

4 August 2014

Mr Marcus Crudden
Acting Director - Water
Essential Services Commission
Level 37, 2 Lonsdale Street
MELBOURNE VIC 3000

Dear Marcus

Submission to Financial Viability - Views Paper

Thank you for the opportunity to respond to your *Assessing the financial viability of Victorian water businesses – Summary of views and proposed new indicator paper*. Melbourne Water supports the consultative approach taken by the Essential Services Commission (ESC) in reviewing the financial indicators that assess the financial viability of water businesses.

In Sydney Water's submission to IPART's Financeability Review in 2013, it highlighted that the objective of using financial indicators in a financeability test should be focussed on ensuring that an efficient and well managed utility is able to fund its operations over the long term and readily address any short term financing needs. Melbourne Water agrees with this objective and believes the ESC's existing benchmarks and the new proposed indicator may not in all cases meet this objective.

Benchmark ranges

Melbourne Water considers that the minimum requirement for the financial indicator benchmarks should be investment grade. The metrics for Moody's Baa quantitative metrics, the lowest level of investment grade, are appropriate and are consistent with meeting the low to medium risk rating against financial sustainability as used by the Victorian Auditor General's Office (see Table 1 below). Benchmark ranges that align with this investment grade level (without taking into account qualitative factors) would provide a better basis for supporting the ongoing financial sustainability of the business.

Table 1 Baa Rating quantitative metrics

FFO interest cover	2.5-4.5 times
Net debt to RAB	55-70%
FFO to net debt	10-15%
Internal financing	1.0-1.5 times

The ESC's proposed benchmark ranges would result in sub-investment grade from a quantitative perspective. In the NERA prepared paper; *Assessing the Financeability of Regulated Water Service Providers* (released December 2013), it was noted that given state ownership, the qualitative factors associated with 'regulatory environment and asset ownership model' would result in the overall assessment of Melbourne Water as an investment grade entity. Melbourne Water considers that the Independent Reviewer's preliminary advice on the economic framework review for the water sector in

Victoria increases the uncertainty in the qualitative criteria for *Stability and Predictability of the Regulatory Environment*. This would mean that a business with Ba metrics (first level of sub-investment grade may not be graded as investment grade (Baa) based on the qualitative assessment).

Interest cover

The ESC has proposed a benchmark for interest cover of 1.5 times with a caution applied for businesses whose interest cover falls below 1.8. Melbourne Water seeks further advice from the ESC how this would apply in practice. Melbourne Water interprets this benchmark range as that if a business' Interest Cover in any given year drops below 1.8 times and if the business fails to meet the secondary indicators, consideration would be given for an adjustment.

Gearing

The ESC has proposed a gearing benchmark range of 70 per cent and for it to be a secondary indicator. Gearing is a leverage measure that reflects the loan-to-value ratio. As such it is a much more stable measure when there are interest rate shocks or in periods of sustained low interest rates where interest cover can appear to be more of a short term measure than a measure for long term financial viability.

Melbourne Water strongly recommends that the ESC reconsiders this as a secondary indicator and it becomes a primary indicator alongside Interest Cover. Gearing is a key input alongside Interest Cover in credit ratings and is used by IPART as a one of three measures in the financeability test alongside Interest Cover and FFO / Net debt.

Melbourne Water notes that the change to the benchmark range for gearing is the minimum to meet investment grade, and this alongside not raising the interest cover benchmark could put our credit rating at risk resulting in a higher Financial Accommodation Levy (FAL).

Internal Financing Ratio

The internal financing ratio gives an indication of the extent to which Melbourne Water is able to fund capital internally. This is similar to RCF / capex indicators used by credit rating agencies where total capital expenditure is on the denominator. The internal financing ratio used by the ESC adjusts capital expenditure customer and government contributions, i.e. net capex.

It would normally be expected that a business of investment grade using a RCF / capex indicator would have a rating of 1.0 times or greater. Melbourne Water considers the ESC's benchmark for the internal financing ratio to be too low at 35 per cent as this would be sub-investment grade and require a substantial increase in debt to fund the required capital expenditure.

Profits

Melbourne Water acknowledges the ESC concerns with introducing a profit indicator, however Melbourne Water remains of the view that a measure of statutory profit should be used as a guide in assessing overall financial viability. Melbourne Water reiterates that it does not consider a specific profit range is appropriate to apply, rather that ongoing accounting losses represent a real risk to the business and should be considered alongside the other indicators in the overall estimation of financeability.

Proportion of Discretionary Revenue

Melbourne Water supports the inclusion of indicators that attempt to assess a business' ability to fund capital and return dividends. The operating expenditure preferably would be as per the statutory accounts operating expenditure and we would recommend that tax expense and interest expense be deducted from the regulatory revenue rather than actual tax and actual interest. This is because there can be significant timing differences with tax calculations from one financial year to another and to a lesser extent interest payments.

Melbourne Water seeks clarification from the ESC on what adjustments will be made for finance lease arrangements such as the desalination contract payments and Build Own Operate Transfer (BOOT) contracts.

It is unclear how the proposed Proportion of Discretionary Revenue (PDR) indicator will be applied in the financeability assessment as no benchmark range has been proposed. Melbourne Water cautions against using this indicator for comparative purposes as each water business has a different regulatory asset bases (RAB) value. Water businesses with large RABs generally have a high proportion of the revenue being generated from depreciation and the return on assets compared to operating expenditure. This is typical of wholesale and vertically integrated businesses which have relatively smaller operating expenditure and this implies a higher PDR value compared to others.

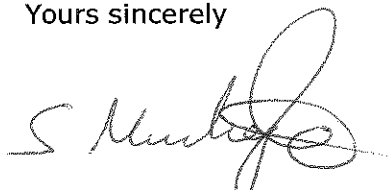
Melbourne Water is of the opinion that the proposed PDR indicator does not accurately reflect the earnings of the business. The calculation of the proposed measure in its current format does not take into account the cost of capital. An improvement on this indicator's ability to measure would be to make an adjustment for regulatory depreciation in the numerator such that:

$$PDR = \left(\frac{\text{Regulated Revenue} - \text{Regulatory Depreciation}}{-\text{Operating expenditure} - \text{Tax expense} - \text{Interest expense}} \right) / \text{Regulated Revenue}$$

This adjustment does not fully alleviate issues of comparability across businesses.

I look forward to the next stage of the financial indicator review process. If you have any questions or would like to discuss our submission further, please contact Jessica Saigar on 9679 7270.

Yours sincerely



SIMON MARCHINGTON
ACTING MANAGER PRICING AND REGULATION

