



25 July 2014

Mr Matthew Donoghue  
Financial Modelling and Data Manager  
Essential Services Commission  
Level 37, 50 Lonsdale Street  
Melbourne 3000

Dear Matthew,

**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 June 2014.

Barwon Water's responses to the Commission's 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 faithfully,

A handwritten signature in black ink that reads "Seamus Butcher".

Seamus Butcher  
Manager  
Corporate Strategy and Regulation

Attachment 1 - Barwon Water Response to 'Assessing the Financeability of Victorian Water Businesses'  
(June 2014)

**Barwon Region Water Corporation**

ABN 86 348 316 514

61-67 Ryrie Street, Geelong Victoria 3220  
PO Box 659 Geelong Victoria 3220 TEL 1300 656 007 FAX +61 3 5221 8236  
DX22061 (Geelong)

[www.barwonwater.vic.gov.au](http://www.barwonwater.vic.gov.au)



Attachment 1 – Barwon Water Response to ‘Assessing the Financeability of Victorian Water Businesses’ (June 2014)

Commission seeking comment on:	Barwon Water Response
<p><b>Proportion of Discretionary Revenue' indicator</b>  <math>PDR = (R - O - T - I) / R</math></p> <p><i>(where R = Regulated Revenue O = Operating Expenditure T = Actual Tax Payments I = Actual Interest payments)</i></p> <p>This indicator gives a reflection of an entity's earnings and discretionary funds available – discretionary funds that can be used to give a return to the shareholder, reduce debt, lower prices, reinvest in an entity's assets, and manage unexpected cashflow constraints.</p>	<p>Barwon Water supports the use of this indicator to measure discretionary funds., However Barwon Water believes the word “discretionary’ can suggest that businesses prices are being set to provide for contingency within businesses when this is certainly not the case as operating and capital expenditure forecast when calculating price outcomes is based on the most efficient programs at that point in time. ‘Discretionary funding only occurs due to the Businesses changing process or achieving efficiencies which were unforeseen or unknown at the time of setting the prices. Barwon Water recommends the discretionary should be replaced with “efficiency savings funding”</p> <p>For purposes of evaluating financial stability of prices calculated by the building block methodology, Barwon Water is of the opinion that a 3 to 5 year average approach should be used to smooth out unforeseen effects on expenditure or demand. Barwon Water also supports not having a benchmark but supports, as noted earlier, using historical data as a guide for making decisions.</p> <p>Barwon Water is of the opinion that events, such as efficiency improvements which may result in a higher PRD, should be considered when making pricing decisions.</p>
<p>Use the five quantitative indicators outlined in table 3.1. These indicators focus mainly on cash flow, which we believe gives us the best indication of a business's underlying financial position.</p>	<p>Barwon Water supports the Commission's approach of using the proposed indicators, with a focus on cash flow, in assessing financial viability in cases where the building block approach prices may result in insufficient revenue as the indicators provide an opportunity to flag a financial viability issue with a business early enough to allow time to implement changes by either reducing costs or re-opening prices determination prior to financial viability becoming a concern.</p>
<p>For interest cover, gearing, FFO / net debt, and the internal financing ratio, assess whether a business meets an investment grade credit rating based on outcomes for ratios for each of the indicators. The ratios we propose to use are provided in table 3.1.</p>	<p>Barwon Water supports the proposed benchmark ratios for the indicators in table 3.1.</p>
<p>Rank estimates for interest cover highest in terms of importance in conducting our financial viability assessments, with gearing ranked second. FFO / net debt, internal financing ratio, and the PDR indicator will be ranked the lowest in terms of the importance to our financial viability assessments.</p>	<p>Barwon Water supports the use of the identified ratios as it provides consistency with indices used by credit agencies.</p> <p>Barwon Water believes that all ratio results should be considered when measuring financial viability and agrees with prioritising interest cover given that it plays an important role in providing an early indication if a business may face difficulty in paying bills when as they fall due. It should be noted however, that this ranking may be considered the most useful for the Commission to meet its purpose of determining pricing adjustments but not necessarily appropriate when being used for other financial analysis external to the ESC . Ratios and ranking of ratios is dependant on the purpose for the review and outcome sought.</p>

Commission seeking comment on:	Barwon Water Response
<p>Make any future viability adjustments on a NPV neutral basis. Note while price increases for financial viability usually occur over one pricing period, we would likely smooth the return of funds to customers through lower prices over a number of years to ensure a business does not re-enter a financially vulnerable position.</p>	<p>Barwon Water maintains support of NPV neutral adjustments in conjunction with a robust and transparent weighted average cost of capital (WACC) setting process to minimise interest rate and inflation risk to businesses, which would in turn lead to improved financial viability over the period.</p>
<p>Not increase customer prices to rectify business decisions – for example, if a business chose to take on high gearing and had no extenuating circumstances. Where business decisions threaten a business's financial viability, primary responsibility rests with a business's management and board to address the issue.</p>	<p>While Barwon Water supports the approach of water businesses being responsible for business decisions, decisions made to mitigate water security or customer service level risk as a result of uncontrollable and unforeseeable external circumstances, climatic turn around or decrease in customer growth, should be taken into account when making regulatory pricing decisions.</p>
<p>Use historic and forecast actual data for financial viability tests as opposed to notional data.</p>	<p>Barwon Water supports the use of historic and forecast actual data for financial viability tests.</p>
<p>Consider adjustments proposed by businesses to the inputs used in our tests (such as for leases) on a case-by-case basis, allowing only material adjustments proposed and substantiated by businesses.</p>	<p>Barwon Water supports the adjustments being made on a case by case basis and only allowing material adjustments when making pricing adjustments to continue financial viability. However, Barwon Water believes a definition of 'material' would aid and provide consistency across the water industry whether this is based on a percentage relative to the size of the water entity. In addition, Barwon Water supports making only material adjustments outside of the Water Plan preparation process. Leading up to and at the commencement of each new regulatory period, all adjustments should be considered before a pricing determination is made.</p>