VICTORIA

Victorian
Auditor-General

Audit summary of Water Entities: Results of the 2008–09 Audits

Tabled in Parliament
25 November 2009

Audit summary

Background

This report covers 19 water businesses, which are wholly owned by the state government. The water industry comprises:

- 16 water corporations constituted under the *Water Act 1989*, which report to the Minister for Water
- three metropolitan retail distribution companies established under the *Corporations Act 2001*, which report to the Treasurer of Victoria.

The key legislation governing the water industry is the *Water Act 1989* and the *Water Industry Act 1994* and provisions within these Acts establish the relationship between the Minister for Water and the 19 businesses.

The *Water Act 1989* addresses the establishment, restructuring, abolition and administration of water corporations.

The *Water Industry Act 1994* contains the provisions that specifically address the application and issue of licences to the regulated water industry.

The Essential Services Commission (ESC) regulates the pricing of the water industry. The 19 entities are required to submit water plans to the ESC for approval. A water plan outlines the proposed operating and capital expenditure over the period of the plan and ultimately drives the prices to be levied for the provision of water, sewerage and other related services.

The Environment Protection Authority (EPA) regulates the environmental performance for the 19 entities.

Results of audits

Financial report

The 16 water corporations are required to prepare financial reports in accordance with the requirements of the Australian Accounting Standards, the *Financial Management Act 1994* (FMA) and the Financial Reporting Directions (FRDs) issued by the Minister for Finance. The FMA requires an entity to submit their annual report for tabling in the Parliament, within four months of the end of the financial year, including the financial report, which must be prepared and audited within 12 weeks. In 2008–09, 14 out of the 16 entities or 88 per cent finalised their financial report within the 12-week statutory time frame (88 per cent in 2007–08).

The three retail distribution companies are required to prepare financial reports in accordance with the Australian Accounting Standards and the *Corporations Act 2001*, which requires companies to report to their members within four months after the end of their financial year. However, as controlled entities of the government and to facilitate the preparation of the annual report of the State of Victoria, the provisions of the FMA require these financial reports to be finalised within 12 weeks. All companies met this time frame (100 per cent in 2007–08).

At 30 September 2009, clear audit opinions had been issued on the 19 financial reports.

Important attributes of the quality of financial reporting are timeliness and accuracy. The accuracy of financial reporting can be measured by the number and size of adjustments required.

Overall, there was a reduction in the number of material adjustments, 26 in 2008–09 compared with 28 in 2007–08. However, the value of the material adjustments was $189 million ($54 million in 2007–08), an increase of $135 million from the prior year.

Of the 26 material adjustments, 18 adjustments (24 in 2007–08) related to the figures reported within the key financial statements of the financial report, which in turn required figures disclosed in the notes to the financial report to be amended. There were a further eight adjustments (four in 2007–08) relating to information disclosed solely by way of note within the financial report.

Performance report

The 13 regional urban water corporations and the two rural water corporations are also required to prepare and submit for audit a performance report.

The average number of weeks to finalise the performance report was 10 weeks (11 weeks in 2007–08).

At 30 September 2009, clear audit opinions had been issued on the 15 performance reports.

Emerging issues

In a future reporting period the three retail distribution companies will revert from state owned companies, reporting under the *Corporations Act 2001*, to publicly owned statutory authorities reporting under the provisions of the FMA. This change will require the companies to adopt accounting policies that are consistent with those contained in the FRDs. The change is dependent on the passing of legislation though it is planned to be effective from 1 July 2010.

An accounting standard that will have an impact upon the financial performance and financial position of the entities in a future reporting period is AASB 1049 *Whole of Government and General Government Sector Financial Reporting*. This standard requires assets within the scope of AASB 116 *Property, Plant and Equipment* to be measured at fair value for reporting periods commencing on or after 1 July 2008.

For 2008–09, transitional relief was granted via FRD121 *Infrastructure Assets (Water/Rail)*, which allowed the 19 entities to continue to record infrastructure assets at cost within their financial report. However, to facilitate the preparation of the annual report of the State of Victoria, the 19 entities determined the fair value of infrastructure assets. The difference between infrastructure assets at cost, as reported in the individual audited annual financial report of the 19 entities for the year ended 30 June 2009, and infrastructure assets at fair value for whole-of-government financial reporting purposes was approximately $7 billion.

Effectiveness of internal control

Internal controls should provide reliable, accurate and timely reporting. The audit of financial reports includes an examination of the internal control framework that relates to financial reporting. Where significant control weaknesses or breakdowns are identified, these matters are reported to the entity's management.

Overall, internal controls as it relates to financial reporting were sound. Nevertheless, we identified some control weaknesses common to a number of entities, these include:

- preparation and review of reconciliations
- management of information systems.

An area of particular control focus in 2008–09 was the fixed assets system as infrastructure assets, property, plant and equipment represent approximately 96 per cent of the water industry's total asset base. As a result, it is important that an entity's information systems support the management of these assets and provide complete and accurate financial information for inclusion in the financial report.

No significant matters of concern were noted from our testing of key internal controls in relation to the fixed asset registers in 2008–09.

Our examination of asset maintenance and asset renewal at seven entities indicated that adequate systems and procedures are in place to record and report on these activities including regular reporting to the board of directors and subcommittees in relation to the capital asset program and maintenance costs. There are appropriate mechanisms in place to respond to actual and potential disruptions to service delivery.

Financial sustainability

The four metropolitan water businesses continue to generate profits and pay dividends to the state government, however, seven of the 13 regional urban water corporations and the two rural water corporations generated a loss in 2008–09.

Over the past four years the financial performance of the water industry has deteriorated, with the net profit before income tax declining by $197 million (44 per cent).

The net assets of the water industry have increased by $1.3 billion (10 per cent) with infrastructure assets and borrowings increasing significantly over the same four-year period. Infrastructure assets have increased by $4 billion. The increase has been predominantly funded by an increase in new borrowings to the value of $3 billion, with contributions (cash and non-cash) from developers accounting for a further $816 million.

The metropolitan water businesses have also drawn upon short term borrowings to finance the payment of dividends to the state government.

To be sustainable, the water entities need to have sufficient capacity to be able to manage future financial risks and shocks without having to radically adjust their current revenue or expenditure policies. One of the key objectives should be to maintain their infrastructure assets and manage debts at an acceptable level to support future operations.

Insight to the financial sustainability of water industry is obtained from an analysis of five financial sustainability indicators. Financial sustainability should be reviewed from both a short and long-term perspective. The short-term indicators provide an insight into an entity's ability to generate a profit and pay debts as and when they fall due within the next 12 months. The long-term indicators signify whether there is adequate funding available to finance asset replacement.

The results of the indicators should be analysed in the context of the regulatory and commercial environment in which these entities operate. Pricing arrangements are regulated by the Essential Services Commission and all long-term borrowings are secured from the Treasury Corporation Victoria, which reduces the re-financing and liquidity risks in the short term.

Our analysis of five indicators of financial sustainability over a period of four years reveals the underlying result for most entities has declined and that the overall liquidity of the industry has deteriorated with the regional urban sector showing a downward trend.

The metropolitan water businesses and regional urban water corporations have increased their level of debt to finance their capital works program, which in turn has increased their financial leverage or gearing.

While the ability of the metropolitan and the regional urban sectors to fund new assets and/or replace existing assets using cash generated by operations has declined, the capital-replacement ratio indicates an increase in the capital spend. The increased spending has predominantly been financed by new debt.

When analysing the trends of each indicator over the four-year period, Coliban Water has been identified as having a high financial-sustainability risk. Key factors having an adverse affect on the business include:

- below average rainfall
- the lowest and second lowest inflows to storages in recorded history
- ongoing water restrictions
- the requirement to purchase water to guarantee water supply
- a fixed cost structure due to the outsourcing of a number of activities.

As a result of the above factors, Coliban Water continues to generate an operating loss, has a deteriorating liquidity ratio and is generating insufficient cash flows from its operations to fund new assets and or replace its existing assets. The board of directors is reviewing the assumptions within the current water plan and exploring a number of strategies to improve its financial sustainability as indicated in the financial report for 2008–09. One possible strategy involves the ESC reopening the previously approved prices within the five-year water plan with a view to increasing prices due to its deteriorating financial performance and position. An increase in revenue will see an improvement in the key financial indicators over time. In the short-term the corporation has approval to draw upon new borrowings to pay operating costs.

Performance reporting

The 13 regional urban water corporations and the two rural water corporations are required to prepare and submit for audit a performance report. This forms part of the annual report, which is tabled in Parliament within four months of the end of the financial year. The performance report is to be presented as a consolidated report.

From our review of the performance reports submitted for audit, we noted that 14 of the 15 performance reports contained performance indicators for which no target had been set. Furthermore, there are performance indicators included in an entity's corporate plan that are not included in the performance report.

While the performance reports are required to include commentary for significant variations between actual performances achieved compared to the targets and the performance of the prior year, the depth of the commentary is quite varied and limited. Opportunities exist for the industry to improve the usefulness of the reports.

Melbourne Water is required to prepare a performance report, however, the information is not subject to audit attestation. Unlike the financial report, the performance indicators are also presented throughout the annual report rather than presented as one consolidated report within the annual report.

There is currently no requirement for the three retail distribution companies to prepare a performance report.

The current performance reporting arrangements do not facilitate comparison of performance across the industry.

The performance information included in the annual report of all entities is varied, with the information subject to differing levels of audit attestation.

In the absence of a consistent performance reporting regime, the ability of Parliament and the community to compare the performance of the 19 water businesses is inhibited.

Sector developments

The two major projects are the Food Bowl Modernisation Project and the Wonthaggi Desalination Plant Project.

The State Owned Enterprise for Irrigation Modernisation in Northern Victoria trading as the Northern Victoria Irrigation Renewal Project (NVIRP) is responsible for delivering the modernised irrigation system.

Stage one of the project with a cost of $1.0 billion commenced in 2007 and is expected to be completed in 2012. As identifiable assets are constructed by NVIRP, they will be transferred to Goulburn-Murray Water, which has responsibility for the Goulburn Murray Irrigation District. There have been no assets transferred to Goulburn-Murray Water to date.

Funding for stage one was going to be provided by the Department of Sustainability and Environment, Melbourne Water and Goulburn-Murray Water. There is no longer a requirement for Melbourne Water to contribute $300 million towards Stage One. The three retail distribution companies are now required to each contribute $100 million to the project, with $15 million contributed during 2008–09 and a further $85 million to be contributed over the next four years. The retailers have made the contributions on the basis that two new bulk water entitlements (BWEs) will be finalised, approved and issued by the state government during November and December 2009 following parliamentary approval.

A contract to build and operate the estimated $3.5 billion water desalination plant at Wonthaggi under a Public Private Partnership (PPP) arrangement was executed on 30 July 2009. The desalination plant project involves the construction of a sea water processing plant and transfer pipelines that connect to Melbourne's existing network.

Costs incurred by the Department of Sustainability and Environment (DSE) in relation to the establishment of the desalination plant are being financed by contributions from Melbourne Water. DSE has indicated the assets will be transferred to Melbourne Water at the end of the project term. At the date of this report, those arrangements are yet to be finalised.

These major capital works projects will be monitored to confirm that accounting treatments and reporting disclosures are applied consistently and appropriately.

Recommendations

Number	Recommendation	Page
1.	Entities with material errors in their draft financial report should adopt the better practice initiatives for financial reporting.	18
2.	The performance report should be subject to the same level of internal quality assurance review as the financial report.	19
3.	Material water entities should align their financial reporting timetable, including audit committee and board meeting dates with the whole-of-government annual financial report timetable.	20
4.	The retail distribution companies should evaluate the differences that exist between the company's current accounting policies and those prescribed by the Financial Reporting Directions to assist with their transition to a statutory authority and preparing a financial report under the requirements of the FMA.	23
5.	DTF should lead the adoption of consistent recognition and valuation of asset policies for whole-of-government reporting and entity level reporting for 2009–10.	24
6.	The 19 entities should monitor developments in relation to Exposure Draft 185 Rate-regulated Activities and assess the likely implications upon their accounting policies for future financial reports.	25
7.	Coliban Water should critically review their current and forecast financial capacity and continue to explore strategies to improve its financial sustainability in the short and long-term.	60
8.	DSE in conjunction with DTF should undertake a review of the current performance reporting arrangements and develop a consistent and contemporary performance reporting framework for the water industry.	66

General

The total cost of preparing and printing this report was $170 000.