Assessing the Financeability of Victorian Water Businesses

Melbourne Water submission

State Government Victoria

Melbourne Water

Summary

Key points:

- Competitive neutrality principles should apply
- NPV neutral adjustments are reasonable in some circumstances but adjustments should be made according to the underlying issue
- Quantitative metrics consistent with an investment grade rating are supported
- Melbourne Water supports the emphasis on cash flows as a fundamental basis for assessing financial viability
- A measure of profit should inform the overall assessment
- Adjustments to financial statements not considered necessary

Introduction

Melbourne Water welcomes the opportunity to comment on the Essential Services Commission's (ESC) consultation paper, *Assessing the financeability of the Victorian water businesses.* It is generally supportive of views outlined in the consultation paper and the recommendations of NERA's report to the ESC, *Assessing the Financeability of Regulated Water Service Providers.*

Melbourne Water considers the review of financial sustainability is appropriate at this time, especially in light of challenges it faces following the capital program undertaken in the second regulatory period and the costs associated with the Victorian Desalination Plant (VDP).

Role of financeability tests

The building block methodology for establishing revenue amounts over a water plan period will, in most cases, ensure sufficient revenue to maintain financial viability. However, as the Water Services Association of Australia (WSAA) notes in its submission to Independent Pricing and Regulatory Tribunal[1] on this topic, the price determination process is not deterministic. For example, in its decision, the ESC provided parameter ranges for the key WACC inputs, with the ultimate decision containing at least a degree of judgment. Further, much of the ESC's final decision for Melbourne Water considered the impact of capitalising part of the VDP contract payments to the state - a decision which could not easily be made on a deterministic

[1] WSAA (2013) Submission to the Independent Pricing and Regulatory Tribunal's draft decision: Financeability tests in price regulation.

basis; but rather, through the balancing of competing objectives covering intergenerational equity, customer affordability and financial sustainability.

As such, we support the use of a financeability test to help inform and guide the price determination process. Melbourne Water is generally supportive of the proposals set out in the consultation paper particularly as they relate to a business maintaining an investment grade rating and the focus on cash flows as a fundamental of financial viability.

Melbourne Water is happy to further discuss any aspects of our response and is happy to participate in further consultation if necessary. Melbourne Water has responded to each of the questions posed by the ESC in its discussion paper and this forms the basis of the submission.

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.

Melbourne Water supports the position recommended by NERA in its report regarding competitive neutrality. Melbourne Water is a corporatised entity with an independent board with independent performance and monitoring. Our processes are consistent with the Victorian Competitive Neutrality Policy, and consistent with this, Melbourne Water's view is the financeability assessment should not make adjustments to account for government ownership.

Melbourne Water notes, however, that in establishing appropriate financial metrics, NERA utilised quantitative metrics associated with a Ba rating. An overall Ba rating is sub-investment grade but an organisation can be considered investment grade by independent credit rating agencies if its performance against qualitative factors is sufficiently strong. NERA considered the performance against the qualitative factors for Victorian businesses would be strong enough such that combined with Ba metric quantitative factors, it would result in an investment grade rating. While Melbourne Water considers that the metrics could be appropriate (see following sections), implicit in the assessment against the qualitative factors is the likelihood that the assessment has been advantaged by being government owned. Government ownership can also impact the ability to access equity injections which can impact the ability to manage gearing rates.

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 paper considers adjustments to cashflows made to alleviate financeability constraints should occur on a short term NPV neutral basis as the building block approach should provide sufficient revenue in the longer term. As described in the introduction, the regulatory process is not necessarily deterministic and judgement can influence key parameter inputs. Financial outcomes can also be influenced by the starting point of the Regulatory Asset Base (RAB). It is therefore feasible that a building block determination will result in ongoing adverse financeabilty issues for which short term cashflow improvements on an NPV neutral basis will result in simply pushing an underlying constraint into the future.

Melbourne Water supports an NPV neutral approach to rectifying short-term constraints. However, rather than a simplified approach, which assumes an NPV neutral approach in every case, Melbourne Water advocates for a case-by-case adjustments which also considers the causes and nature of the financial constraint in making any adjustments and ensures the long-term financial health of the business.

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

Melbourne Water considers the objective of maintaining an investment grade rating is appropriate for the financeability assessment. Melbourne Water supports the continued use of quantitative indicators as the underlying basis for financeability assessments as these provide an industry standard approach.

It is noted NERA appears to have assessed Moody's quantitative metrics for a Ba rated entity as being suitable because, combined with an A rating for qualitative factors associated with 'regulatory environment and asset ownership model', this would result in an overall assessment as an investment grade entity.

Melbourne Water considers further investigation is required to confirm a qualitative A rating and quantitative Ba rating would result in an overall investment grade rating. NERA considers that Victorian water businesses would achieve a qualitative rating of A based on an assessment of Sydney Water. Melbourne Water's review of Moody's methodology for assessments of qualitative factors indicates that it would not necessarily meet the requirements an A rating for qualitative factors as was achieved by Sydney Water. For example, Melbourne Water may not perform as well as Sydney Water against the criteria for *Stability and Predictability of Regulatory Environment* given the current review of the economic regulatory framework. While supportive of NERA's general approach, Melbourne Water considers that further work is required to confirm the basis for its assessment and that the approach would result in consistent investment grade assessments across the major ratings agencies.

If these factors do result in an investment grade rating, Melbourne Water considers the indicators, as proposed by NERA, reasonable as a 'safety-net' approach to ensure a bare minimum level of financial sustainability as a supporting mechanism to the building block approach to regulation.

Melbourne Water would however prefer metrics based on Moody's Baa quantitative metrics (see Table 1 below). This is investment grade level (without taking into account qualitative factors) and would provide a better basis for the ongoing financial sustainability of the business. Application of these metrics would also support meeting a medium to low risk rating against the financial sustainability risk assessment criteria used by the Victorian Auditor-General's Office (VAGO). At its most recent review for 2012-13, VAGO found Melbourne Water to be at a medium to high risk against all its financial sustainability risk criteria.

Table 1 Baa rating quantitative metrics

FFO interest cover	2.5-4.5
Capital adjusted interest cover	1.2-1.5
Net debt to RAB	55-70%
FFO to net debt	10-15%
Internal financing	1.0-1.5
Dividend cover	>1

Melbourne Water supports the emphasis on cash flows as a fundamental basis for assessing financial viability. For internal analysis, Melbourne Water considers FFO interest cover and Net Debt / RAV provide the best indicators of financeability as these indicate the overall debt levels and the ability to service it. Future cashflows of Melbourne Water are also considered an important indicator to ensure against potential impairment issues of assets. However, an overall picture of financeability is best understood through consideration of all the indicators (including profit – see following discussion).

Melbourne Water notes that a dividend cover metric is unlikely to provide any meaningful information. Based on current Department of Treasury and Finance policy, Melbourne Water's dividend calculation is equal to:

65% of Net profit before tax *less* tax paid.

Given this, as long as the dividend calculation remains as is current, the metric of Dividend Cover = Earnings (taken to be net profit after tax) / Dividends, will always be above 100%.

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?

Melbourne Water acknowledges that statutory profit as an indicator can be influenced by accounting treatments which are not necessarily reflective of the ongoing financial viability of the organisation as a whole. However, Melbourne Water remains of the view that a measure of overall statutory profit or an equivalent measure remains one of the indicators that should guide in the overall estimation of financial viability.

Significant and ongoing accounting profits and losses represent a divergence between the regulatory building block approach, which should result in 'normal' profit levels, to that of statutory accounting. As Melbourne Water stated in its submission response to the Draft Water Plan determination, profitability assists in maintaining continuity in business performance and avoids eroding the value of the Victorian Government's (and community's) investment in Melbourne Water (represented by the return on equity); as well avoiding the need for further price increases in response to unanticipated shocks (such as bushfires, floods or changes in the economy). It should also be noted that S94 of the *Water Act 1989* requires water corporations to "act as efficiently as possible consistent with commercial practice". Melbourne Water considers that a period of ongoing losses is not consistent with good commercial practice.

Melbourne Water does not consider a specific profit target range should be applied, rather that ongoing accounting losses represent a real risk to the business and should be considered in the overall estimation of overall estimation of financeability.

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?

Melbourne Water does not consider it necessary to make adjustments for operating leases, superannuation obligations or capitalised interest. Example operating lease obligations for Melbourne Water include the building tenancy and motor vehicles which are considered manageable in the regulatory construct as they form part of the operating cost of the building block.

For Melbourne Water, the nature of the adjustments associated with superannuation obligations or capitalised interest are immaterial over time and unlikely to materially impact the calculation of indicators. As such Melbourne Water does not consider it necessary to adjust actual data as included in statutory accounts for the purposes of estimating financial indicators.

In summary, Melbourne Water is supportive of the overall approach taken and welcomes the opportunity to discuss this submission further where required.

The key point of our submission are:

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