South East Water

healthy water for life

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Matthew Donoghue
Financial Modelling and Data Manager
Water Division
Essential Service Commission
Level 37
2 Lonsdale Street
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Dear Matthew

Response to Consultation Paper

Thank you for the opportunity to comment on the ESC's Consultation Paper titled "Assessing the Financeability of Victorian Water Businesses".

South East Water has considered the questions raised by the ESC and would like to offer the following comments:

Question 1 – given that it is common practice for corporate finance specialists and credit rating agencies to include government ownership as part of their assessment of the credit worthiness of a government owned entity it would appear appropriate to take this factor into account when determining benchmarks to assess the financeability of Victorian water businesses.

Question 2 – the adjustment to prices appears appropriate if the potential outcome, if not adjusted, is an over-recovery of costs through water prices.

Question 3

- FFO Interest Cover - is NERA's benchmark range consistent with gearing and cost of debt assumptions used to set the regulatory WACC?
- Capital Adjusted Interest Cover - this measure appears to mix notional and actual data which is not the preferred approach for the ESC.
- Net Debt/RAV % - NERA's benchmark range of 70-80% is inconsistent with the regulatory WACC gearing.
- FFO/Net Debt % - building block model provides revenue to service interest cost on 60% of water businesses RAV. In theory there is no revenue provided to service the

repayment of debt so unclear why measure is important for ratings purposes. NERA range is not materially different to ESC's.

- Internal Financing % - NERA commentary (page 19) notes that a firm with a significant capital expenditure program relative to available cash flow has less flexibility to react to changing economic circumstances than a firm that can easily fund its capital expenditure requirements by internally generated cash flows. This assumption ignores that water businesses can apply to the Treasurer each year for approval to increase borrowings to fund capital expenditure requirements. Access to this funding is readily provided by TCV. NERA's proposed range of 50-100% would be difficult to achieve where large growth related capex is required. Metric also not logical in respect of developer contributions – included in FFO (the numerator) and capital expenditure (the denominator). Developer contributions cannot be treated as both an operating cash flow and an investing cash flow.

- Dividend Cover - as noted by NERA (page 21) only a few Victorian water businesses pay dividends and are wholly owned by the State. Accordingly, this measure is of limited value.

It is recommended that a range of return based measures be considered to ensure that businesses are meeting or exceeding the minimum return implied by the cost of equity (nominal) within the WACC.

Question 4 – we agree that there should be a strong focus on interest cover as well as other measures used by key stakeholders to assess the financial sustainability of Victorian water businesses. We do not consider it necessary to apply a weighting to the proposed financial indicators.

Question 5 – statutory profit alternatives include EBITDA and EBITDA excluding developer contributed assets as measures of underlying profit and cash earnings.

Question 6 - variations in profit are normal where prices are fixed for 5 years. Price adjustment should only be needed in extreme circumstances. The equity beta (0.65) provides the shareholder with a higher return to compensate for variations in profit over the regulatory period – returns should average out over the long term.

Question 7

- Operating leases – recognition of operating leases should be consistent with accounting standard criteria. Where applicable, materiality test should apply.

- Superannuation obligations – treatment should be consistent with accounting standards which have no provision for recognising DBF liabilities as a debt obligation and payments above the SG rate (9.25%) as interest.

- Capitalised interest – metro water businesses carry assets at fair value using the income approach (discounted cash flow) which precludes the capitalisation of interest charges. Unlikely that regional and rural water businesses would be capitalising interest charges.

For your reference, we have provided a copy of our work papers (attachment 1) which incorporate additional comments and observations on the matters raised in the consultation paper.

Should you require additional information please do not hesitate to call me on (03) 9552 3355.

Regards

Sue Madden
Commercial Manager

Attachment 1:

Page	Section	Comments
2	1.1 Reasons for Consulting	We support the proposal to include a profitability measure as part of a financial sustainability check.
3	1.2 Scope of Consultation	We recommend that a review of the rate of return estimate be included to ensure that an appropriate income stream is provided to cover the nominal cost of debt and equity.
5	2.1 Relationship between Prices and Financeability	Strongly agree that water prices should ensure that each business can maintain an investment grade rating. Need to recognise that water prices also need to generate cash flows to provide a return to the shareholder (in nominal terms) consistent with the cost of equity estimated via the capital asset pricing model. Recommend a review of the financial impact of variations between the recovery of regulatory depreciation in water prices and accounting depreciation. Appears to be a significant under-recovery of income which requires businesses to borrow to fund maintenance capex. Agree that value is created when returns exceed the weighted average cost of capital. This can be achieved by improving profit margins, capital turnover or efforts to reduce the weighted average cost of capital.
6 –	2.2 Role of Financeability Assessments	Need to recognise that short term viability issues can be a significant issue for some stakeholders (Boards, VAGO, DTF, DEPI). Financial sustainability assessments need to include profitability as well as cash flow. Disagree that it is not necessary to maintain an investment grade rating every year – a rating below investment grade can result in higher financial accommodation charges which are not recovered through regulated revenue, increase the cost of debt and have a negative impact on cash interest cover ratios. A commercial return for the shareholder in nominal dollars is the key which can be influenced by other factors outside of management/board control e.g. demand variations, developer activity, Australian accounting standards related to fixed asset valuations.
8	3.1 Indicators and Ranges we currently use	A focus on cash related KPI's needs to be balanced with accounting based measures which are used by other stakeholders to assess performance of the business. Profitability assessments are considered important in the privately owned utility sector. Water sector profitability measures are distorted in large part by differences between

Page	Section	Comments
		statutory and regulatory asset valuations – this can be mitigated by focussing on EBITDA profitability and return measures.
9	Table 3.1 Current Financial Indicators Used	FFO Interest Cover – is the benchmark consistent with the ESC's cost of capital estimate in nominal terms? Gearing - upper gearing ratio of 65% is inconsistent with the benchmark used to determine the weighted average cost of capital. Is this logical? FFO/Net Debt % - not sure what this is trying measure as serviceability of debt is best measured by FFO net interest cover. Internal financing % - it is not logical for this measure to include cash from new customer contributions in FFO (the numerator) and to deduct new customer contributions from capital expenditure (the denominator). If New Customer Contribution (NCC) revenue is included in the FFO it needs to be included in capital expenditure as it relates to capital expenditure that is being funded by NCCs rather than water and sewerage prices.
10	3.2 Inputs used to calculate indicators	Agree with emphasis on cash interest cover as a measure of entities ability to meet interest obligations but ignores returns required to meet the cost of equity (Ke) expectations ie return on equity >= cost of equity. Notional vs Actual Data – is there a risk that using actual data can distort the true results of the building block model to determine a revenue requirement for the business ie what would the measures look like if the actual operations of a water business mimicked the revenue, costs, depreciation, interest charges and financial structure (60% gearing) assumed in the building block model (in nominal dollars)
12 -13	4.1 Our Initial Views	Maintain investment grade rating over time – Board expectations are likely to be that water businesses must maintain an investment grade rating every year! A rating below investment grade will result in higher financial accommodation charges (profit and cash flow impact). Benefits of maintaining an investment grade rating (fund provision of services, service debt & provide a reasonable return to shareholders) – no measures used by ESC to determine whether water businesses do provide a reasonable return to shareholders (assume ROE should be >= the Cost of Equity)! Allowance for Government ownership in credit rating – if corporate finance specialists (Deloitte) and credit rating agencies (Moody's) believe it is appropriate to take this factor should be allowed. In practice, the Government will not allow any water business to fail or be in a position where it cannot meet its interest obligation. Usual strategies

Page	Section	Comments
		to mitigate involve deferment of dividends, a reopening of the price determination, capital restructure, merger with another water business, cross subsidy payments etc NPV neutral price adjustments – logic makes sense if the potential outcome if not done this way is an over-recovery of costs through water prices.
14 -15	Table 4.1 Nera's recommended Indicators and Ranges	FFO Interest Cover – is NERA's benchmark range consistent with gearing and cost of debt assumptions used to set the regulatory WACC? FFO Interest Cover – is NERA's range consistent with the assumptions used to determine the regulatory WACC and regulatory depreciation? Capital Adjusted Interest Cover – this measure appears to mix notional and actual data which is not the preferred approach for the ESC. Net Debt/RAV % - NERA's benchmark range of 70-80% is inconsistent with the regulatory WACC gearing. FFO/Net Debt – building block model provides revenue to service interest cost on 60% of water businesses RAV. In theory there is no revenue provided to service the repayment of debt so unclear why measure is important for ratings purposes. NERA range is not materially different to ESC's. Internal Financing % - NERA commentary (page 19) notes that a firm with a significant capital expenditure program relative to available cash flow has less flexibility to react to changing economic circumstances than a firm that can easily fund its capital expenditure requirements by internally generated cash flows. This assumptions ignores that water businesses can apply to the Treasurer each year for approval to increase borrowings to fund capital expenditure requirements. Access to this funding is readily provided by TCV. NERA's proposed range of 50-100% would be difficult to achieve where large growth related capex is required. Metric also not logical in respect of developer contributions – included in FFO (the numerator) and capital expenditure (the denominator). Developer contributions cannot be treated as both an operating cash flow and an investing cash flow. Dividend Cover – as noted by NERA (page 21) only a few Victorian water businesses pay dividends and are wholly owned by the State. Accordingly, this measure is of limited value. Additional indicator - NPAT/Equity – Propose an additional profitability measure to compare nominal cost of equity provided for in the WACC with the actual NPAT. Statutory profit – influenced to a greater extent by the

Page	Section	Comments
		requirements of Australian Accounting Standards, Vic Govt Financial Management Act, DTF Financial Reporting Directions and the Victorian Auditor-General's Office which are applied consistently across businesses across different years. Use of EBITDA (to avoid the impact of asset valuations on depreciation charges) would provide a reasonable estimate of ability to pay bills and fund capital expenditure. Transactions related to activities outside of the regulatory framework are included as part of the cash based measures eg non prescribed revenue, new customer contributions, asset sale proceeds etc . Major variations would be accounting depreciation and income from developer contributed assets which can be easily identified and excluded for a profit based measure of financial sustainability. Agree with the ESC, that a dividend measure is not required – the cost of equity provides a return to the shareholder as part of the WACC estimate. Return based measures are recommended to ensure that businesses are meeting or exceeding the minimum return implied by the cost of equity (nominal) within the WACC. Regulatory benchmarks for gearing (60%) do set targets for a business's capital structure. The benchmark gearing rate implies that the value of the business is maximised (and the cost of capital is minimised) at a 60% gearing level. Gearing levels below 60% increase the business's cost of capital relative to returns allowed via the regulatory price setting process. ESC/NERA Indicators – preference is for ESC indicators and further consideration of inclusion of profitability/return measures, the logic used to derive the internal financing % (new customer contributions) and an assessment of the benchmarks based on notional data to ensure the revenue requirement in nominal dollars is adequate to provide a return consistent with the nominal cost of debt and equity implied by the regulatory WACC. Focus on interest cover – agree that this important but also needs to consider other measures which are used by other stakeholders as a measure of financial sustainability (DTF, DEPI, VAGO, NPR, Board's). Weighting of indicators not recommended.
16-17	4.3 – Our initial views	Statutory profit alternatives – consider EBITDA or EBITDA excluding developer contributed assets. EBITDA excluding developer contributed assets should be a close proxy for funds from operations. Variations in profit are normal where prices are fixed for 5 years. Price adjustment should only be needed in extreme

Page	Section	Comments
		circumstances. The equity beta (0.65) provides the shareholder with a higher return to compensate for variations in profit over the regulatory period – returns should average out over the long term. Operating leases – recognition of operating leases should be consistent with accounting standard criteria. Where applicable, materiality test should apply. Superannuation obligations – treatment should be consistent with accounting standards which have no provision for recognising DBF liabilities as a debt obligation and payments above the SG rate (9.25%) as interest. Capitalised Interest – metro water businesses carry assets at fair value using the income approach (discounted cash flow) which precludes the capitalisation of interest charges. Unlikely that regional and rural water businesses would be capitalising interest charges.