwise have been identified if no allowance had been made.
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.	**Barwon Water does support this view, any short term financeability issues should be managed by an increase in immediate cashflows through higher prices.** Customers should however not be penalised through price increases in the future as well. The business should manage longer term financial sustainability by either reducing operating or capital expenditure to manage the lower prices in the future. In addition, any adjustment to prices implemented on an NPV neutral basis will depend on using an appropriate weighted average cost of capital rate (WACC) which will allow businesses to maintain financially sustainable cash flows through minimising cost of debt and inflation risk through a robust WACC setting process.
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.	**Barwon Water is of the view that indicators and targets should be applied consistently between reporting requirements.** For example, indicators and ranges used by the Victorian Auditor Generals office to assess water business financial sustainability as part of its annual review, the Department of Environment and Primary Industries as part of water businesses annual corporate plan submission, and by the Commission are all different to some extent. To achieve consistency, increase efficiency, reduce duplication and margin of error, Barwon Water recommends that VAGOs' indicators and ranges are applied consistently as these are recognised by government, used by Treasury, and highlight any risk of financial un-sustainability. In addition, VAGO measures financial sustainability using a 5 year average in conjunction with the past year results to flag any risk of financial concern. This supports NERA's recommendation to use actual results rather than notional (forecast results). Furthermore, VAGO's target ranges do not suggest that there is a maximum level that should be achieved. Financial stress is signalled only when results fall below the target. Barwon Water does however see merit in having a recommended maximum for some indicators because this would encourage efficient use of financial assets. Having said that, business should not be penalised as severely for overachieving a target range as they would for underachieving. Underachieving should be discouraged and de-incentivised, meeting the range should be encouraged and incentivised while overachieving should require rationalisation.
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.	**Barwon Water believes the focus on interest cover is appropriate as it clearly signals the businesses ability to repay interest expense on outstanding debt based on it current cashflows.** Although not a direct balance sheet ratio, it determines how easily a company can pay interest expenses on outstanding debt. The lower the ratio, the more the company is burdened by debt expense. When a company's interest coverage ratio is only 1.5 or lower its ability to meet interest expenses may be questionable. Being based on cashflows rather than profit provides a much greater level of financial transparency. In addition, interest cover is also aligned with credit rating analysis and calculation which is a standard measure and indicator used by both public and private sectors.

Commission seeking comment on:	Barwon Water Response
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?	**Barwon Water's view is that there is an overarching misalignment of statutory accounting values (SAV) compared to regulatory asset values (RAV) of all water business, with the latter being, in some cases, significantly lower than the statutory values.** As a result, accounting results reflect losses as prices are calculated based on RAV's but then when applied against the accounting profit model, do not generate enough revenue to cover statutory depreciation. Although this does not directly impact cash flow, it does indicate the business is not achieving enough revenue to renew assets as they depreciate. This misalignment is varied across the water businesses as the RAV's were set without regard to their SAV's. As such, some businesses RAV's and SAV's are more closely aligned others which results in disparity and inconsistencies between businesses. Ultimately, revenue generated by prices should provide for the replacement and renewal of assets based on their true cost of replacement which is more likely to be aligned with their statutory value which is re-valued every 5 years and indexed each year to be in line with current market prices.
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?	**Barwon Water's view that this option should not be considered.** Water businesses profits can vary for numerous reasons other than price related impacts. Changes include asset revaluations which impact on depreciation, additional capital contributions either via government or private industry as result of development growth or capital investment, changes in financing charges as a result of interest rate changes. As a result, prices should not be automatically changed to reflect these changes. Ultimately businesses should be provided with the ability to manage their financial position over the short term and long term with little influence from external drivers stepping and reviewing inputs such as prices. Customers also need to be provided with certainty and therefore prices should be set over a period of time to minimise any price shocks to customers.
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?	**Barwon Water's view is the approach taken needs to be in line with the primary purpose of measuring financial sustainability.** Making adjustments for these inputs influence the indicators which identify financial sustainability. In most instances, adjusting for these inputs will impact indicators negatively, except for superannuation obligations which is dependant on share market valuations. Ultimately, these inputs are required by the business therefore if businesses are experiencing financial hardship there is a risk they may not be able to pay these obligations and as such this needs to be identified as early as possible to enable the situation to be assessed and decided whether it is appropriate to adjust the businesses revenue stream to manage through this financially stressful time. Other inputs which may need to be considered could be Public /private partnership obligations (although often treated similarly to a finance lease and therefore already considered). The main criteria is understanding what are the indicators main purpose and driver. Based on the review, it is to determine whether expected revenues will be sufficient for an efficient water business to pay its bills when and as they fall due and undertake its capital expenditure program in order to deliver services. As such it is Barwon Water's view that adjustments should be made for inputs where they will be an obligation to pay.