ESSENTIAL SERVICES COMMISSION

ASSESSING THE FINANCEABILITY OF VICTORIAN WATER BUSINESSES

Consultation Paper

December 2013

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CONTENTS

1 INTRODUCTION 1

1.1 REASONS FOR CONSULTING 1

1.2 SCOPE OF OUR CONSULTATION 2

1.3 WE ARE SEEKING FEEDBACK 3

1.4 TIMELINES 4

2 RELATIONSHIP BETWEEN PRICES AND FINANCEABILITY 5

2.1 HOW WE DERIVE PRICES 5

2.2 ROLE OF FINANCEABILITY ASSESSMENTS 6

3 OUR CURRENT APPROACH 8

3.1 INDICATORS AND RANGES WE CURRENTLY USE 8

3.2 INPUTS USED TO CALCULATE INDICATORS 10

4 CONSIDERATION OF OUR FUTURE APPROACH 11

4.1 HIGH LEVEL PRINCIPLES 11

4.2 FINANCIAL INDICATORS AND RANGES 13

4.3 INPUTS USED TO CALCULATE INDICATORS 16

5 NEXT STEPS 19

1 INTRODUCTION

This consultation paper considers the Essential Services Commission's (the Commission's) approach to assessing the financeability of Victoria's water businesses. A financeability assessment helps to determine whether expected revenues will be sufficient for an efficient water business to pay its bills as they fall due, and undertake its forecast capital program in order to deliver services. In other words, a financeability assessment helps to assess whether a business is financially viable. In this paper, we use the terms financeability and financial viability interchangeably.

In the paper, we outline the relationship between our financeability assessments and prices, our current approach to assessing financeability, and seek feedback on the key recommendations in a report prepared for us by NERA Economic Consulting (NERA) in order to inform our future approach.

1.1 REASONS FOR CONSULTING

The *Essential Services Commission Act* 2001 (ESC Act) 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.*[1]

1 *Essential Services Commission Act* 2001, Section 8.

The ESC Act also specifies we must have regard for a range of matters in seeking to achieve this objective, including having regard to the financial viability of industries we regulate.[2] And the *Water Industry Regulatory Order* (WIRO) provides that we must ensure the viability of individual water businesses.

Our current approach to financeability assessments in Victoria's water industry was established close to a decade ago. Since commencing this role, we believe approved prices have met the financial viability objectives set out in the ESC Act. We also believe we have approved prices that meet the principles in the WIRO.[3]

Since it first began regulating water prices in 2004, the Commission has made viability adjustments to prices for only one of the 19 water businesses.

Nevertheless, we want to test whether we need to make any changes for future price reviews given that economic, financial and industry conditions have changed since commencing our price determination role. We also wish to look at the merits of using statutory profit or an alternative measure of profit for our financeability assessments (raised by Melbourne Water in our recent price review).[4]

The objective of our consultation is to ensure the approach we adopt to financeability assessments best positions us to meet our obligations to the requirements under the ESC Act and the WIRO. It is in the long term interests of customers that a water business is financeable or financially viable so that it can provide services desired by customers.

1.2 SCOPE OF OUR CONSULTATION

The scope of our consultation relates to the financial indicators and their ranges, which we use to undertake financeability assessments. We also look at the nature of the data inputs used to calculate the financial indicators.

Our consultation does not extend to qualitative factors that make up a substantial weighting of the assessments done by private sector agencies for the purpose of

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

[3] Water Industry Regulatory Order, clause 14(1)(a).

[4] Melbourne Water 2013, *Melbourne Water's response submission to the ESC's draft decision*, May.

assigning a credit rating to an entity.[5] We do not intend to replicate the qualitative analysis undertaken by ratings agencies. Nor is it our intention to derive and publish a credit rating for each business.

Further, our consultation does not extend to the application of the building block model used to estimate and approve prices, or specific elements of the building block model. For instance, our consultation does not cover the rate of return (or the weighted average cost of capital). We will review our approach to the rate of return in a separate process.[6] In addition, our consultation does not cover the value of assets used for pricing.

1.3 WE ARE SEEKING FEEDBACK

Any changes to the way we undertake financeability assessments could impact on the prices we approve in future reviews. Therefore, we are seeking feedback from all interested parties on our approach. While not seeking to limit the nature of any feedback, this paper sets out a number of issues on which we are particularly interested in receiving further comments from stakeholders (chapter 4).

You can send a written submission or comments in response to this paper. Written comments are due Friday, 14 February 2014.

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

You can also send comments by mail to:

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

[5] This includes both the stability of the regulatory regime, and whether an appeal process is in place for regulatory decisions.

[6] Essential Services Commission 2013, *Price Review 2013: Greater Metropolitan Water Businesses — final decision*, June, p111.

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

1.4 TIMELINES

The timeline for completion of our consultation is July 2014. At that time, we will release guidance on Water Plans to be prepared by Melbourne Water and Goulburn Murray Water for prices applying from 1 July 2016.

Date	Consultation process
December 2013	Release ESC consultation paper and NERA report for consultation
14 February 2014	Submissions in response to ESC consultation paper close
Early April 2014	Summary of Commission views
Mid May 2014	Submissions in response to Summary of Commission views close
July 2014	ESC releases final views in Water Plan guidance

2 RELATIONSHIP BETWEEN PRICES AND FINANCEABILITY

The Commission interprets the financial viability and sustainability requirements under the ESC Act and the WIRO to mean that the prices we approve should provide a high level of certainty that each business can maintain an investment grade credit rating. Further, prices should enable each business to generate cash flow to service the financing costs arising from investment in infrastructure to meet service expectations.[1]

2.1 HOW WE DERIVE PRICES

We use the building block model as the basis for estimating and approving prices. The building block model allows a business to recover its efficient costs over the life of assets – operating costs are recovered as they are incurred, and capital costs (including renewals) once they are incurred are recovered through a return on (via a benchmark weighted average cost of capital) and of (via regulatory depreciation) investment spread over the life of assets.

The building block model also allows for a return to the shareholder (or profit) through the equity component of the weighted average cost of capital. A business may achieve a greater rate of return if it reduces costs below the benchmarks used in the building block model. For example, this could be through efficiency gains in delivering projects or through arrangements that reduce financing costs below the benchmark weighted average cost of capital.

[1] Essential Services Commission 2005, *Regulatory asset values for the Victorian water businesses – Advice to the Minister for Water*, March.

2.2 ROLE OF FINANCEABILITY ASSESSMENTS

While the building block model supports the long term financial viability of businesses, in some circumstances a business may encounter short term viability issues.

Short term viability issues may emerge due to a range of factors, such as the use of a benchmark rate of return.[2] A financeability assessment helps to determine whether, after estimating prices through the building block approach, cash flow will be sufficient to allow a business to meet its obligations in a pricing period. A financeability assessment is a safety net not an input to pricing, and we undertake a financeability assessment for each business we regulate before approving prices.

To test whether a business will be financially viable, given the prices estimated via the building block model, we assess whether quantitative indicators of a business' financial position provide a high level of comfort that a business can achieve an investment grade credit rating.[3] The assessment takes into account the estimated level and trends of the indicators over a ten-year period based on the submitted data from our financial templates used for pricing. It is not a requirement that a business achieves an investment grade credit rating every single year; the trend overtime is important. The indicators we currently use for our assessments are in chapter 3.

A business (or the Commission) may seek an adjustment to the prices previously approved for a pricing period due to unexpected or unforseen financial viability concerns. These adjustments within a pricing period are limited only to significant concerns caused by uncertain and unforeseen events in the interests of price certainty and stability, and to maintain incentives for business management to manage their operations.

If an assessment identifies a viability issue, we will consider an upward price adjustment (beyond those implied by the building block model) only after assessing whether the issue should be addressed by business management and/or the shareholder.

[2] See NERA report pages 4-5 for other factors.

[3] Credit ratings are an assessment of a business' ability to pay financial obligations (i.e. credit worthiness). And under Standard and Poor's and Moody's approaches, **investment grade credit ratings** are those at or above ratings of BBB- or Baa3, respectively. Generally speaking, businesses with investment grade ratings are businesses that have adequate capacity to meet their financial obligations.

Management and a business' board make decisions about the prices they need to deliver services (reflected in their proposed prices in Water Plans), the focus and time profile of expenditure (including major capital works), and the mix of debt and equity funding. Management and a business' board also have a critical role in driving efficiency savings. The building block model used by the Commission assumes a business will generate a commercial return for its shareholder, however, whether a business actually delivers a return relies heavily on the decisions of a business' management and board.

We believe it is not our role to increase customer prices to rectify poor business decisions. Where poor business decisions put a business' viability in question, primary responsibility rests with business management and board to address the issue.

Where the Commission finds a business' financial viability is threatened, and we believe the issue cannot be addressed by a business' management and board, the Commission will consider an application for an adjustment to prices. The Commission is generally reluctant to make such adjustments because it involves increasing customer prices. But where an adjustment is necessary, we only seek to lift prices to a level where a business becomes financially viable and no higher.

It is important to note that financeability assessments will always require the Commission to exercise a degree of judgement. This includes interpreting the range of financial indicators and outcomes used, and consideration of the impacts of any adjustments on customers.

3 OUR CURRENT APPROACH

This chapter focuses on the financial indicators, the range of outcomes considered desirable when assessing the financeability of a water business, and the inputs used to calculate the indicators.

3.1 INDICATORS AND RANGES WE CURRENTLY USE

The Commission has relied on four quantitative indicators to assess the financeability of water businesses (table 3.1). The four indicators we chose reflected best practice when we commenced our price determination role in the water industry.[1]

A common element in three of the four indicators we use is ‘funds from operations’ (FFO). FFO is approximately equal to the accounting definition of cash flow from operating activities, less the sources of non-recurrent revenue. The primary emphasis of the indicators is the cash needs of businesses.

Cash-related indicators are not influenced by a business’ accounting policies. The impact of changes in accounting policies on the water businesses’ statutory asset values and therefore, depreciation and profits, was the focus of a recent article in the *Economic Papers*.[2] Indicators such as statutory profit may not be easily compared over time (for individual businesses and across businesses) and may not provide the best indication of a business’ underlying financial position.

In deriving the ranges for each of the indicators in table 3.1 at the beginning of the pricing role in 2004, we had regard to the actual ratios observed for privately owned

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1 For example, similar indicators were used by Standard & Poors, Moody’s, the Water Service Regulation Authority UK (now Ofwat), and the Independent Pricing and Regulatory Tribunal (IPART) New South Wales.

2 Nicholas Pawsey and Lin Crase 2013, *The Mystique of Water Pricing and Accounting – Economic Papers*, September p328-339.

utilities, the ranges adopted by rating agencies, and the levels adopted by other regulators for an investment grade entity.

The range of values reflected the varying ratios used by different agencies and regulators. The ranges were also generally consistent with benchmark ranges proposed by water businesses in our consultation with them prior to the commencement of our pricing role in 2004.

We incorporate the indicators and benchmark ranges for our financeability assessments into the financial templates we provide to water businesses as part of our price reviews. And through these price reviews, we have found that water businesses generally meet or exceed the financeability benchmarks (with estimates for indicators measured using data for a full financial year).

TABLE 3.1 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 making dividends.

Notes: FFO refers to 'funds from operation', and RAV refers to the 'regulatory assets value'.

We have not weighted the individual indicators in financeability assessments. While considering all indicators in table 3.1, we have implicitly placed an emphasis on interest cover as the primary indicator for our financeability assessments.[3] Largely this emphasis is founded on the observation that the Victorian water businesses are rarely at risk of breaching the ranges for the other three indicators; and that relative to our other three indicators, interest cover gives the best indication of a business' ability to meet cash constraints (for example, operating payments and financing obligations).

3.2 INPUTS USED TO CALCULATE INDICATORS

The calculation of financial ratios for financeability tests can use either forecasts of actual outcomes (actual) or notional data. Notional data is based on the benchmarks used in the building block model to calculate prices—for example, the notional data uses the level of gearing and the costs of debt and equity assumed in the calculation of the benchmark weighted average cost of capital. The Commission uses actual data for its financeability tests, as notional data does not provide a true indication of a business' financial position. This is in contrast with our use of benchmark financial data in the building block model used to calculate revenues.

3 For example see: Essential Services Commission 2013, *Price Review 2013: Regional Urban Water Businesses — final decision*, June p89.

4 CONSIDERATION OF OUR FUTURE APPROACH

This chapter sets NERA's recommendations for the indicators and their ranges, which we should use in our future financeability assessments. We also look at NERA's recommendations as to whether actual or notional financial data should be assessed, and whether any adjustments need to be made to the data.

To inform its recommendations on a set of indicators and ranges for our future financial viability assessments, NERA reviewed the approach adopted by the Commission, our equivalent regulatory body in New South Wales (the Independent Pricing and Regulatory Tribunal), United Kingdom (based regulators Ofwat and Ofgem), and a top tier private ratings agency (Moody's).

We are seeking feedback on NERA's key recommendations. We also include commentary to provide stakeholders with an indication of our initial views. While we list a number of questions for feedback, stakeholders may provide us with views on any matters they think are relevant to our consultation.

4.1 HIGH LEVEL PRINCIPLES

NERA's report outlined some high level recommendations relevant to the assessment of financial indicators and ranges that should be used in any financeability assessment. These are[1]:

- Maintaining an investment grade credit rating over time is an appropriate objective for a financeability assessment of a regulated water service provider.

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

- If a financeability constraint is identified, a cash flow adjustment should be made only if the constraint is not a result of poor management practices, such as excessive gearing or poor financial decisions.

- Any financeability assessment should be undertaken on the basis of competitive neutrality (that is, no allowance should be made to the ranges adopted for each financial indicator based on government ownership).

NERA also recommended that any adjustment to prices on the grounds of financial viability should be implemented on a net present value (NPV) neutral basis. That is, price increases for viability in the near term should be paid back to customers through lower prices later.

OUR INITIAL VIEWS

Our initial view is that we should continue to conduct our financeability assessments based on whether a business is likely to meet an investment grade credit rating over time. If a business satisfies investment grade over time, there is a high probability that it will be in a position to fund the provision of services desired by customers, service or repay debt, and provide a reasonable return for the shareholder. We do not believe a business needs to meet investment grade in every single year. We propose to continue an approach that takes into account a longer term view of a business' financial position (based on ten years of data in our financial templates).

We believe that we should only make a cash flow adjustment (that is, increase prices) if the financial viability constraint is not a result of poor management. Businesses should be able to demonstrate that they have exhausted all management options to remain viable.

We are seeking stakeholder views on NERA's proposition that there should be no adjustments to the financeability assessment to account for government ownership of the water businesses. In a recent report prepared by Deloitte for the Commission, it was noted that when assessing the creditworthiness of a government owned entity, strong government support would usually be taken into account.[2] In addition, Moody's recent assessment of its credit rating for Sydney Water included an adjustment to

2 Deloitte 2013, Desalination capitalisation scenarios, June, p8.

account for government ownership of the business. Mimicking the approach taken by private sector ratings agencies is an option open to the Commission. Making an allowance for government ownership would mean that it is easier for the water businesses to meet investment grade (relative to a privately owned business). We also note there has been significant regulatory debate in the energy sector on the significance of government ownership and access to government funding, particularly in relation to the weighted average cost of capital.[3]

We are also seeking views on the merits of making any adjustments to prices on an NPV neutral basis. Our initial view is that there is a strong argument to suggest that any adjustment should be NPV neutral. Not doing so means that over the long run, a business would recover (via customer prices) more than efficient costs.[4]

The Commission seeks comment on the following:

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.

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.

4.2 FINANCIAL INDICATORS AND RANGES

NERA's recommended financial indicators, and ranges for each, are summarised at table 4.1. NERA recommended a set of primary indicators that would form the basis of our financeability assessments—these indicators are the same as those currently adopted by the Commission, but for their proposal to include a new measure for capital

[3] AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper, 29 November 2012, Sydney.

[4] A business receives extra revenues to manage short term viability above those necessary to recover efficient costs derived from the building block model. And if the extra revenue business received (adjusting for the time value of money) is not paid back in the future, businesses would have earned efficient costs plus the extra revenue, and customers would pay higher prices than those needed recover efficient costs.

adjusted interest cover.[5] NERA also recommended we adopt a new indicator of secondary importance (dividend cover) to assess the ability of water businesses to pay its dividend to the shareholder and whether those dividends are sustainable.

In terms of the ranges for each of the indicators, NERA recommends an increase in the lower threshold for FFO interest cover and a lowering of the upper threshold. It also recommends an increase in the range for gearing (based on regulatory asset values), an increase in the range for the internal financing ratio, and a lowering of the range for the FFO / Net Debt measure.

TABLE 4.1 NERA'S RECOMMENDED 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[6]	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[7]	More than 100 per cent	Indicator not currently used

NERA states that statutory profit does not give a clear indication of the near term requirements for payments to equity and debt providers, which should be the basis for any regulator's decision to adjust the cash flows of a regulated entity. Further, NERA notes that the adequacy of statutory profitability in the long term is addressed in the building block model through the equity component of the rate of return.

NERA did not propose we weight its recommended primary indicators for the purpose of conducting a financeability assessment. However, relative to other primary

5 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.

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

7 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.

indicators, NERA places a lower level of importance on the internal financing ratio and the ratio for funds from operations to net debt in any financial viability assessment.

OUR INITIAL VIEWS

Our initial view is that a continued focus on cash flow based indicators of financeability, similar to those implemented by ratings agencies, other regulators, and as recommended by NERA, is appropriate. A measure of gearing based on regulatory asset values is also appropriate for a financeability assessment.

We do not think statutory profit is appropriate for a financeability assessment because:

- it is influenced by a business' accounting policies and its interpretation, which can change over time, and therefore 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 financeability tests).
- its calculation includes transactions related to activities that are not covered by the regulatory framework.

While we do not think statutory profit should be considered, we are interested in any arguments to the contrary to change our view. Stakeholders may have views on other profit measures that we could use. We are also not convinced of the suggested need for a new measure for dividend cover because a dividend allowance does not form an input to price decisions.

In addition, incentives within the building block model allow well-managed businesses scope to generate profit (that can be used to pay dividends, to pay down debt, retained within the business, or lower customer prices). Both from the regulatory rate of return, and businesses' ability to beat regulatory expenditure benchmarks to create even further returns for their shareholder (or lower prices for customers). Further papers in 2014 will deal with matters concerning the broader regulatory framework.

The benchmarks ranges we use for assessing viability are not regulatory targets. For example, we do not set targets for a business' mix of debt and equity or its level of debt. Decisions about appropriate gearing or targets for other financial outcomes are an issue for a business' management and its board. We use these benchmarks ranges only to assess a business' financial viability to inform whether a regulatory intervention is warranted.

The Commission seeks comment on the following:

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.
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.
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?
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?

4.3 INPUTS USED TO CALCULATE INDICATORS

NERA recommends actual (rather than notional) data be used in financeability assessments, which is consistent with the Commission's current approach.

Based on the approach taken by Moody's, NERA recommends the Commission consider, where applicable to a business, the following items be adjusted for the purposes of estimating financial indicators:

- Operating leases – on the basis that businesses do not recognise operating leases as a debt on their balance sheet, even though they have a contractual obligation to make lease payments and non-payment can trigger default. This adjustment would affect debt and interest expenses, having a negative impact on cash flow based indicators (like interest cover) and gearing (Net debt / RAV).

- Superannuation obligations – on the basis that any underfunded obligations relating to future defined benefit payments should be treated as debt. This adjustment would have a positive or negative impact on debt and interest expenses. This would affect cash flow based indictors and gearing, depending on share market valuations at the time.

- Capitalised interest – on the basis that an analysis of interest coverage should expense all incurred interest costs regardless of the accounting treatment. This adjustment would increase interest expenses and have a negative impact on cash flow based indicators and gearing.

OUR INITIAL VIEWS

Our view is 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 financeability assessment.

We are seeking 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.

In terms of operating leases, there is an argument that if lease payments by water businesses are treated as an operating cost in the building block model (whereby costs are fully allowed as operating costs in approved prices in the year that they are incurred) the lease arrangements do not impact on the financial risk facing a business. This may imply that there should be no adjustment to financial indicators for lease arrangements for the purposes of conducting a financeability test. This matter may be particularly contentious where the life of the lease does not match the life of its underlying assets.

The Commission seeks comment on the following:

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?

5 NEXT STEPS

We are seeking feedback from stakeholders on key questions raised in this chapter. However, stakeholders may wish to comment on any other matter that they think is relevant to our consideration of our future financial viability assessments. Stakeholders can provide feedback via email or post. Details are provided on page 3.

The timeline for our consultation on financeablity assessments is set out below. We will seek to finalise our future approach in July 2014.

Date	Consultation process
December 2013	Release ESC consultation paper and NERA report for consultation
14 February 2014	Submissions in response to ESC consultation paper close
Early April 2014	Summary of Commission views
Mid May 2014	Submissions in response to Summary of Commission views close
July 2014	ESC releases final views