Southern Rural Water
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13 February 2014

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

Response to Consultation Paper
Assessing the Financeability of Victorian Water Businesses

Thank you for the opportunity to comment on the Essential Services Commission's approach to assessing financial viability as part of the water price review process. We have reviewed the NERA report and your consultation paper, and offer the following for your consideration.

Firstly, we have addressed a number of broad issues regarding the framework within which financial viability must be assessed, following which we have responded to the specific questions from your consultation paper.

In summary, we contend that:

- Department of Treasury and Finance (DTF), as representative of our shareholder and the provider of finance, should be responsible for establishing the criteria against which financial viability is assessed
- The WIRO should be amended to make clear the arrangements for assessing financial viability, and to provide for recovery of revenue to preserve financial viability
- Water businesses should be responsible for submitting plans which include sufficient revenue to maintain viability, and
- Without provision in the WIRO to adjust prices to maintain viability, water businesses are likely to budget more conservatively to avoid adverse outcomes, which could mean higher prices.

Elements of Financial Viability

For a water business to be viable, it must have a reliable revenue stream to meet its efficient operating costs and to service its financing obligations, and it must have access to finance in order to meet its investment proposals.

It follows that financial viability can be impacted by:

- Changes in operating costs
- Changes in revenue

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- Changes in interest rates
- Access to finance

Financing the Water Industry

The responsibility for providing finance to Victoria's water businesses belongs to the DTF. Water businesses require DTF approval to obtain finance, and must borrow through Treasury Corporation of Victoria.

The DTF will grant approvals based on the merit of investment decisions for significant projects, and also based on the broader context of state debt and credit rating.

Recommendation 1:

We believe that the DTF, as representative of the shareholder, should be responsible for determining the acceptable limits of financial viability for water businesses – and that this responsibility should be captured within the WIRO. This could be implemented by the DTF either by:

- Assessing the financial viability of draft Water Plans prior to (or alongside) assessment by the ESC (this could also provide borrowing approval, or
- Establishing financial viability targets or outcomes for the regulatory period, as an input to the Water Plan process.

NERA Report and Credit Ratings

The NERA report proposes that maintaining an 'investment grade' credit rating is an appropriate objective for assessing financial viability.

Credit ratings are used by financial markets to assess risk in investment decisions, and in the private sector will influence the amount of finance that a business can access and the cost of that finance. However, water businesses do not compete in financial markets for finance. As noted above, DTF is responsible for providing finance.

Recommendation 2:

We believe that any direction on whether a water business should be maintaining a particular credit rating should come from DTF.

Water Industry Regulatory Order (WIRO)

The WIRO sets out regulatory principles against which the Commission must assess pricing proposals. These principles describe the costs that should be recovered through pricing, within the context of providing a sustainable revenue stream. However, the WIRO does not provide any guidance on what 'sustainable revenue stream' means, nor any explicit provision to recover an additional amount (above the building blocks costs) to achieve sustainability.

Recommendation 3:

We believe that the WIRO should be amended to:

- Provide guidance on assessing the sustainability of a revenue stream (possibly by assigning responsibility for this to DTF as per Recommendation 1 above); and
- Include an explicit provision within the regulatory principles to recover an amount of money necessary to ensure that the water business remain financially viable

Role of the Essential Services Commission vs. Role of Water Businesses

We recognise that the ESC has a role in assessing the financial viability of pricing proposals, and in doing so, to ensure that prices comply with the regulatory principle of providing a sustainable revenue stream. We also recognise that some of the risks to financial viability stem from the pricing model imposed by the Commission.

For example, the NERA report notes that:

> *The building block pricing model … indexes the RAB for changes in consumer prices…*
>
> *One consequence of indexing the RAB is that building block revenues provide for only a real return on assets. However, a business is generally required to pay a nominal return on debt… which may give rise to short term financeability constraints.*

This suggests that the current approach is a feature of the regulatory framework. However, whilst we recognise that a pricing model can provide a useful template for businesses, it is not the role of the Commission to determine a particular model for setting prices. The role of the Commission is to assess pricing proposals against the regulatory principles contained in the WIRO, and the procedural requirements set out in the Statement of Obligations.

In the first instance, businesses should seek to manage risks to viability through the pricing settings they propose. For example, a proposal to apply a nominal (rather than real) rate of return to assets would reduce one source of risk, and wouldn't appear to contravene the regulatory principles.

Water businesses should understand the scale of expected variation in revenues and costs, and should include analysis within the Water Plan how these variations impact financial viability, by reference to viability criteria established by the DTF and/or captured in the WIRO (as per Recommendations 1 and 3 above).

Recommendation 4:

We believe that businesses should not be beholden to the pricing models developed by the Commission, and that alternatives should be assessed objectively against the regulatory principles.

Recovery of Losses

In some instances, variations will occur which do not threaten the financial viability of the water business. However, these variations mean that customers have not paid the full cost of the services provided over a period of time. Most commonly, this will be the case where low demand (or constrained supply) causes revenue to fall below the fixed costs of maintaining infrastructure and capacity. This may occur within a regulatory period, and give cause for a water business to seek a pricing variation, or may be assessed as part of the transition from one regulatory period to the next.

Under a revenue cap, the Commission has allowed unrecovered revenue to be carried forward from one regulatory period to the next; however, there is no explicit provision in the regulatory principles as a basis for this.

Whilst this is not strictly a matter of financial viability, we believe it is appropriate to raise here, as under-recovery may precipitate future financial viability risks.

Recommendation 5:

We believe that the WIRO should include an explicit provision for recovery of past losses where variations in costs or revenues have meant that customers have not paid for the full cost of services, and conversely to reduce prices where such variations have caused customers to be charged more than the full cost of services.

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Response to questions in the Consultation Paper

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.*

   This question seems to assume that a financeability assessment will be based on maintaining an investment grade credit rating.

   As noted earlier, we believe that a decision on whether to target a particular credit rating should be made by DTF (refer Recommendation 2 above).

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 report does not clarify what an NPV neutral adjustment is. Presumably this means that the present value of necessary additional funds over a regulatory period must match the present value of the recovery of those funds through prices, regardless of the timing over which each occurs.

   This seems a reasonable basis for assessing proposals by water businesses to recover additional revenue through pricing to maintain viability, above the efficient operating and financing costs.

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 have reviewed the set of indicators and they seem reasonable. Importantly, we contend that the shareholder ultimately wears the risk of our financial viability, and so should be responsible for setting the criteria for assessing viability. This will help to create alignment within government, as different departments and agencies currently make assessments using different measures and targets.

   There are some further questions which we believe should be considered in setting assessment criteria for financial viability:

   - Are all of the indicators necessary? Whilst the measures seem relevant to assessing financial viability, there may be a direct correlation – and therefore effective duplication between some indicators.
   - Should the same targets apply to all businesses? Targets are usually set with an implicit risk margin – for example, a business with an interest cover ratio of 1.0 can meet its interest payments, but targeting this level leaves no margin for

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uncertainty so the target is set at a higher level. However, not all businesses have the same risk profile.

- What is the relevance of upper limits on target ranges? If, for example, interest cover is greater than 2.5, what is the consequence for our financial viability?
- Should different limits apply to different planning scenarios? For example, targeting an interest cover ratio of 1.8 under median planning assumptions, but remaining above 1.2 in a worst case scenario.
- What is the purpose of distinguishing between primary and secondary indicators? The assessment ultimately needs to lead to a decision on whether the business will have a sustainable revenue stream, and if not, to quantify the change needed to reach a sustainable level. It's not clear how the primary and secondary measures contribute to the assessment.

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.*

   We believe that a focus on interest cover is appropriate – noting our assertion above that the shareholder should set the limits.

   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 cash flow adequacy.

   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?*

   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. This 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 a higher price 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. We have used both of these approaches in the past – always with the support of our customer groups.

Again, it should be the responsibility of each water business to consult with customers on price paths.

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?*

   We do not believe that the Commission needs to designate specific costs as relevant to viability assessments. In the first instance, businesses should propose to recover appropriate costs over an appropriate timeframe. If, for example, an operating lease will require payments over a given period, then those payments should be incorporated in a revenue requirement and into pricing proposals.

   If the WIRO provides for revenue to ensure financial sustainability, then any necessary change to revenue to maintain viability should be possible.

Again, thank you for the opportunity to comment on the Commission's approach to assessing financial viability. Please contact Lincoln Eddy, Manager, People and Performance on 03) 5139 3258 to discuss further.

Kind regards

CLINTON RODDA
Managing Director