Water Entities: Results of the 2008–09 Audits

Victorian Auditor-General's Report

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Victorian Auditor-General's Office

Auditing in the Public Interest

The Hon. Robert Smith MLC
President
Legislative Council
Parliament House
Melbourne

The Hon. Jenny Lindell MP
Speaker
Legislative Assembly
Parliament House
Melbourne

Dear Presiding Officers

Under the provisions of section 16AB of the *Audit Act 1994*, I transmit my report on *Water Entities: Results of the 2008–09 Audits.*

Yours faithfully

D D R PEARSON
Auditor-General

25 November 2009

Contents

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.

Audit Act 1994 section 16–submissions and comments

Introduction

In accordance with section 16(3) of the *Audit Act 1994* a copy of this report, or relevant extracts from the report, were provided to the Department of Sustainability and Environment, the Department of Treasury and Finance and the 19 entities with a request for comments or submissions.

The comments and submissions provided are not subject to audit nor the evidentiary standards required to reach an audit conclusion. Responsibility for the accuracy, fairness and balance of those comments rests solely with the entity.

Submissions and comments received

RESPONSE provided by the Department of Sustainability and Environment

The department notes and confirms the factual accuracy of the report.

In relation to the presentation of the financial sustainability indicators, the department supports the principle of using indicators to measure and monitor the financial sustainability of entities.

The five chosen indicators are derived from standard indicators utilised in the analysis of private sector for-profit companies. The full applicability and understanding of such ratios in relation to the water industry must be set in the unique operational context of the highly regulated Victorian water industry.

Pricing, financial performance and reporting and service delivery and quality are all regulated by a combination of legislation, Government departments and statutory bodies. This regulatory framework reduces the risk faced by the water entities in two key areas: the Essential Services Commission is required to approve a pricing regime that ensures the entities have a sustainable revenue stream and the entities have access to borrowings through Treasury Corporation Victoria.

RESPONSE provided by the Department of Treasury and Finance

The Department of Treasury and Finance notes the recommendations made by the Auditor-General in the report regarding the key outcomes of financial audits within the water industry and will continue to work collaboratively with the Department of Sustainability and Environment and the water industry to review and ensure a consistent and appropriate performance reporting framework.

DTF is also continuing to work with the water industry to implement a consistent approach to the valuation of infrastructure assets for whole-of-government and entity reporting purpose.

RESPONSE provided by Coliban Water

Coliban Water has commenced a process with key stakeholders to review assumptions in the current water plan which have proven incorrect. This will increase prices. An increase in revenue will see an improvement in the key financial indicators over time. As per the original water plan Coliban Water has approval to draw upon its facility with TCV to pay operating costs.

RESPONSE provided by South East Water

Broadly, the Report appears to provide an adequate overview of the structure, governance and nature of the Victorian water industry. In addition, the key findings and recommendations as a result of the 2008–09 audits by VAGO have been noted and will be considered by management as part of its planning model for the 2009–10 financial accounts and the transition to a statutory authority.

Financial sustainability is a high priority for South East Water and as such it has a well developed capital management plan which is regularly reviewed by external consultants. The most recent review has confirmed that South East Water will retain a strong credit rating of AA to A and will record further improvements in key metrics due to the increase in water prices over the period 2009–13 period.

South East Water is of the view that VAGO's financial sustainability metrics, risk assessment and resulting analysis is inconsistent with ESC regulatory water pricing frameworks and the aims, objectives and targets of the company's Capital Management, Water Plan and Corporate Plan.

RESPONSE provided by Western Water

Western Water would like to acknowledge that whilst the overall financial sustainability risk assessment is noted high, due solely to the Liquidity ratio being less than 1, this is just one financial indicator however in isolation does not indicate financial stress.

Western Water manages cash resources to both minimise interest expense, by not drawing on loans too early, and ensures that the cash balances maintained are only held for immediate needs.

It has a strong record in delivering of its capital works program and has adopted a high quality cash flow forecasting model to support its cash management/liquidity strategy.

RESPONSE provided by Yarra Valley Water

In relation to section 2 Results of audits and in particular the recommendations made Yarra Valley Water respond as follows:

Recommendation 3*—Whilst we understand the requirement to align material water entities financial reporting timelines with the whole-of-government financial report timetable, this would be unrealistic given how onerous and complex accounting disclosures have become over recent years.*

Recommendation 4*—Agreed. Yarra Valley Water has completed a high level review of the differences that exist between the Company's current accounting polices and those prescribed by the Financial Reporting Directions to assist with the Company's transition to a statutory authority and in preparing a financial report under the requirements of the Financial Management Act.*

Recommendation 5*—Agreed. Yarra Valley Water with the other Melbourne metropolitan water retailers has reviewed the potential implications of the Exposure Draft 185 Rate-regulated Activities. It is our interpretation that the Exposure Draft does not apply to Yarra Valley Water as prices set by the Essential Services Commission are not designed to recover previously incurred specific costs of an entity but rather recover future estimated costs.*

In relation to section 4 Financial Sustainability and in particular the Dividends section, the Treasurer has accepted our submission that no final dividend be paid by Yarra Valley Water for the 2008/09 financial year taking into account our relatively high gearing level, low interest cover ratios, high proportion of developer gifted non-cash assets as well as the substantial capital expenditure program.

In relation to the indicators of financial sustainability in section 4 Financial Sustainability, it is important to note that under the Economic Regulatory Framework, the Essential Service Commission (ESC) provides a sustainable revenue stream to the regulated water businesses in the setting of prices. As such, financial sustainability indicators to measure the financial performance of the water businesses should align to the regulatory environment in which the water industry operates.

The overall risk assessment in Figure 4W results in a high risk assessment for Yarra Valley Water that does not reflect the financial sustainability of the Company in an economic regulatory framework. Furthermore, considering only past performance does not take into account the positive financial outlook that is forecast from the ESC's final pricing decision in June 2009 for the next four years.

Below is our response in relation to the individual financial sustainability indicators commenting on their appropriateness and other potential indicators for assessing financial sustainability in an economic regulatory framework.

Underlying Result

The Underlying Result is a measure of whether a business has a high margin or low margin relative to its revenue but does not directly provide a clear measure of an entity's capacity to service its debt or fund its future capital expenditure.

In considering this analysis the discussion simply states 'The graph indicates that the underlying results have deteriorated over the four year period'. A more meaningful analysis would discuss the declining trend resulting from the continuing impact that the drought and water restrictions have had on the Company's revenue.

Liquidity

This indicator is not a strong measure of an entity's ability to pay existing liabilities in the next 12 months as there is no requirement for the Yarra Valley Water to repay its short term borrowings.

An analysis of the largest component of current liabilities is short term borrowings. In line with the ESC regulatory framework, the Company's debt portfolio strategy is to shorten the debt portfolio duration from 5 to 3 years to ensure prices within the regulatory period sufficiently cover the current interest allowed by the regulator. A part of this strategy is to maintain a relatively high level of short term borrowings. In doing so, this will always produce a very low liquidity ratio. Each year the Treasurer approves additional borrowings for the current financial year up to an agreed amount as per the Corporate Plan submitted to Government to enable the Company to meet its obligations when they fall due. The current rating of high risk of short term and immediate sustainability concerns are unwarranted as there is no risk that Yarra Valley Water will not be able to refinance its short term debt.

A more meaningful ratio that should to be included in the overall risk assessment is Funds from Operation Interest Cover, which measures the extent that gross funds cover interest obligations on debt. The ESC also set a benchmark for this ratio which provides guidance and measurement of financial sustainability.

Debt to Equity

The Debt to Equity ratio is not a strong measure of long term sustainability for an entity's capacity to service its proposed capital expenditure and levels of borrowings.

A more meaningful gearing ratio that should be included to calculate the overall risk assessment is Debt to Assets rather than Debt to Equity. Levels of capital expenditure for the forthcoming regulatory period are included in the return on investment set by the regulator through the ESC's building block principles for price setting. The ESC benchmark for an appropriately geared water business is 60%. Using Debt to Assets as a measure of gearing for the water business provides a measurement against the ESC's benchmark of 60% debt to assets. The ESC's benchmark gearing of 60% is consistent with a credit rating of BBB+ which is not a sign that Yarra Valley Water is under financial stress.

In addition, further commentary explaining that the increased levels of borrowings have been to fund the capital expenditure for water and sewer infrastructure to service growth in the northern suburbs for Yarra Valley Water and renewals of infrastructure to meet customers' expectations of service levels would be more useful.

Self Financing

The Self-financing indicator is not a strong measure of an entity's ability to replace assets from operating cash flow. There is nothing directly in the measure relating to asset values or capital investment.

A more meaningful self financing ratio that should be included to calculate the overall risk assessment is the Internal Financing Ratio calculated as operating cash flow less dividends, divided by cash outflows for capital expenditure. This is a more direct measure of the ability to finance capital expenditure. In addition it is important that this measurement tracks performance over time. The current declining trend is a result of the continuing impact the drought and water restrictions have had on the Company's revenue.

1 Background

1.1 Introduction

This report is the fourth of six reports to be presented to Parliament covering the results of our audits of public sector financial reports and performance reports. The reports in this series are outlined in Figure 1A.

The purpose of this report is to inform Parliament on the key outcomes of financial audits within the water industry, augmenting the assurance provided through audit opinions issued on financial reports and performance reports and to provide details on significant issues arising from financial audits for 2008–09. The report also comments on the effectiveness of internal controls, assesses the financial sustainability of the industry, analyses performance reporting across the industry and provides an overview of the major capital projects.

Figure 1A
VAGO reports on the results of audits

Reports	Description
Local Government: Results of the 2008–09 Audits	The **first** report, tabled in Parliament on 11 November 2009, contains the results of the annual audit of 79 councils, 12 entities they control and 12 regional library corporations.
Public Hospitals: Results of the 2008–09 Audits	The **second** report, tabled in Parliament on 11 November 2009, contains the results of the annual audit of 88 public hospitals, 22 entities they control and four associated entities.
Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2008–09	The **third** report, tabled in Parliament on 24 November 2009 contains the results of the audit of the State's Annual Financial Report.
Water Entities: Results of the 2008–09 Audits	The **fourth** report, tabled in Parliament on 25 November 2009 contains the results of the annual audit of 19 entities, comprising 16 water corporations and three retail distribution companies.
Portfolio Departments and Associated Entities: Results of the 2008–09 Audits	The **fifth** report, to be tabled provides a summary of the results of the annual audit of financial reports of the 10 portfolio departments and 198 associated entities with 30 June 2009 balance dates.
Results of Audits for Entities with other than 30 June 2009 Balance Dates	The **sixth** of these reports, to be tabled by mid 2010 provides the results of the annual audit of financial reports of 120 entities in Victoria's public sector, which have a financial year other than 30 June 2009. These entities principally comprise 76 higher education entities, 34 vocational training entities and Victoria's five alpine resorts.

Source: Victorian Auditor-General's Office.

1.2 Victoria's water industry

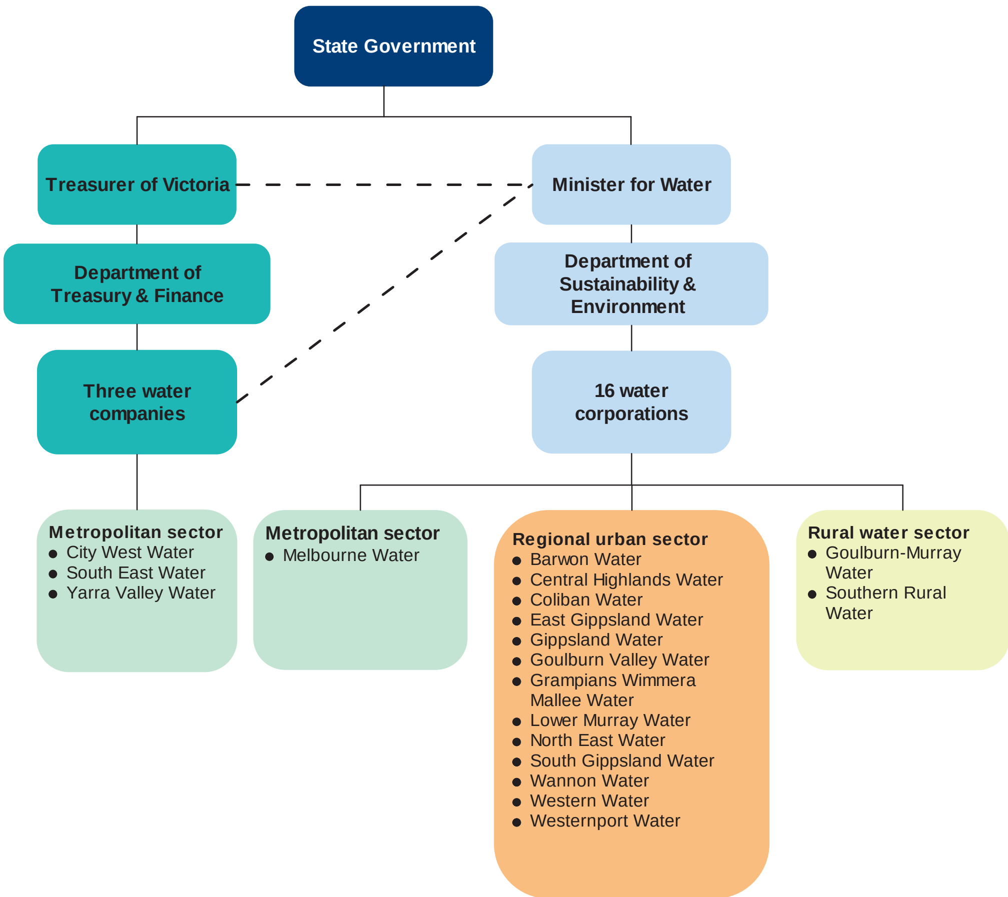
The Victorian water industry comprises 19 entities (20 entities in 2007–08). All entities are wholly owned by the state and are expected to operate in a commercial manner. The 19 entities consist of:

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

The industry can be divided into the metropolitan (four entities), regional urban (13 entities) and rural (two entities) sectors. Refer Figure 1B.

The responsible minister is the Minister for Water. The Office of Water, a business unit within the Department of Sustainability and Environment (DSE), supports and advises the minister.

Figure 1B
Overview of the water industry



Source: Victorian Auditor-General's Office.

1.3 Key legislation

The relationship between the Minister for Water and the 19 water entities is established by the *Water Act 1989* and the *Water Industry Act 1994*.

1.3.1 *Water Act 1989*

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

Other matters specifically dealt with in the *Water Act 1989* include:

- the Crown's right to the use, flow and control of all water in a waterway and all groundwater
- preparation of sustainable water strategies
- water shares
- allocation of water
- the Victorian Water Register
- finance and accountability matters covering the preparation of a corporate plan, a statement of corporate intent, and the borrowing powers of the water industry.

1.3.2 *Water Industry Act 1994*

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

The regulated water industry comprises Melbourne Water, the three retail distribution companies (collectively known as the Licensees), the 13 regional urban water corporations and two rural water corporations.

In essence, the Minister for Water can issue the following licences:

- a water licence
- a water and sewerage licence
- a drainage licence
- a sewage treatment licence
- a water head works licence.

A licence is not transferable and a licensee provides essential services within a designated geographical area.

The Minister for Water may also issue a statement of obligations to a licensee specifying the obligations of the licensee in performing its functions and exercising its powers.

1.4 Metropolitan water businesses

The metropolitan water sector comprises four entities, a wholesale water corporation and three retail distribution companies.

The wholesale/retail split was created in 1994 following the restructure of Melbourne's water industry. Prior to the split, Melbourne Water (formerly the Melbourne and Metropolitan Board of Works) was responsible for providing water, sewerage and trade waste services to the Melbourne metropolitan area.

Figure 1C lists the four entities and the trading name of each entity.

Figure 1C
Metropolitan water businesses

Entity	Trading name
Wholesaler	
Melbourne Water Corporation	Melbourne Water
Retail distribution companies	
City West Water Limited	City West Water
South East Water Limited	South East Water
Yarra Valley Water Limited	Yarra Valley Water

Source: Victorian Auditor-General's Office.

1.4.1 Wholesaler

Melbourne Water is a statutory authority established under the *Melbourne Water Corporation Act 1992* and is responsible to the Minister for Water. It is subject to the provisions of the *Financial Management Act 1994* (FMA) in relation to financial accountability and reporting.

The corporation manages Melbourne's storage reservoirs and is responsible for the harvesting, treatment and transfer of water to the three retail distribution companies. It also treats the majority of sewage and trade waste collected by the three retailers.

It has bulk water supply agreements with each of the retailers. The objective is to provide a reliable supply of safe, high-quality drinking water.

In addition to the three retail distribution companies, the corporation also supplies water to Western Water and recycled water to Southern Rural Water and the Eastern Irrigation Scheme.

The corporation is responsible for managing rivers and creeks and major drainage systems throughout the Port Phillip and Westernport catchment area. The drainage system carries rainwater from roads and buildings through gutters, drains and channels, and discharges it into rivers and creeks where it eventually flows into the bays.

All property owners within the Melbourne metropolitan licensed area are subject to an annual drainage charge. Following a decision by the state government to extend the waterways and drainage boundary as part of the *Our Water Our Future* action plan with effect from 1 July 2008, there are now property owners within the licensed boundary of Barwon Water, Central Highlands Water, Western Water and Westernport Water that are also subject to an annual drainage charge.

The three retail distribution companies and four of the regional urban water corporations are required by legislation to bill and collect the waterways and drainage charge for customers within their licenced boundary on behalf of Melbourne Water. The drainage charge is referred to as the waterways and drainage charge on customer invoices in urban areas, and the waterways charge in rural areas.

1.4.2 Retailers

The three retail distribution companies were established under the *State Owned Enterprises Act 1992* and must comply with the requirements of the *Corporations Act 2001*. The retailers are public companies, with the shares being held by the State Trustees Limited on behalf of the state government. Their primary reporting relationship is to the Treasurer of Victoria; however, the companies are also accountable to the Minister for Water.

The three retail distribution companies commenced operations on 1 January 1995 with a licence issued by the Minister for Water under the *Water Industry Act 1994*. They are responsible for providing water, sewerage, trade waste and recycled water services to residential, commercial and industrial customers within a specific geographical area. As a result, each retailer does not compete directly with the other retailers for customers. Figure 1D summarises the geographical area they service.

Figure 1D
Retailer service area

Retailer	Geographical area
City West Water	Melbourne’s central business district, the inner and western suburbs
South East Water	Melbourne’s south eastern suburbs
Yarra Valley Water	Melbourne’s northern and eastern suburbs

Source: Victorian Auditor-General’s Office.

1.5 Regional urban water corporations

The 13 regional urban water corporations are statutory authorities established under the *Water Act 1989* and are responsible to the Minister for Water. They are subject to the provisions of the FMA in relation to financial accountability and reporting.

The 13 corporations operate within a designated geographical area providing essential water and sewerage services to people living in regional cities and towns throughout country Victoria.

Like the three metropolitan retail distribution companies, the 13 regional urban water corporations do not compete directly with each other for customers. Their customer base is smaller than the metropolitan retailers and their customers are generally dispersed across broader geographic regions.

Figure 1E lists the 13 corporations and the trading name of each corporation.

Figure 1E
Regional urban water corporations

Entity	Trading name
Barwon Region Water Corporation	Barwon Water
Central Gippsland Region Water Corporation	Gippsland Water
Central Highlands Region Water Corporation	Central Highlands Water
Coliban Region Water Corporation	Coliban Water
East Gippsland Region Water Corporation	East Gippsland Water
Goulburn Valley Region Water Corporation	Goulburn Valley Water
Grampians Wimmera Mallee Water Corporation	Grampians Wimmera Mallee Water
Lower Murray Urban and Rural Water Corporation	Lower Murray Water
North East Region Water Corporation	North East Water
South Gippsland Region Water Corporation	South Gippsland Water
Wannon Region Water Corporation	Wannon Water
Western Region Water Corporation	Western Water
Westernport Region Water Corporation	Westernport Water

Source: Victorian Auditor-General's Office.

The services provided include:

- harvesting water and operating and managing headworks although some regional urban businesses purchase water from the rural water businesses
- treating water
- distributing water to households and industrial customers
- collecting, treating and disposing of sewage and further treating sewage for recycling and reuse purposes
- a range of retail customer service functions, including meter reading, billing and payment, and handling call centre enquiries and complaints.

Coliban Water, Grampians Wimmera Mallee Water and Lower Murray Water also provide services to rural customers.

1.6 Rural water corporations

There are two rural water corporations. They are statutory authorities established under the *Water Act 1989,* are responsible to the Minister for Water and subject to the provisions of the FMA in relation to financial accountability and reporting.

Figure 1F lists the two corporations and the trading name of each corporation.

Figure 1F
Rural water corporations

Entity	Trading Name
Gippsland and Southern Rural Water Corporation	Southern Rural Water
Goulburn-Murray Rural Water Corporation	Goulburn-Murray Water

Source: Victorian Auditor-General's Office.

Southern Rural Water and Goulburn-Murray Water, in conjunction with Coliban Water, Grampians Wimmera Mallee Water and Lower Murray Water, manage the supply and delivery of water that supports agricultural production and the needs of rural customers. The services provided include:

- supplying water for irrigation, private diverters, stock and domestic water users
- providing irrigation drainage services
- supplying water to fulfil delivery and source bulk entitlements
- operating storage facilities and the infrastructure of irrigation districts
- constructing and maintaining delivery and irrigation drainage services
- licensing groundwater and surface water extraction
- a range of customer service functions including handling customer complaints, billing and payment collection.

First Mildura Irrigation Trust

The First Mildura Irrigation Trust ceased to exist on 19 August 2008, having previously provided irrigation services to the Mildura region.

The Minister for Water, in light of findings stemming from an independent review of the Trust appointed Lower Murray Water to take over the whole of the functions, powers and duties of the Trust from 20 August 2008.

The final financial report of the trust covered the period 1 July 2007 to 19 August 2008. The trust had net assets of $55.4 million at the time of wind up, with the net assets transferred to Lower Murray Water.

1.7 Regulation

The water industry is subject to regulation by the Essential Services Commission (ESC) and the Environment Protection Authority (EPA) who have a role in setting economic, environmental and social obligations for the 19 water businesses.

1.7.1 Prices

The *Water Industry Regulatory Order 2003* made under section 4D of the *Water Industry Act 1994* gives the ESC the power to regulate the price of water, sewerage and other related services.

The ESC began regulating the prices and service standards of the 19 entities from 1 January 2004.

In September 2004, all entities with the exception of those that provide services to the rural customers were required to prepare and submit to the ESC a three-year water plan for the period 2005–06 to 2007–08. Entities providing services to the rural customers were required to prepare and submit a water plan, for a two-year period from 2006–07 to 2007–08.

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 related services. Customer growth, demand forecasts and the level of water restrictions that may apply during the period of the water plan are some of the other factors considered by the entities when preparing the plan.

The ESC must approve all of the prices that a water business may charge prior to the commencement of a regulatory period, having regard to the following principles:

- providing the regulated entity with a sustainable revenue stream
- allowing the regulated entity to recover its operational, maintenance and administrative costs
- allowing the regulated entity to recover its expenditure on renewing and rehabilitating existing assets
- allowing the regulated entity to recover all costs associated with existing debt
- providing a rate of return on assets
- providing incentives for the sustainable use of Victoria's water resources.

For the second regulatory period, the regional urban water corporations, rural water corporations and Melbourne Water (for its waterways and drainage services) were required to submit a five-year water plan for the period 2008–09 to 2012–13.

The pricing review of the metropolitan water businesses was deferred while the Victorian Competition and Efficiency Commission conducted an inquiry into the structure of Melbourne's retail water industry. Interim price increases determined by the Minister for Water were adopted for these businesses for 2008–09. The metropolitan water businesses have submitted a four-year water plan for the period 2009–10 to 2012–13, that has been approved by the ESC.

1.7.2 Environment

The EPA aims to protect, care for and improve our environment. It sets environmental standards and regulates environmental performance for the 19 water entities. Compliance with EPA regulations is a condition of the licence issued by the Minister for Water.

Each water business has a single licence with the EPA to cover all of its wastewater facilities. Previously, a separate licence was required for each wastewater facility. The licence relates to the discharge of treated wastewater into waterways and the management of biosolids generated at treatment plants.

1.8 VicWater

In Victoria the peak industry body is the Victorian Water Industry Association Inc. (VicWater). All 19 entities are members of VicWater.

VicWater organises various forums to stimulate discussion, facilitates the sharing of information, prepares publications, and represents the water industry in discussions with government.

2 Results of audits

At a glance

Background

All 19 entities are required to prepare an annual financial report, with 15 of the 19 also required to prepare a performance report. The financial report and performance report must be audited, and the resulting audit opinions are appended to the relevant statements.

Findings

- Clear audit opinions were issued on all 19 financial reports and 15 performance reports.
- 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.
- The average number of adjustments required by the entities to finalise their performance report was three. One entity required 15 adjustments, which indicates an ineffective internal quality assurance process.
- The time taken by entities to finalise their financial report has improved. The 16 water corporations finalised their financial report within 10 weeks (11 weeks in 2007–08), whilst the three retail distribution companies finalised their financial report within eight weeks (nine weeks in 2007–08).
- Five out of the six material water entities did not finalise their annual financial report in accordance with the milestones set for the preparation of the annual financial report of the State of Victoria.
- There is a $7 billion difference between infrastructure assets at cost, as reported in the individual audited annual financial report of the 19 entities, and infrastructure assets at fair value for whole-of-government financial reporting purposes.
- The retail distribution companies have adopted accounting policies that are not consistent with the accounting policies outlined in the Financial Reporting Directions (FRDs), which requires revised figures to be submitted to the Department of Treasury and Finance to facilitate the preparation of the annual report for the State of Victoria.

At a glance – *continued*

Recommendations

- Entities with material errors in their draft financial report should adopt the better practice initiatives for financial reporting.
- The performance report should be subject to the same level of internal quality assurance review as the financial report.
- 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.
- The retail distribution companies should evaluate the differences that exist between the company's current accounting policies and those prescribed by the FRDs to assist with their transition to a statutory authority and preparing a financial report under the requirements of the FMA.
- 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.
- 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.

2.1 Financial audit framework

The financial audit framework applied in the conduct of the 2008–09 audits is set out in Figure 2A.

Figure 2A
Financial audit framework

Planning

Planning is not a discrete phase of a financial audit, rather it continues throughout the engagement. However, initial audit planning is conducted at two levels:

- At a high or entity level, planning involves obtaining an understanding of the entity and its environment, including its internal controls. The auditor identifies and assesses the key risks facing the entity; the entity's risk mitigation strategies; any significant recent developments; and the entity's governance and management control framework.
- At a low or financial statements line item level, planning involves the identification, documentation and initial assessment of processes and controls over management, accounting and information technology systems.

The output from the initial audit planning process is a detailed audit plan and a client strategy document, which outlines the proposed approach to the audit. This strategy document is issued to the client after initial audit planning and includes an estimate of the audit fee.

Conduct

The conduct phase involves the performance of audit procedures aimed at testing whether or not financial statement balances and transactions are free of material error. There are two types of tests undertaken during this phase:

- Tests of controls, which determine whether controls identified during planning were effective throughout the period of the audit and can be relied upon to reduce the risk of material error.
- Substantive tests, which involve detailed examination of balances and underlying transactions; assessment of the reasonableness of balances using analytical procedures; and a review of the presentation and disclosure in the financial statements, for compliance with the applicable reporting framework.

The output from this phase is a final (and possibly an interim) management letter which details significant findings along with value-adding recommendations on improving controls and processes. These documents are issued to the client after any interim audit work and during the reporting phase.

Reporting

The reporting phase involves the formal presentation and discussion of audit findings with the client management, and / or the audit committee. The key outputs from this process are:

- A signed audit opinion, which is presented in the client's annual report alongside the certified financial statements.
- A report to the minister responsible for the entity of significant findings identified during the audit.
- A report to Parliament on significant issues arising from audits either for the individual entity or for the sector as a whole.

Source: Victorian Auditor-General's Office.

2.2 Reporting framework

All 19 entities are required to prepare an annual financial report, with 15 of the 19 also required to also prepare a performance report. The financial report and performance report must be audited.

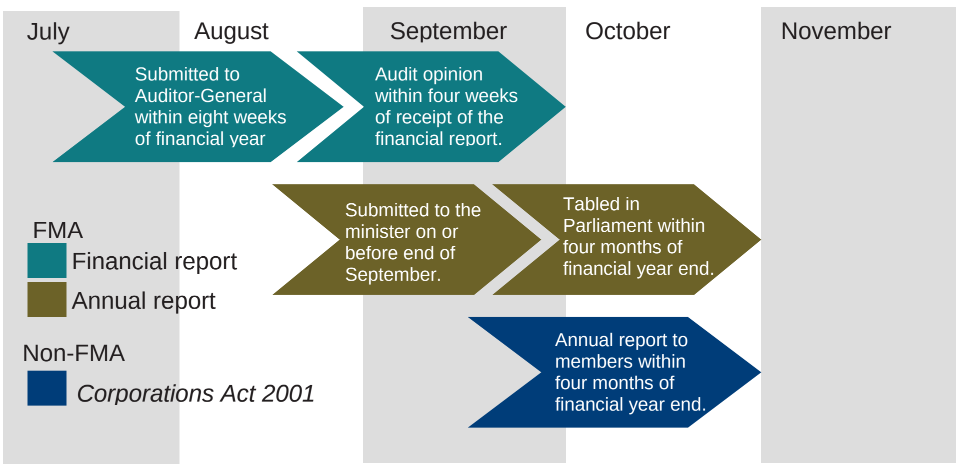
2.2.1 Financial report

The 16 water corporations prepare their financial report 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 should be prepared and audited within 12 weeks.

The three metropolitan retail distribution companies comply with the requirements of the Australian Accounting Standards and the *Corporations Act 2001* when preparing their financial report. The *Corporations Act 2001* requires the 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 the financial report finalised within 12 weeks. The companies are also encouraged to comply with the requirements of the FRDs to achieve consistency in the application of accounting policies from a whole of government financial reporting perspective.

Figure 2B provides an overview of the financial reporting framework.

Figure 2B
Financial reporting framework



Source: Victorian Auditor-General's Office.

2.2.2 Performance report

Financial Reporting Direction 27A *Presentation and Reporting of Performance Information* requires the 13 regional urban water corporations and the two rural water corporations to prepare and submit for audit a performance report.

The Minister for Water, under section 51 of the FMA, specifies the form and content of the performance report and requires the report to be included in the annual report tabled in Parliament within four months of the end of the financial year.

2.3 Audit opinions issued

The independent audit opinion adds credibility to the financial report and the performance report by providing reasonable assurance that the information in the report is reliable. A qualified audit opinion means that a statement has not been prepared in accordance with the relevant reporting framework and, therefore, is less reliable and useful as an accountability document.

2.3.1 Financial report

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

2.3.2 Performance report

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

2.4 Quality of reporting

2.4.1 Financial report

The quality of financial reports can be measured by the number of drafts required prior to finalisation and the number and size of adjustments required. An important attribute of the quality of financial reporting is its accuracy.

Our analysis of the process indicated that on average entities prepare four drafts of the financial report prior to audit clearance.

Errors identified in the draft financial report during the audit process are raised with the entity and, if the errors are considered to be material, adjustments are requested. The nature, frequency and size of errors in the draft financial report requiring adjustment are direct measures of accuracy.

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.

Our analysis of the errors revealed that eight entities (13 in 2007–08) across the three sectors required material adjustments to finalise their financial report. An average of three material adjustments (two in 2007–08) was processed.

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.

The material adjustments relating to the key financial statements can be further categorised as misstatements and misclassification. Misstatement adjustments result in a change to the net result or net asset position of the entity, while classification adjustments do not alter the net result or net asset position of the entity.

This year, the value of the misstatement adjustments was $13.5 million ($1.8 million in 2007–08). The most common adjustments related to:

- **accrued revenue, operating expenditure, capital expenditure, prepayments and payables** resulting from:
  - invoices being recorded in the incorrect reporting period
  - errors with accounting estimates
  - the incorrect application of goods and service tax.

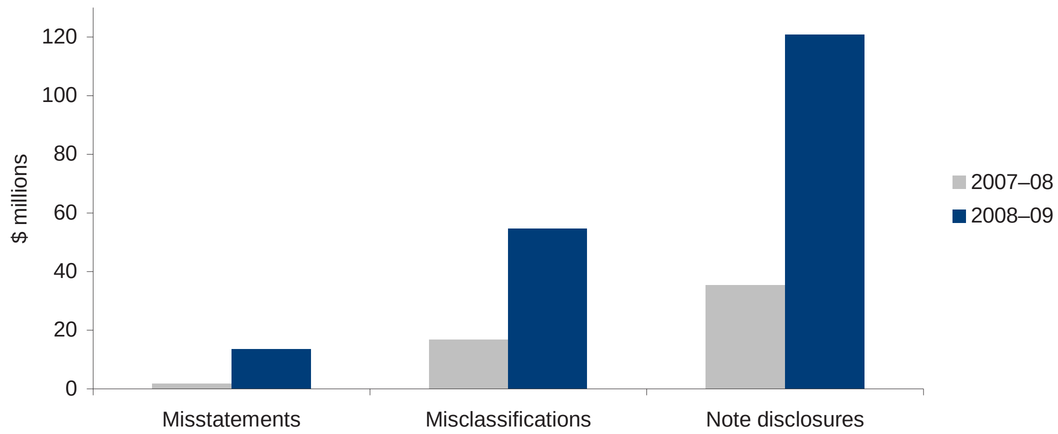
The misclassification adjustments totalled $54.7 million in 2008–09 ($16.8 million in 2007–08). The misclassifications related to:

- **interest-bearing liabilities:** incorrect classification of debt between current and non-current liabilities
- **prepayments:** a number of transactions were classified as a prepayment when the underlying nature of the transaction reflected a receivable or vice versa, which also had an impact on the financial instrument disclosures
- **intangible assets:** tradeable water rights incorrectly classified as property, plant and equipment
- **government grants:** government grants were treated as contributed capital when they were revenue in nature.

The eight material adjustments in the notes to the financial report relate to commitment disclosures and the value of the adjustments in 2008–09 was $120.8 million ($35.4 million in 2007–08). Adjustments relating to capital commitments totalled $87.4 million, while other commitments totalled $33.4 million.

Figure 2C provides a summary of the adjustments. Whilst the number of audit adjustments declined, the value of the adjustments significantly increased in 2008–09.

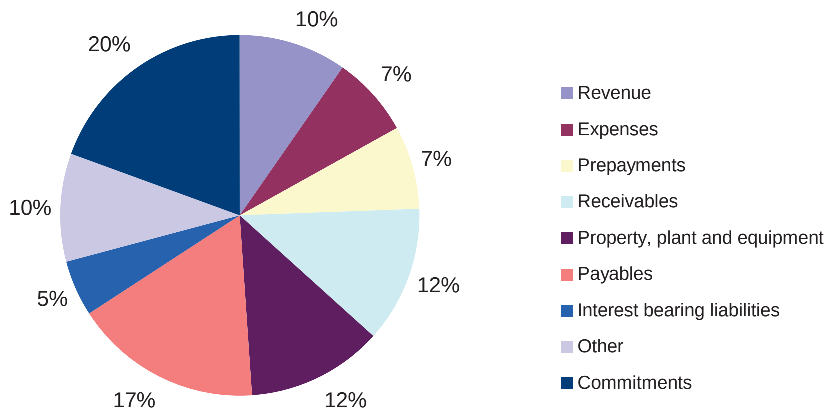
Figure 2C
Value of material adjustments



Source: Victorian Auditor-General's Office.

Figure 2D identifies the items within the draft financial report that were impacted by material adjustments.

Figure 2D
Material adjustments by category



Source: Victorian Auditor-General's Office.

There are better practice initiatives that entities could implement to improve the quality of reporting. These initiatives can be implemented both before and after the end of the financial year.

Initiatives before year end include:

- preparation of a project plan that includes the required human and financial resources, assignment of responsibility, and sets time frames for financial reporting
- reviewing actual and proposed changes to accounting standards, financial reporting directions and other pronouncements, to identify significant accounting and reporting issues, and obtain agreement with VAGO about any significant changes in accounting policy or reporting practice
- preparation of shell financial reports that can be reviewed by VAGO before the final audit visit
- undertaking a hard close at an interim balance date, a month or two ahead of the end of the financial year
- give consideration to the extent to which current financial systems have performance gaps, such as the ability to generate full accrual information with minimal manual intervention.

Initiatives after year end include:

- analysing significant variances between actual and the previous period results and budgeted outcomes to identify any potential omissions or errors
- establishing a system of documented sign-offs by executive managers with responsibility for components of the financial report
- undertaking a quality assurance review of the draft financial report before submission for audit
- submitting the draft financial report to the audit committee for review and endorsement before finalisation.

These better practice initiatives are actively promoted as part of our engagement with entities.

Recommendation

1. Entities with material errors in their draft financial report should adopt the better practice initiatives for financial reporting.

2.4.2 Performance report

The quality of performance reports can be measured by the number of drafts required prior to finalisation and the number of adjustments required. An important attribute of the quality of performance reporting is its accuracy.

Our analysis of the process indicated that on average entities prepare two drafts of the performance report prior to audit clearance.

The average number of adjustments required by the entities to finalise their performance report was three, although one entity required 15 adjustments, which indicates an ineffective internal quality assurance process.

Recommendation

2. The performance report should be subject to the same level of internal quality assurance review as the financial report.

2.5 Timeliness of reporting

2.5.1 Financial report

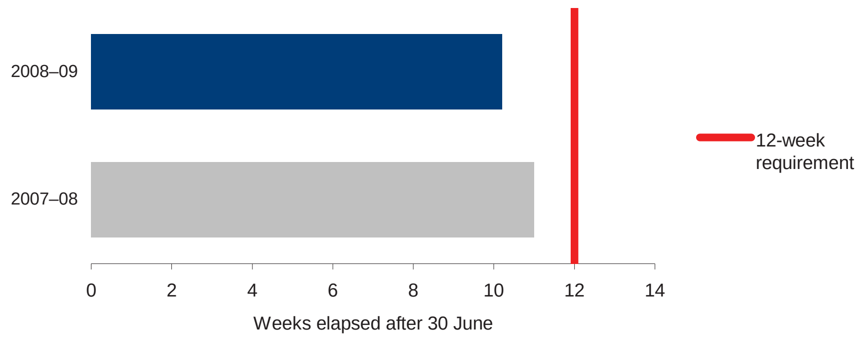
It is important that entities prepare and publish timely financial information. The later the financial reports are produced and published after year end, the less useful they become.

Water corporations

The 16 water corporations are required under the FMA to submit a complete draft financial report to audit within eight weeks of the end of the financial year and they are required to finalise their financial reports within 12 weeks of the end of the financial year. This year, 14 out of 16 (88 per cent) entities achieved the required 12-week time frame to finalise their financial report. The timeliness is consistent with 2007–08 where 15 out of 17 (88 per cent) achieved the required 12-week time frame.

Figure 2E sets out the average time taken by the water corporations to finalise their financial reports (10 weeks in 2008–09 and 11 weeks in 2007–08).

Figure 2E
Average time taken to finalise financial reports



Source: Victorian Auditor-General's Office.

Companies

The three metropolitan retail distribution companies are required under the *Corporations Act 2001* to have their financial reports finalised within four months of the end of the financial year. However, as controlled entities of the state and to facilitate the preparation of the annual report of the State of Victoria, the provisions of the FMA require the financial report to be finalised within 12 weeks. All of these entities met the FMA requirement in 2008–09, the same as last year.

The average number of weeks to finalise the financial report has improved, eight weeks in 2008–09 compared with nine weeks in 2007–08.

Material entities within the water industry

To facilitate the preparation of the annual financial report of the State of Victoria, six water entities should meet an earlier time line. They were:

- Barwon Water
- City West Water
- Goulburn-Murray Water
- Melbourne Water
- South East Water
- Yarra Valley Water.

Only three entities (four in 2007–08) submitted their first complete draft financial report by the requested target date of 24 July 2009 (25 July in 2007–08).

The complete financial report of Goulburn-Murray Water and South East Water were received within a week of the target date, 29 July 2009 and 28 July 2009, respectively. The complete financial report of Barwon Water was received on 7 August 2009, two weeks after the target date.

Barwon Water was the only material water entity that finalised their financial report by the requested target date of 14 August 2009 (15 August in 2007–08). A further three material entities had received verbal clearance from VAGO by the target date with the financial report adopted by the board of directors at the board meeting held during the last week of August 2009.

Recommendation

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.

Status of audits

Figure 2F summarises the dates of when the financial reports were finalised.

Figure 2F
Audit status–financial reports

	Audit type		Financial report		Timeliness of financial reports completed	
Entity	**FMA**	**Non-FMA**	**Clear opinion**	**Opinion date**	**Within 12 weeks**	**> 12 weeks**
Metropolitan						
Wholesaler						
Melbourne Water	●		✓	21-Aug-09	●	
Retailers						
City West Water		C	✓	27-Aug-09	●	
South East Water		C	✓	24-Aug-09	●	
Yarra Valley Water		C	✓	26-Aug-09	●	
Regional urban						
Barwon Water	●		✓	14-Aug-09	●	
Central Highlands Water	●		✓	14-Sep-09	●	
Coliban Water	●		✓	24-Sep-09		●
East Gippsland Water	●		✓	10-Sep-09	●	
Gippsland Water	●		✓	17-Sep-09	●	
Goulburn Valley Water	●		✓	14-Sep-09	●	
Grampians Wimmera Mallee Water	●		✓	17-Sep-09	●	
Lower Murray Water	●		✓	29-Sep-09		●
North East Water	●		✓	08-Sep-09	●	
South Gippsland Water	●		✓	17-Sep-09	●	
Wannon Water	●		✓	14-Sep-09	●	
Western Water	●		✓	19-Aug-09	●	
Westernport Water	●		✓	22-Sep-09	●	
Rural						
Goulburn-Murray Water	●		✓	21-Aug-09	●	
Southern Rural Water	●		✓	17-Sep-09	●	
2008–09 Total	**16**	**3**			**17**	**2**
2008–09 Total number of entities = 19						
2007–08 Total	17	3			18	2
2007–08 Total number of entities = 20						

Note: Non-FMA audit types: C – *Corporations Act 2001*.
Source: Victorian Auditor-General's Office.

2.5.2 Performance report

FRD 27A *Presentation and Reporting of Performance Information* requires the 13 regional urban water corporations and the two rural water corporations to prepare and submit a performance report for audit.

The directive issued by the Minister for Water under section 51 of the FMA requires the performance report to form part of the annual report tabled in Parliament within four months of the end of the financial year.

The performance report is generally prepared and submitted to audit at the same time as the financial report. The average number of weeks taken to finalise the performance reports was 10 weeks in 2008–09 (11 weeks in 2007–08). Figure 2G summaries the dates of when the performance reports were finalised.

Figure 2G
Audit status–performance reports

	Performance report		Timeliness of performance reports completed	
Entity	**Clear opinion**	**Opinion date**	**Within 12 weeks**	**> 12 weeks**
Regional urban				
Barwon Water	✓	14-Aug-09	●	
Central Highlands Water	✓	14-Sep-09	●	
Coliban Water	✓	24-Sep-09		●
East Gippsland Water	✓	10-Sep-09	●	
Gippsland Water	✓	17-Sep-09	●	
Goulburn Valley Water	✓	14-Sep-09	●	
Grampians Wimmera Mallee Water	✓	17-Sep-09	●	
Lower Murray Water	✓	29-Sep-09		●
North East Water	✓	08-Sep-09	●	
South Gippsland Water	✓	17-Sep-09	●	
Wannon Water	✓	14-Sep-09	●	
Western Water	✓	19-Aug-09	●	
Westernport Water	✓	22-Sep-09	●	
Rural				
Goulburn-Murray Water	✓	21-Aug-09	●	
Southern Rural Water	✓	17-Sep-09	●	
2008–09 Total			**13**	**2**
2008–09 Total number of entities = 15				
2007–08 Total			14	2
2007–08 Total number of entities = 16				

Source: Victorian Auditor-General's Office.

2.6 Emerging financial reporting issues

2.6.1 Water industry reforms

On 3 July 2008, the Victorian Government announced that the status of the three retail distribution companies would be changed from state-owned companies, reporting under the *Corporations Act 2001*, to publicly owned statutory authorities, reporting under the FMA. This decision was made in response to recommendations within the Victorian Competition and Efficiency Commission report, *Water Ways: Inquiry into Reform of the Metropolitan Retail Water Sector*. The change is dependent on the passing of legislation though it is planned to be effective from 1 July 2010.

The impact of the pending change is that the retail distribution companies will be required to prepare their annual financial report in accordance with the requirements of the FMA and the FRDs. This will require the three retailers to revise a number of existing accounting policies to achieve consistency with the accounting policies outlined in the FRDs, specifically:

- **FRD 103D *Non-Current Physical Assets*:** non-current physical assets to be measured at fair value rather than at cost.
- **FRD 112B *Defined Benefits Superannuation Obligations:*** defined benefit superannuation gains and losses to be recognised in the operating statement.

FRD 21A *Responsible Person and Executive Officer Disclosures in the Financial Statements* will also require changes to the disclosure in relation to the remuneration of executive officers.

Recommendation

4. The retail distribution companies should evaluate the differences that exist between the company's current accounting policies and those prescribed by the FRDs to assist with their transition to a statutory authority and preparing a financial report under the requirements of the FMA.

2.6.2 Application of AASB 1049 Whole of Government and General Government Sector Financial Reporting

Australian Accounting Standard AASB 1049 *Whole of Government and General Government Sector Financial Reporting* 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.

Fair value is usually determined from market based evidence. However, if there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.

Whilst public sector entities are required to record property, plant and equipment at fair value, the water and rail entities were provided with transitional relief for 2008–09.

The transitional relief was granted via FRD 121 *Infrastructure Assets (Water/Rail)* and allowed the water industry to continue to record infrastructure assets at cost within their financial report. However, the 19 entities were required to determine the fair value of their infrastructure assets as at 30 June 2009. The audited financial report was adjusted to account for the impact of recording infrastructure assets at fair value, with the revised financial figures submitted to the Department of Treasury and Finance (DTF) to facilitate the preparation of the annual report of the State of Victoria.

At the written direction of the DTF under the direction of the Minister for Finance the water industry will be required to implement the fair valuation of their infrastructure assets in their financial reports in either 2009–10 or 2010–11. Assuming current revenue, this change in accounting policy will result in a higher depreciation charge and have an impact upon the net result, tax related balances and dividends to be paid to the state government in the future.

The four metropolitan water entities, being for-profit entities, adopted an income approach whilst the regional and rural water entities, being not-for-profit entities, adopted a depreciated replacement cost approach to determining a fair value of their 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.

Recommendation

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.

2.6.3 Exposure Draft (ED) 185 Rate-regulated Activities

The Australia Accounting Standards Board (AASB) released Exposure Draft (ED) 185 Rate-regulated Activities in July 2009 and comments were sought by 9 October 2009.

It specifically addresses rate-regulated activities that meet the following criteria:

- an authorised body is empowered to establish rates that bind customers
- the price established by regulation (the rate) is designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a specified return (cost-of-service regulation).

This ED proposes that when the scope criteria above are met, regulatory assets are recognised in the regulated entity's balance sheet separately from other assets. Regulatory assets are the rights of a regulated entity to earn specific return and recover previously incurred costs in relation to its regulated activities. The effect of this requirement is to initially recognise as an asset (liability), amounts that would otherwise be recognised as an expense (income).

On initial recognition and at the end of each subsequent reporting period regulatory assets (liabilities) are measured at their expected present value, and assessed for impairment.

Recommendation

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.

3 Effectiveness of internal control

At a glance

Background

Internal control encompasses the systems, policies and behaviours established by entities to reliably and cost effectively meet their business objectives.

When undertaking our financial audit we conduct an assessment of the effectiveness of internal controls established by management over the reliability of financial reporting. While it is not our responsibility to form an opinion on internal controls, we nevertheless raise with management any control weaknesses or breakdowns we identify.

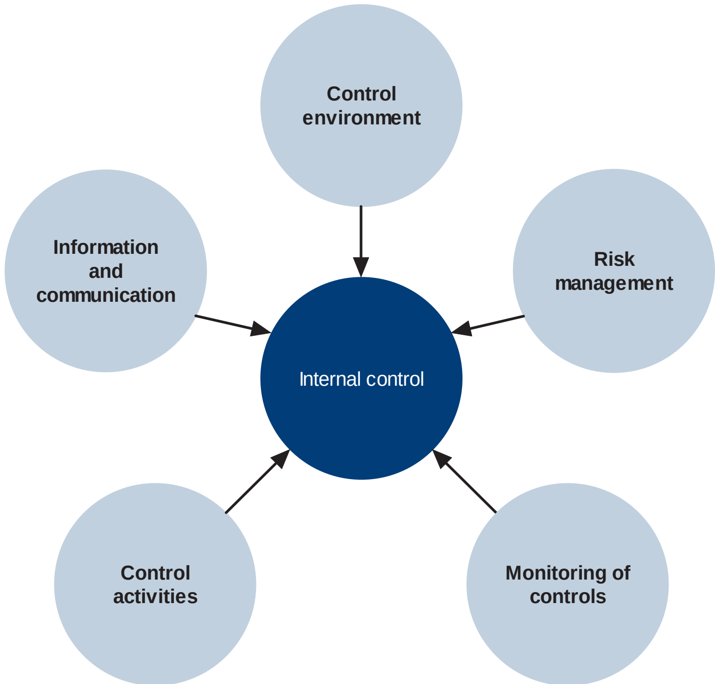
Finding

- Internal controls are generally sound, although weaknesses in the areas of account reconciliations and information systems were noted in 26 per cent and 37 per cent of water businesses, respectively.

3.1 Introduction

Each entity's governing body is responsible for the development and maintenance of its internal control structure. Internal control refers to systems, processes and procedures that are established by an entity. Figure 3A identifies the major components of internal controls. Sound internal controls provide an effective and efficient vehicle for the delivery of reliable, accurate and timely external and internal reporting.

Figure 3A
Internal control framework



Source: Victorian Auditor-General's Office.

The audit of financial reports includes an examination of the internal control framework that relates to financial reporting.

Weaknesses in internal controls identified in an audit will usually not result in a qualified audit opinion. Only when they give rise to significant uncertainty about the financial information being reported is a qualification warranted. Often, there are other compensating control procedures and audit processes that are used to mitigate the risk of material error. Nevertheless, any weaknesses noted are brought to management's attention.

This section summarises the major internal control weaknesses commonly identified during the financial audits for the year ended 30 June 2009.

3.2 Common internal control weaknesses

Overall, our assessment of the internal control structure is that systems for internal controls were adequate for financial reporting purposes. The most commonly identified control weaknesses related to:

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

3.2.1 Preparation and review of account reconciliations

A financial report is generally prepared based on information captured by the entity's general ledger, with key balances within the general ledger often supported by information recorded by subsidiary ledgers. As a result, a periodic reconciliation of the general ledger with the subsidiary ledger balances is vital to confirm the completeness and accuracy of data.

This year, issues relating to key account reconciliations were identified at five of the 19 entities (26 per cent). We found instances where:

- balance sheet reconciliations were not being prepared
- there was no evidence of balance sheet reconciliations being independently reviewed.

In the absence of account reconciliations being prepared in a timely manner and independently reviewed, there is a risk that errors may go undetected or may not be resolved in a timely manner. This in turn may also result in a material misstatement within the financial report.

3.2.2 Management of information systems

The key information systems of an entity contain personal details of customers and suppliers. It is important that access to the information systems is appropriately restricted to protect the confidentiality of the data.

Effective management of information systems is also critical to the reliability and integrity of financial data.

In 2008–09, the following control weaknesses were identified at seven of the 19 entities (37 per cent):

- weak password settings, including use of non-complex passwords and no change or no regular change to passwords
- inadequate controls over network security
- a lack of complete register of all changes made to software and hardware and no evidence of approval of change requests

- a lack of monitoring of the activities of privileged users, such as system administrators
- a lack of information technology policies and the existence of out dated policies.

Weaknesses in information system controls increase the risk of unauthorised access. It also increases the risk of fraudulent activity.

3.3 Review of the fixed assets system

At 30 June 2009 the water industry had assets to the value of $21.1 billion ($19.2 billion in 2007–08). Infrastructure assets, property, plant and equipment account for $20.2 billion ($18.2 billion in 2007–08) or 96 per cent (95 per cent in 2007–08) 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.

3.3.1 Fixed asset register

An entity often maintains a number of systems to facilitate the management of their infrastructure assets, property, plant and equipment. A key system is the fixed asset register. The register provides management with information relating to the assets it controls. Each asset is assigned an asset number with the purchase date, the gross cost or revalued amount, and the useful life recorded. At the end of each month the system is able to calculate the depreciation charge.

Of particular interest to audit is the effectiveness of internal controls in relation to asset additions, disposals, retirements, valuations, the calculation of depreciation expense and management's assessment of asset useful lives, the accounting treatment for maintenance costs, the reconciliation of figures within the fixed asset register with balances reported in the general ledger and system access controls.

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

3.3.2 Asset maintenance and renewal process

Infrastructure assets within the water industry are acquired, constructed or gifted by developers. They are maintained and renewed over an extended period of time. The recording, utilisation and reporting of infrastructure assets is supported by asset management systems which provide a structured approach to the long-term management of assets to efficiently deliver services.

An entity's strategy in relation to the long-term management of infrastructure assets involves routine maintenance and an asset renewals program.

Expenditure related to maintenance can be classified as either preventative/scheduled (according to asset life cycle requirements) or responsive/emergency (dealing with service disruption), while asset renewal represents the restoration of the service potential of the asset, thereby extending the useful life of the asset. The relining of pipelines is an example of an asset renewal.

A review of asset maintenance and asset renewal was undertaken for a sample of seven entities. The entities were selected from each sector of the industry and represented more than 70 per cent of the industry's total asset base.

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.

4 Financial sustainability

At a glance

Background

This part of the report presents an analysis of selected financial sustainability ratios. These ratios provide a set of interrelated indicators to assess the financial performance and position of the 19 entities over the past four years.

To be financially sustainable, 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.

Findings

- The financial performance of the water industry has deteriorated over the past four years, with the net profit before income tax declining by $197 million (44 per cent).
- In 2008–09 the four metropolitan water businesses continued to generate profits and pay a dividend to the state government. Seven of the 13 regional urban water corporations and the two rural water corporations generated a loss.
- At 30 June 2009, 14 of the 19 entities had a liquidity ratio of less than one (12 entities in 2007–08). However, the entities have approval to access additional borrowings in the next financial year up to an agreed amount and are able to draw upon the new borrowings to meet obligations as and when they fall due within the next 12 months.
- The metropolitan water businesses are financing their capital works program with new borrowings. There has been an upward shift in debt by the regional urban sector over the past two years to fund their capital works program as well. The level of borrowings for the rural water corporations has remained relatively unchanged.
- The entities have tended to refinance debt rather than repay maturing debt over the past four years.

At a glance – *continued*

Findings – *continued*

- Coliban Water has been identified as having a high-financial sustainability risk. The board of directors is reviewing the assumptions within the current water plan and exploring a number of strategies to improve its financial sustainability. One possible strategy involves the Essential Services Commission reopening the prices within the five-year water plan with a view to increasing its prices due to its deteriorating financial performance and position. In the short-term it also has approval to draw upon new borrowings to pay operating costs.

Recommendation

- 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.

4.1 Introduction

To be financially sustainable, public sector entities need the capacity to meet current and future expenditure as it falls due. They must also be able to absorb foreseeable changes and financial risks as they materialise.

Insight to the financial sustainability of water industry is obtained from an analysis of five financial sustainability indicators. These indicators reflect each entity's revenue and expenditure policies, and indicate whether these policies are financially sustainable.

The results of the indicators should be analysed in the context of the regulatory and commercial environment in which these entities operate.

4.2 Financial performance

Financial performance is measured by the net result, which is the difference between revenues and expenses for the reporting period.

4.2.1 Revenue

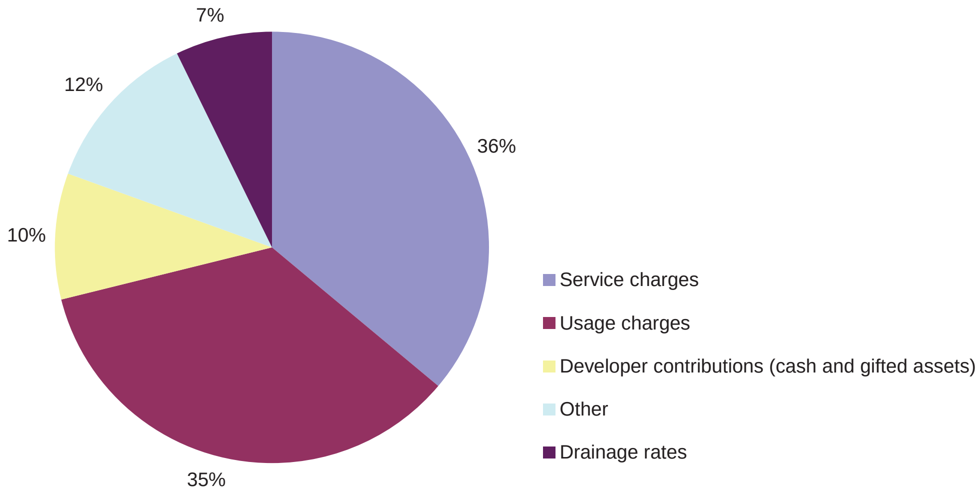
In 2008–09, the water industry generated revenue of $2.3 billion, an increase of $250 million or 12 per cent from 2007–08. The increase relates to the following items:

- **Service charges** increased by $131 million (18 per cent) and **usage charges** $125 million (18 per cent); the increases result from higher prices being levied for services relating to the provision of water and sewage.
- **Drainage revenue** increased by $23 million (7 per cent), the increase in part is due to a decision by the government to extend the drainage and waterways boundary. Since 1 July 2008 more property owners have been subject to the annual charge.

These increases have been partly offset by a decrease in government grants of $16 million (16 per cent), which can fluctuate from year to year.

Figure 4A provides a breakdown of revenue for the year ended 30 June 2009, the split being comparable to the break up for 2007–08. The main revenue items are service charges (36 per cent), usage charges (35 per cent) and developer contributions (10 per cent). Other revenue (12 per cent) comprises fees for services, trade waste charges and government grants.

Figure 4A
Revenue composition for 2008–09



Source: Victorian Auditor-General's Office.

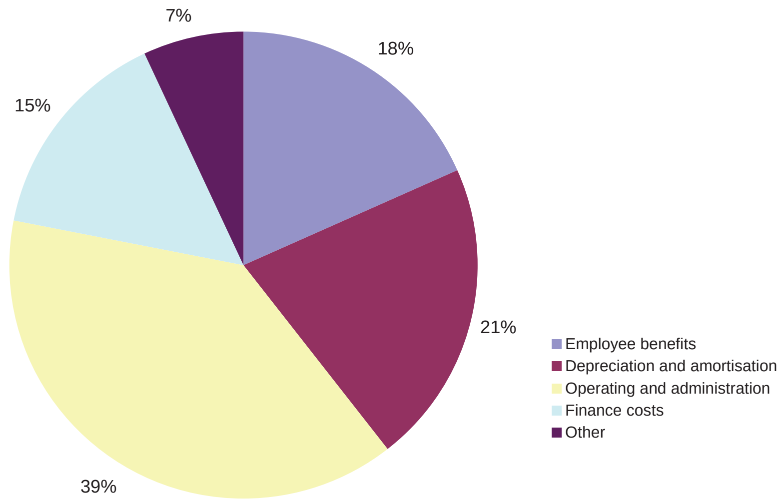
4.2.2 Expenses

In 2008–09, the water industry generated expenses of $2.1 billion, an increase of $196 million or 10 per cent from 2007–08. The increase relates to the following items:

- **Finance costs** increased by $47 million (18 per cent), the increase due to the growth in interest-bearing liabilities.
- **Employee benefits** increased by $36 million (10 per cent), the increase associated with an increase in employee numbers and pay rises under employment awards.
- **Depreciation and amortisation** increased by $32 million (8 per cent), the increase is due to the growth in infrastructure assets.
- **Operations and administration expenses** increased by $55 million (7 per cent), the overall increase due to increases in supplies and consumables, maintenance and electricity costs.

Figure 4B provides a breakdown of expenses for the year ended 30 June 2009, the split being comparable to the break up for 2007–08. The main expense items are operating and administration expenses (39 per cent), depreciation and amortisation (21 per cent), employee benefits (18 per cent) and finance costs (15 per cent). Other expenses (7 per cent) include the payment of an environmental contribution levy to the state and recognised losses incurred in relation to unfunded defined benefit superannuation funds.

Figure 4B
Expense composition for 2008–09



Source: Victorian Auditor-General's Office.

4.2.3 Net result

The state government has determined that the water industry is subject to the National Tax Equivalent Regime (NTER), which is administered by the Australian Taxation Office (ATO). The NTER is an administrative arrangement under which relevant taxation laws are applied notionally to government-owned enterprises as if they were subject to Commonwealth laws. The essential difference between the NTER and Commonwealth legislation is that the tax liability is to be paid to the state government and not the Commonwealth Government.

Accordingly, the net result before and after income tax is outlined in this report.

Net result before income tax

The water industry generated a net profit before income tax of $250 million for the year ended 30 June 2009. This represented an increase of $61 million or 32 per cent from the prior year.

The overall increase in the net profit before income tax is predominantly attributed to higher service and usage charges which have exceeded rises in operating expenses.

Whilst the four metropolitan water entities continue to generate a profit, seven of the 13 regional urban water corporations and the two rural water corporations reported a loss. Figure 4C summarises the net profit or loss before income tax by sector for the past two years.

Figure 4C
Net profit or loss before income tax by sector

Sector	2007–08 Net profit / (loss) before tax ($mil)	2008–09 Net profit / (loss) before tax ($mil)
Metropolitan	213.7	332.1
Regional Urban	(38.0)	(44.7)
Rural	13.7	(37.4)
Total	**189.4**	**250.0**

Source: Victorian Auditor-General's Office.

Net result after income tax

The water industry reported a net profit after income tax of $145 million in 2008–09, an increase of $24 million or 20 per cent from the prior year.

Dividends

The 19 entities are required to pay a dividend in accordance with a determination of the Treasurer of Victoria under the *Public Authorities (Dividend) Act 1983*, based on a prescribed percentage of the previous year's adjusted net profit before tax. However, an obligation to pay a dividend only arises after consultation with the relevant minister and the Treasurer and a formal determination is made by the Treasurer.

In 2008–09 the metropolitan water sector continued to pay an interim and final dividend to the state government. The dividend payments were in the main financed by new borrowings with the four metropolitan businesses accessing funds from the Treasury Corporation of Victoria, based on the cash flow requirements of the business at the time of making the payment. Dividends of $154 million were paid during the year; this is a decrease of $29 million or 16 per cent, compared with 2007–08. There were no dividends paid by the regional urban or rural water sector entities in either year.

4.3 Financial position

Financial position is measured by reference to net assets, which is the difference between total assets and total liabilities.

The water industry reported net assets of $12.9 billion at 30 June 2009, an increase of $186 million or 1 per cent in comparison with the prior year.

The growth in assets of $1.9 billion in 2008–09 has largely been offset by new borrowings of $1.4 billion and increased payables of $230 million.

4.3.1 Assets

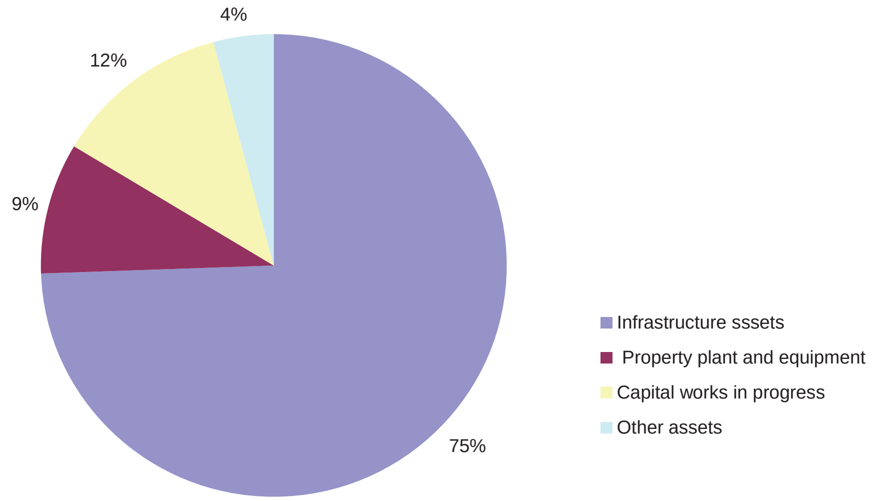
At 30 June 2009 the water industry had assets to the value of $21.1 billion, an increase of $1.9 billion or 10 per cent in comparison with the prior year. The main areas of growth were:

- **Infrastructure assets** which increased by $1.2 billion (8 per cent) and the **capital works in progress** balance by $804 million (45 per cent). The increases have been driven by the large number of capital projects that are currently being undertaken across the state to secure water supplies during these record breaking drought conditions. Significant projects are underway at Melbourne Water, Yarra Valley Water, Gippsland Water and Grampians Wimmera Mallee Water.
- **Receivables** increased by $73 million (18 per cent), the increase results from higher service and usage charges.
- **Intangible assets** increased by $61 million (104 per cent), the increase predominantly due to the purchase of permanent water rights by two regional urban water corporations.
- **Prepayments** increased by $61 million (692 per cent), the increase is a result of the three retail distribution companies each making a payment of $15 million to the Northern Victoria Irrigation Renewal Project (i.e., stage one of the Food Bowl Modernisation Project), the payment representing their first contribution towards the project. The retailers have made the contributions on the basis that two new bulk water entitlements (BWE) will be finalised, approved and issued by the state government during November and December 2009, following parliamentary approval.

Offsetting the increases, was a decrease in cash assets of $269 million (72 per cent), the decrease is due to the payment of suppliers in relation to capital and operating expenditure.

Figure 4D provides a breakdown of assets as at 30 June 2009. The proportion of each major asset category is consistent with the prior year. Infrastructure assets, which comprise dams, pipelines, water and sewer main connections, wastewater treatment plants and irrigation channels, represent 75 per cent of total assets. Capital works in progress represents 12 per cent of total assets, property plant and equipment 9 per cent and other assets 4 per cent. Other assets comprise cash assets, receivables, prepayments, intangible assets, biological assets and other current assets.

Figure 4D
Asset composition as at 30 June 2009



Source: Victorian Auditor-General's Office.

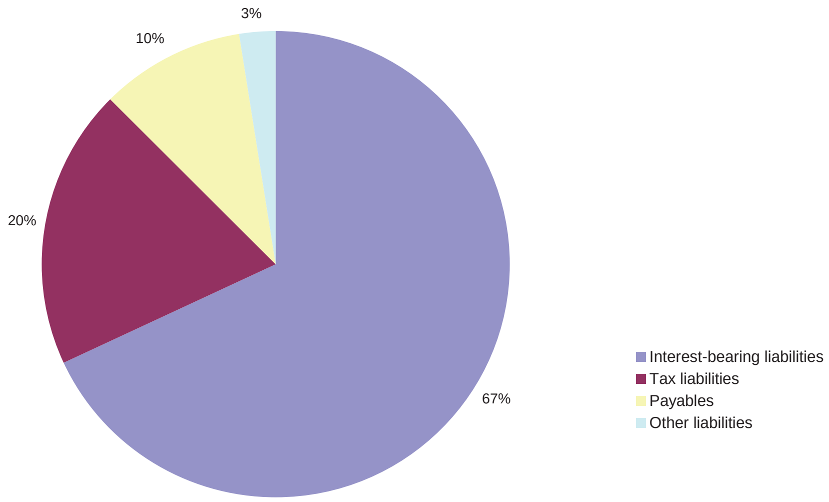
4.3.2 Liabilities

At 30 June 2009 the water industry had liabilities to the value of $8.2 billion, an increase of $1.7 billion or 27 per cent in comparison with the prior year. The main areas of growth were:

- **Interest-bearing liabilities** increased by $1.4 billion (34 per cent), the new borrowings financing the construction of new infrastructure assets and the payment of dividends to the state government. Approximately 50 per cent of the growth in interest-bearing liabilities relates to Melbourne Water for major projects such as the Sugarloaf Pipeline and Northern Sewer Project.
- **Payables** increased by $230 million (39 per cent), the increase driven by the significant increase in capital works activity over the past 12 months.

Figure 4E provides a breakdown of liabilities as at 30 June 2009. The key liabilities are consistent with 2007–08.

Figure 4E
Liabilities composition as at 30 June 2009



Source: Victorian Auditor-General's Office.

4.4 Trends in financial performance and financial position

A review of the financial performance and financial position of the water industry for the four-year period 1 July 2005 to 30 June 2009 indicates that:

- net profit before income tax has declined by $197 million (44 per cent)
- net assets have increased by $1.3 billion (10 per cent).

The trends reflect the impact of the ongoing drought conditions, water restrictions and various initiatives taken by the state government under the white paper *Securing Our Water Future Together*.

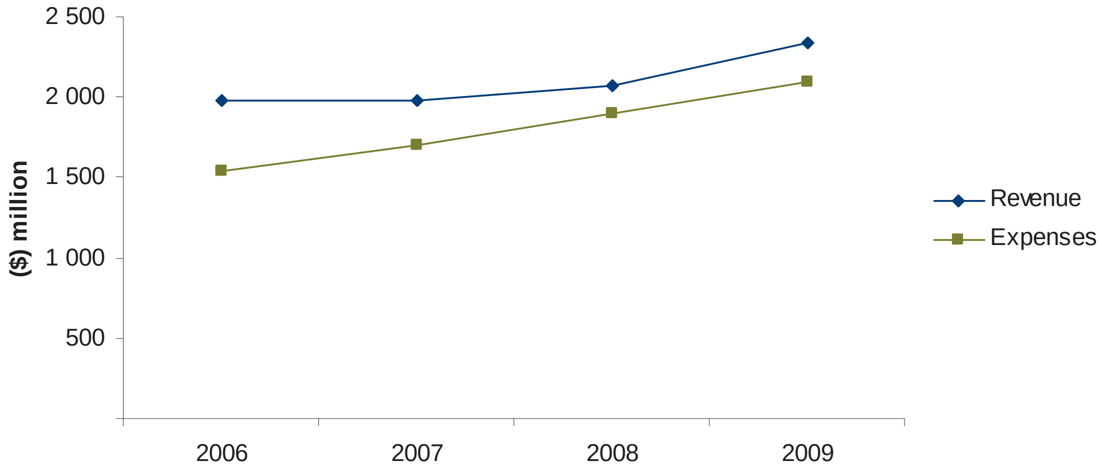
A $4.9 billion infrastructure plan has been put in place under the *Our Water Our Future – The Next Stage of the Government's Water Plan* ('Victorian water plan') released in June 2007. This plan provided for an acceleration of major water augmentation projects that had been previously flagged as longer-term. The major projects under the plan include the desalination plant and pipeline to Melbourne at $3.1 billion (now estimated to cost $3.5 billion), stage one of the Food Bowl Modernisation Project for $1 billion and the Sugarloaf Pipeline costing $750 million.

As a result, 2008–09 and to a lesser extent 2007–08, reflect the initial impact of the initiatives under the Victorian water plan.

Profitability of the water sector over the four-year period 2005–06 to 2008–09 has declined from a net profit before income tax of $447 million in 2005–06 to $250 million in 2008–09, a reduction of around 44 per cent over that period. Over the three years from 2005–06 to 2007–08, the growth in operating expenses exceeded the rise in revenue generated, resulting in lower overall profits.

Figure 4F indicates the relative decline in the net profit before income tax for the water industry over the four-year period.

Figure 4F
Comparison of revenue and expenses

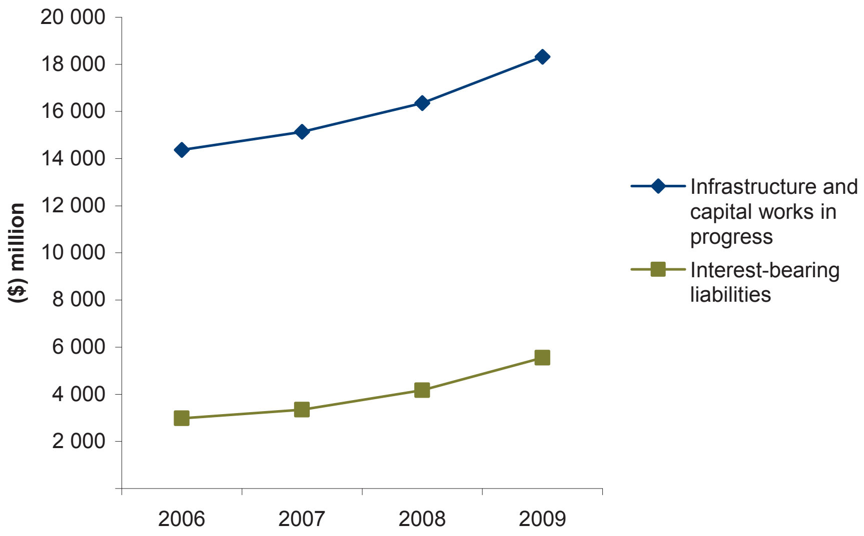


Source: Victorian Auditor-General's Office.

While the level of capital works over the three-year period from 2005–06 to 2007–08 was significant with assets to the value of $2 billion being constructed, a further $2 billion was spent on capital projects in 2008–09 alone. 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.

Figure 4G highlights the extent to which the capital works program has been funded by new borrowings from the Treasury Corporation of Victoria.

Figure 4G
Comparison of infrastructure assets and borrowings



Source: Victorian Auditor-General's Office.

The impact, going forward, will be an increase in the depreciation charge and higher finance costs, both of which will increase the expenses of the individual entities and the industry as a whole. The higher operating costs are to be recovered by further price increases.

The ESC has approved average price increases for the metropolitan sector of between 13.5 per cent and 20.1 per cent for 2009–10. The higher usage and service charges are to fund an entity's capital works program and allow the business to meet higher operating costs.

4.5 Indicators of financial sustainability

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.

Figure 4H describes the sustainability indicators used in this report. These indicators should be considered collectively and are more useful when assessed over time as part of a trend analysis. These indicators have been applied to the published financial information of each entity for a four-year period from 2005–06 to 2008–09.

Figure 4H
Financial sustainability indicators

Indicator	Formula	Description
Underlying result (%)	Adjusted net result/total underlying revenue	A positive result indicates a surplus, and the larger the percentage, the stronger the result. A negative result indicates a deficit. Operating deficits cannot be sustained in the long-term. Net result and total revenue is obtained from the operating statement and is adjusted to take into account large one off (non-recurring) transactions.
Liquidity	Current assets/current liabilities	This measures the entity's ability to pay existing liabilities in the next 12 months. A ratio of one or more means there are more cash and liquid assets than short-term liabilities. Current liabilities have been adjusted to exclude long-term employee provisions and on-costs disclosed as current liabilities in their financial report.
Debt-to-equity (%)	Debt/equity	This is a longer-term measure that compares all current and non-current interest-bearing liabilities to equity. It complements the liquidity ratio, which is a short-term measure. A low ratio indicates less reliance on debt to finance the capital structure of an organisation. Interest-bearing liabilities and equity is obtained from the balance sheet.
Self-financing (%)	Net operating cash flows/underlying revenue	Measures an entity's ability to replace assets using cash generated by their operations. The higher the percentage the more effectively this can be done. Net operating cash flows are obtained from the cash flow statement.
Capital replacement	Cash outflows for PP&E[a]/ depreciation	Comparison of the rate of spending on infrastructure, property, plant and equipment and intangibles with its depreciation. This is a long-term indicator, as capital expenditure can be deferred in the short-term if there are insufficient funds available from operations and borrowing is not an option. Cash flows for infrastructure, property, plant and equipment and intangibles are taken from the cash flow statement. Depreciation and amortisation is taken from the operating statement.

Note: (a) PP&E is an acronym for property, plant and equipment.
Source: Victorian Auditor-General's Office.

VAGO has consulted with representatives of DSE in connection with the application of the financial sustainability indicators and contributed to a working party convened by DTF to consider the financial sustainability indicators.

The analysis of financial sustainability in this report reflects on the industry by sector (metropolitan, regional urban and rural) and on an individual entity basis.

The financial sustainability indicators used in this report are consistent with those used in previous reports to Parliament.

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.

4.6 Financial sustainability risk assessment

4.6.1 Risk assessment criteria

The financial health of each entity has been assessed using the risk criteria outlined in Figure 4I.

Figure 4I
Risk assessment criteria for financial sustainability indicators

Risk	Underlying result	Liquidity	Debt-to-equity	Self-financing	Capital replacement
High	**Negative 10% or less** Insufficient revenue is being generated to fund operations and asset renewal.	**Equal to or less than 1.0** Immediate sustainability issues with insufficient current assets to cover current liabilities.	**More than 60%** Potential long-term concern over ability to repay debt levels from own-source revenue.	**Less than 10%** Insufficient cash from operations to fund new assets and asset renewal.	**Equal or less than 1.0** Spending on capital works has not kept pace with consumption of assets.
Medium	**Negative 10% to 0** A risk of long-term run-down of cash reserves and inability to fund asset renewals.	**1.0–1.5** Need for caution with cash flow, as issues could arise with meeting obligations as they fall due.	**40–60%** Some concern over the ability to repay debt from own source revenue.	**10–20 %** May not be generating sufficient cash from operations to fund new assets.	**1.0–1.5** May indicate spending on asset renewal is insufficient.
Low	**More than 0** Generating surpluses consistently.	**More than 1.5** No issues with repaying short-term liabilities as they fall due.	**40% or less** No concern over the ability to repay debt from own-source revenue.	**20% or more** Generating enough cash from operations to fund assets.	**More than 1.5** Low risk of insufficient spending on asset renewal.

Source: Victorian Auditor-General's Office.

The overall financial sustainability risk assessment has been calculated using the ratings determined for each indicator as outlined in Figure 4J. This assessment is performed at the sector level and entity level over the past four years. An industry average has also been calculated for each indicator.

Figure 4J
Overall financial sustainability risk assessment

High risk of short-term and immediate sustainability concerns indicated by:

- **red** underlying result indicator or
- **red** liquidity indicator.

Medium risk of longer-term sustainability concerns indicated by either:

- **red** self-financing indicator
- **red** debt-to-equity indicator
- **red** capital-replacement indicator.

Low risk of financial sustainability concerns—there are no high-risk indicators.

Source: Victorian Auditor-General's Office.

4.6.2 Analysis of indicators

Our analysis of the indicators covers a four-year period (2005–06 to 2008–09), during which the ESC has had responsibility for regulating the prices of the industry.

In essence, 2008–09 was the first year of the second regulatory period. Water plans covering the period 2008–09 to 2012–2013 were developed by the 19 entities during a time of ongoing drought conditions, below average rainfall and the existence of water restrictions.

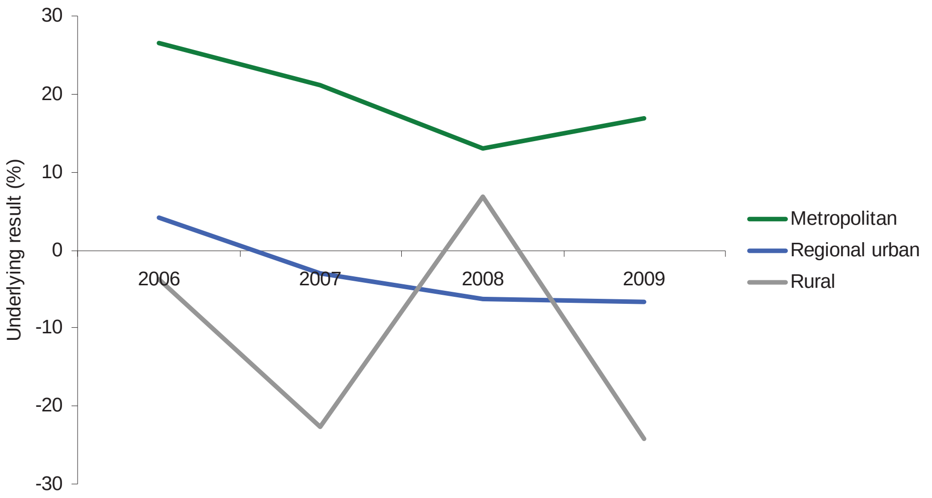
As a consequence, the current water plans provide for significant increases in prices over the period of the plan to fund significant capital works designed to secure water supplies.

Underlying result

Under the regulatory framework, a number of assumptions are built into the forecast expenditure and revenues over the regulatory period. Variations between actual and forecast figures can adversely impact the financial performance of the entity. For example, should customer growth be lower than expected and the level of water restrictions more severe than planned, the revenue generated will be lower, which in turn impacts upon the reported net result.

Figure 4K summarises the aggregated underlying results by sector. The graph indicates that the underlying results have deteriorated over the four-year period. Factors contributing to the decline include the continuing drought conditions and the existence of water restrictions across the state.

Figure 4K
Underlying result



Source: Victorian Auditor-General's Office.

Figure 4L summaries the underlying result by entity and indicates that a number of the regional urban and rural water corporations consistently recorded an operating deficit during the past four years.

Figure 4L
Underlying results by entity (%)

	Underlying result (%)					
Metropolitan	**2006**	**2007**	**2008**	**2009**	**4-year average**	**Trend**
Wholesaler						
Melbourne Water	38.4%	30.2%	15.6%	23.7%	26.8%	▼
Retailers						
City West Water	24.3%	18.4%	16.4%	20.8%	20.0%	▼
South East Water	22.8%	21.6%	15.2%	13.9%	18.2%	▼
Yarra Valley Water	13.7%	8.6%	4.9%	6.2%	8.2%	▼
Metropolitan - retail average	**19.8%**	**15.9%**	**11.6%**	**12.8%**	**14.9%**	▼
Regional urban						
Barwon Water	11.8%	8.5%	5.9%	11.2%	9.4%	▼
Central Highlands Water	-7.1%	-3.6%	-14.2%	-16.5%	-10.8%	▼
Coliban Water	-24.7%	-35.1%	-58.7%	-51.1%	-42.8%	▼
East Gippsland Water	16.7%	17.0%	11.7%	10.5%	13.8%	▼
Gippsland Water	11.6%	5.1%	-0.4%	1.6%	4.2%	▼
Goulburn Valley Water	1.0%	4.9%	0.6%	4.3%	2.8%	▲
Grampians Wimmera Mallee Water	-20.9%	-56.2%	-52.1%	-69.9%	-50.7%	▼
Lower Murray Water	1.6%	1.7%	3.5%	-4.3%	0.5%	▼
North East Water	13.0%	-2.1%	-4.3%	-3.5%	0.9%	▼
South Gippsland Water	9.2%	-15.5%	-2.5%	-1.4%	-2.8%	▼
Wannon Water	-6.7%	2.9%	0.2%	-3.4%	-1.6%	▲
Western Water	31.4%	14.1%	19.2%	11.6%	19.1%	▼
Westernport Water	9.6%	8.2%	9.0%	17.8%	11.6%	▲
Regional urban average	**4.1%**	**-3.0%**	**-6.3%**	**-6.6%**	**-3.2%**	▼
Rural						
First Mildura Irrigation Trust *	-7.7%	0.5%	-25.0%	N/A	-12.6%	▼
Goulburn-Murray Water	-3.5%	-23.8%	10.5%	-27.2%	-9.3%	▼
Southern Rural Water	-4.4%	-23.6%	-5.0%	-11.2%	-10.8%	▼
Rural average	**-3.8%**	**-22.7%**	**6.8%**	**-24.2%**	**-9.6%**	▼
Industry average	**19.2%**	**12.4%**	**7.8%**	**8.9%**	**11.9%**	▼

* The First Mildura Irrigation Trust ceased operations on 19 August 2008.

▲ an increasing ratio is a deteriorating trend
▼ a decreasing ratio is a deteriorating trend
▲ an increasing ratio is an improving trend
▼ a decreasing ratio is an improving trend
► no substantial trend

Source: Victorian Auditor-General's Office.

Liquidity

Figure 4M summarises the liquidity of the three sectors. The graph indicates that overall the liquidity of the industry has deteriorated over the four-year period with the regional urban sector showing a downward trend. The decline in essence is a consequence of increased borrowings and an increase in payables.

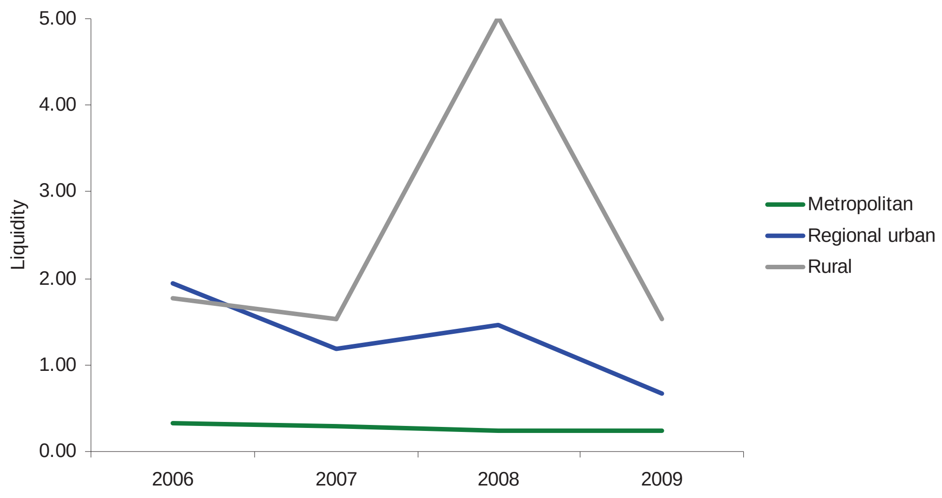
The 19 entities source all their borrowings from the Treasury Corporation Victoria with debt maturing within the next 12 months classified as a current liability at balance date. However, the entities have approval to refinance the maturing debt and they have tended to refinance the debt for a new term rather than repay the debt. The approval also provides for additional borrowings in the next financial year up to an agreed amount.

While entities have approval to refinance maturing debt, they need to generate sufficient cash flows from operations to:

- service the increasing interest charges as debt levels increase and the variable interest rates rise
- repay the growing debt in the long-term.

As mentioned earlier, the increase in payables has been driven by the significant increase in capital works activity. As a result, at balance date a large proportion of trade creditors and accrued expenses relate to capital projects. As the invoices fall due for payment an entity, as needed, will access funds under its approved finance facility.

Figure 4M
Liquidity



Source: Victorian Auditor-General's Office.

At 30 June 2009, 14 of the 19 entities had a liquidity ratio of less than one (12 entities in 2007–08). Refer Figure 4N.

Figure 4N
Liquidity by entity

	Liquidity					
Metropolitan	**2006**	**2007**	**2008**	**2009**	**4-year average**	**Trend**
Wholesaler						
Melbourne Water	0.22	0.15	0.12	0.13	0.14	▼
Retailers						
City West Water	0.32	0.76	0.54	0.50	0.50	▲
South East Water	0.61	0.53	0.44	0.47	0.50	▼
Yarra Valley Water	0.35	0.32	0.34	0.34	0.34	►
Metropolitan – retail average	**0.39**	**0.45**	**0.41**	**0.41**	**0.42**	▲
Regional urban						
Barwon Water	0.65	0.75	1.13	0.96	0.88	▲
Central Highlands Water	4.04	1.12	2.15	0.84	1.55	▼
Coliban Water	1.16	0.27	0.28	0.20	0.34	▼
East Gippsland Water	2.36	0.97	0.94	0.73	1.06	▼
Gippsland Water	4.15	2.56	0.70	0.67	1.43	▼
Goulburn Valley Water	2.23	0.88	1.41	1.16	1.28	▼
Grampians Wimmera Mallee Water	2.00	2.06	4.51	0.40	2.27	▼
Lower Murray Water	5.48	5.07	3.50	2.20	3.75	▼
North East Water	2.19	1.32	0.84	0.57	1.01	▼
South Gippsland Water	0.14	0.62	0.57	0.25	0.36	▲
Wannon Water	2.51	1.12	0.86	1.68	1.39	▼
Western Water	0.51	0.69	0.64	0.53	0.60	▲
Westernport Water	3.17	1.01	0.43	0.85	1.04	▼
Regional urban average	**1.93**	**1.18**	**1.46**	**0.68**	**1.18**	▼
Rural						
First Mildura Irrigation Trust *	14.27	5.08	1.18	N/A	3.15	▼
Goulburn-Murray Water	1.35	1.26	5.97	1.61	2.30	▲
Southern Rural Water	3.61	2.89	2.41	1.04	2.05	▼
Rural average	**1.77**	**1.54**	**5.01**	**1.52**	**2.29**	▼
Industry average	**0.66**	**0.55**	**0.66**	**0.37**	**0.53**	▼

* The First Mildura Irrigation Trust ceased operations on 19 August 2008.

▲ an increasing ratio is a deteriorating trend
▼ a decreasing ratio is a deteriorating trend
▲ an increasing ratio is an improving trend
▼ a decreasing ratio is an improving trend
► no substantial trend

Source: Victorian Auditor-General's Office.

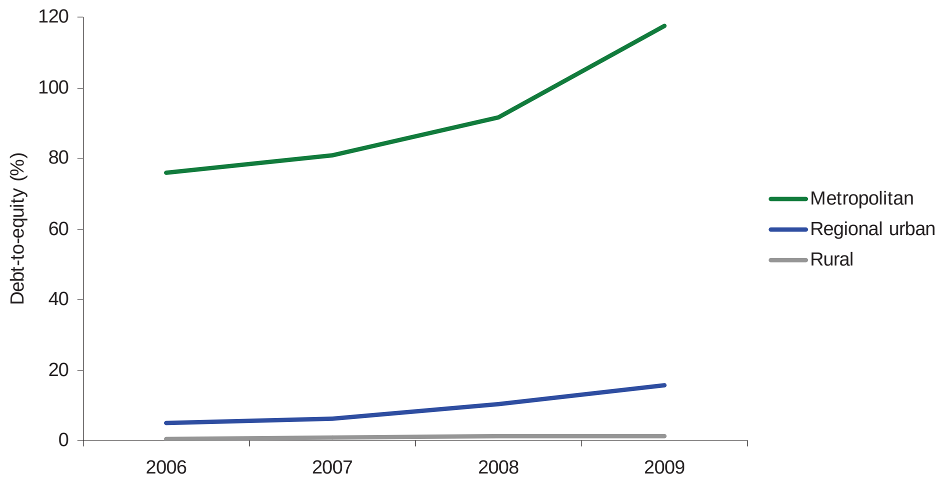
Debt-to-equity

A gearing ratio is any ratio that measures an entity's financial leverage, therefore demonstrating the degree to which an entity's activities are funded by debt. Commonly used gearing ratios include debt-to-equity and debt-to-assets.

Figure 4O summarises the debt-to-equity results by sector. The graph indicates the:

- metropolitan water businesses have substantially increased their borrowings
- regional urban water corporations have increased their debts levels from a low base
- rural water corporations are less reliant on borrowings.

Figure 4O
Debt-to-equity



Source: Victorian Auditor-General's Office.

Figure 4P summaries the result of the debt-to-equity ratio by entity over the four years.

Figure 4P
Debt-to-equity by entity (%)

	Debt-to-equity (%)					
Metropolitan	**2006**	**2007**	**2008**	**2009**	**4-year average**	**Trend**
Wholesaler						
Melbourne Water	68.5%	70.4%	82.0%	117.4%	85.2%	▲
Retailers						
City West Water	67.5%	77.7%	83.4%	105.0%	83.5%	▲
South East Water	60.7%	60.1%	67.4%	77.0%	66.6%	▲
Yarra Valley Water	120.9%	139.2%	155.4%	173.8%	147.8%	▲
Metropolitan – retail average	**84.2%**	**92.1%**	**102.3%**	**118.0%**	**99.5%**	▲
Regional urban						
Barwon Water	6.9%	8.0%	11.8%	16.0%	10.7%	▲
Central Highlands Water	7.1%	9.0%	12.2%	15.5%	11.3%	▲
Coliban Water	14.6%	17.5%	26.6%	38.1%	24.2%	▲
East Gippsland Water	0.0%	2.0%	8.1%	12.6%	5.8%	▲
Gippsland Water	2.6%	5.2%	15.6%	29.6%	13.5%	▲
Goulburn Valley Water	6.4%	7.3%	11.6%	14.7%	10.0%	▲
Grampians Wimmera Mallee Water	0.5%	0.6%	1.7%	3.9%	1.9%	▲
Lower Murray Water	0.1%	0.1%	0.1%	0.8%	0.3%	►
North East Water	0.4%	0.3%	2.4%	5.3%	2.1%	▲
South Gippsland Water	3.8%	11.5%	14.2%	15.5%	11.2%	▲
Wannon Water	3.4%	4.0%	8.8%	14.2%	7.5%	▲
Western Water	1.7%	5.9%	12.3%	19.5%	10.0%	▲
Westernport Water	3.6%	2.9%	3.7%	2.3%	3.1%	▼
Regional urban average	**4.9%**	**6.3%**	**10.5%**	**15.5%**	**9.5%**	▲
Rural						
First Mildura Irrigation Trust *	0.0%	7.0%	8.5%	N/A	5.0%	▲
Goulburn-Murray Water	0.7%	0.7%	1.1%	1.1%	0.9%	►
Southern Rural Water	0.0%	0.0%	0.0%	1.4%	0.3%	►
Rural average	**0.6%**	**0.8%**	**1.1%**	**1.1%**	**0.9%**	►
Industry average	**25.6%**	**27.8%**	**32.6%**	**43.0%**	**32.5%**	▲

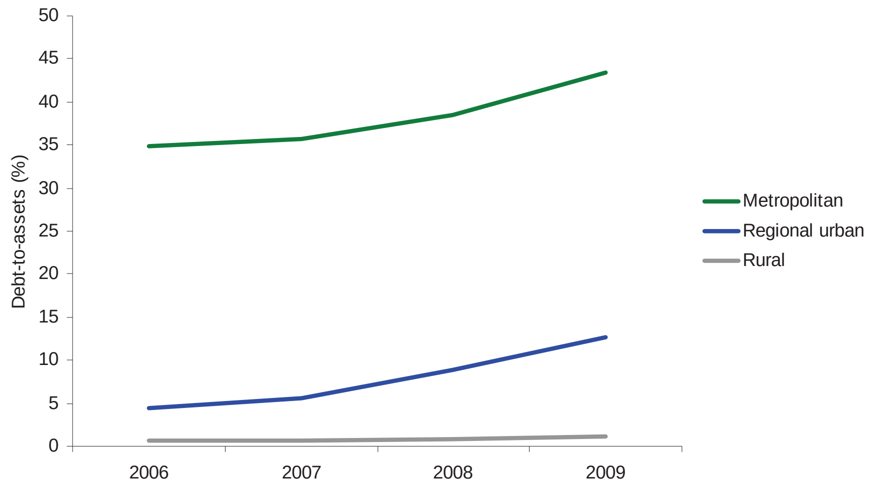
* The First Mildura Irrigation Trust ceased operations on 19 August 2008.

▲ an increasing ratio is a deteriorating trend
▼ a decreasing ratio is a deteriorating trend
▲ an increasing ratio is an improving trend
▼ a decreasing ratio is an improving trend
► no substantial trend

Source: Victorian Auditor-General's Office.

The debt-to-assets ratio is the gearing ratio used by the Department of Treasury and Finance to monitor the financial health of the government trading enterprises. Figure 4Q summarises the debt-to-assets results by sector. The graph indicates the level of financial leverage has increased over the past two years as the metropolitan and regional urban sectors increased their level of borrowings.

Figure 4Q
Debt-to-assets



Source: Victorian Auditor-General's Office.

In assessing an entity's ability to meet ongoing interest costs and therefore service the debt, an interest-cover ratio is a measure commonly used. The ratio is calculated as follows:

$$\text{Interest-cover ratio} = \frac{\text{Net result before income tax and finance costs}}{\text{Finance costs}}$$

Figure 4R provides a summary of the interest cover of the four metropolitan businesses for the past two years, as they have the highest financial leverage across the industry.

Figure 4R
Interest cover

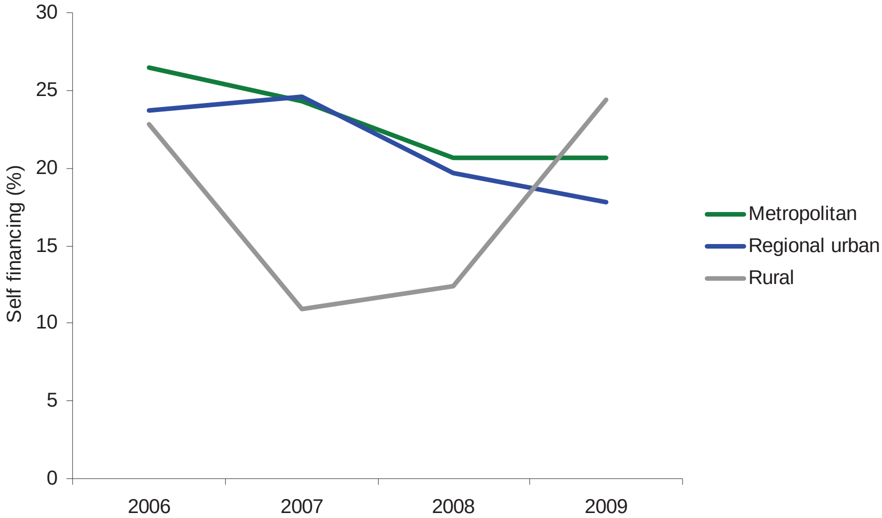
Entity	30 June 2008	30 June 2009
Melbourne Water	1.9:1	2.4:1
City West Water	3.0:1	3.8:1
South East Water	2.9:1	2.9:1
Yarra Valley Water	1.3:1	1.4:1

Source: Victorian Auditor-General's Office.

Self-financing

Figure 4S shows the self-financing results of the water industry for the past four years. The graph indicates that 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. Whilst the four-year trend indicates the capacity of the rural sector has shown an overall improvement, the ratio for the larger entity improved at a rate greater than the deterioration of the other entity in the sector.

Figure 4S
Self-financing



Source: Victorian Auditor-General's Office.

Figure 4T summarises the results of the self-financing ratio by entity over the past four years and indicates for the past three years one regional urban water corporation has generated insufficient cash from its operating activities to fund new assets and or replace existing assets.

Figure 4T
Self-financing by entity (%)

	Self-financing (%)					
Metropolitan	**2006**	**2007**	**2008**	**2009**	**4-year average**	**Trend**
Wholesaler						
Melbourne Water	36.7%	38.5%	27.3%	38.1%	35.3%	▲
Retailers						
City West Water	19.1%	13.7%	19.8%	11.8%	15.9%	▼
South East Water	20.9%	19.1%	18.8%	13.2%	17.8%	▼
Yarra Valley Water	21.1%	14.7%	12.9%	6.7%	13.5%	▼
Metropolitan – retail average	**20.5%**	**16.1%**	**16.8%**	**10.4%**	**15.7%**	▼
Regional urban						
Barwon Water	30.3%	27.5%	21.8%	26.9%	26.6%	▼
Central Highlands Water	22.3%	21.8%	13.9%	12.6%	17.3%	▼
Coliban Water	4.9%	-5.3%	-10.2%	-12.6%	-6.1%	▼
East Gippsland Water	25.0%	35.2%	18.0%	32.8%	27.7%	▲
Gippsland Water	31.6%	42.6%	23.1%	25.3%	30.3%	▼
Goulburn Valley Water	21.4%	29.2%	23.7%	18.9%	23.1%	▼
Grampians Wimmera Mallee Water	27.3%	22.5%	24.3%	24.2%	24.5%	▼
Lower Murray Water	23.4%	31.3%	43.1%	14.8%	27.7%	▼
North East Water	24.0%	31.0%	19.6%	16.5%	22.6%	▼
South Gippsland Water	27.7%	18.8%	19.3%	11.6%	18.9%	▼
Wannon Water	21.4%	16.9%	12.8%	15.9%	16.6%	▼
Western Water	16.4%	14.6%	20.2%	13.1%	16.1%	▼
Westernport Water	31.9%	28.0%	38.7%	33.7%	33.2%	▲
Regional urban average	**23.7%**	**24.6%**	**19.7%**	**17.8%**	**21.3%**	▼
Rural						
First Mildura Irrigation Trust *	12.5%	20.3%	-9.9%	N/A	5.3%	▼
Goulburn-Murray Water	25.3%	10.6%	13.3%	28.0%	18.9%	▲
Southern Rural Water	12.8%	9.9%	14.8%	8.8%	11.6%	▼
Rural average	**22.8%**	**10.9%**	**12.4%**	**24.4%**	**17.3%**	▲
Industry average	**25.5%**	**23.5%**	**19.7%**	**20.2%**	**22.1%**	▼

* The First Mildura Irrigation Trust ceased operations on 19 August 2008.

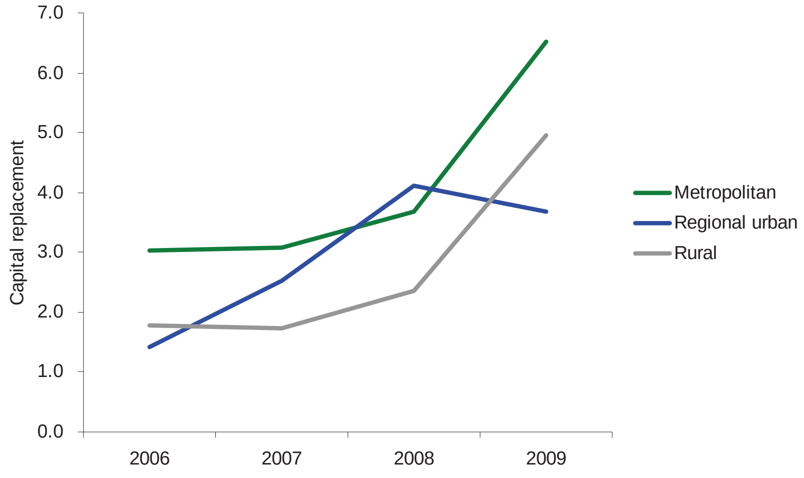
▲ (red)	an increasing ratio is a deteriorating trend
▼ (red)	a decreasing ratio is a deteriorating trend
▲ (green)	an increasing ratio is an improving trend
▼ (green)	a decreasing ratio is an improving trend
►	no substantial trend

Source: Victorian Auditor-General's Office.

Capital replacement

Figure 4U summarises capital replacement by sector. The graph indicates the industry, particularly the metropolitan and rural sectors, have increased their spending on infrastructure assets. As previously mentioned, the capital works spending is being financed predominantly by new borrowings.

Figure 4U
Capital replacement



Source: Victorian Auditor-General's Office.

Figure 4V summarises the results of the capital replacement ratio by entity for the past four years.

Figure 4V
Capital replacement by entity

	Capital replacement					
Metropolitan	**2006**	**2007**	**2008**	**2009**	**4-year average**	**Trend**
Wholesaler						
Melbourne Water	2.8	2.8	4.2	8.9	5.0	▲
Retailers						
City West Water	3.2	3.1	2.7	4.4	3.4	▲
South East Water	2.1	2.6	2.8	3.4	2.7	▲
Yarra Valley Water	4.1	4.2	3.8	4.3	4.1	▲
Metropolitan – retail average	**3.2**	**3.4**	**3.2**	**4.0**	**3.4**	▲
Regional urban						
Barwon Water	1.6	1.5	2.1	2.7	2.0	▲
Central Highlands Water	1.0	4.1	11.0	4.0	4.9	▲
Coliban Water	1.0	3.8	4.5	3.2	3.2	▲
East Gippsland Water	1.5	3.3	3.1	3.2	2.8	▲
Gippsland Water	2.5	3.7	5.3	4.4	4.1	▲
Goulburn Valley Water	1.1	1.5	1.9	2.1	1.7	▲
Grampians Wimmera Mallee Water	0.8	3.7	6.9	8.1	5.3	▲
Lower Murray Water	1.0	0.9	2.1	2.0	1.5	▲
North East Water	0.7	1.0	1.2	1.4	1.1	▲
South Gippsland Water	2.9	1.4	1.5	1.6	1.8	▼
Wannon Water	1.6	1.6	2.6	2.8	2.2	▲
Western Water	2.4	1.7	2.7	3.4	2.6	▲
Westernport Water	0.9	1.9	2.1	1.2	1.5	▲
Regional urban average	**1.4**	**2.5**	**4.1**	**3.7**	**3.0**	▲
Rural						
First Mildura Irrigation Trust *	2.2	4.7	0.7	N/A	2.3	▼
Goulburn-Murray Water	1.8	1.5	2.5	5.4	2.9	▲
Southern Rural Water	1.3	2.2	2.5	2.3	2.1	▲
Rural average	**1.8**	**1.7**	**2.3**	**5.0**	**2.7**	▲
Industry average	**2.1**	**2.7**	**3.8**	**5.1**	**3.5**	▲

* The First Mildura Irrigation Trust ceased operations on 19 August 2008.

Note: Legend for trends
▲ (red) an increasing ratio is a deteriorating trend
▼ (red) a decreasing ratio is a deteriorating trend
▲ (green) an increasing ratio is an improving trend
▼ (green) a decreasing ratio is an improving trend
► no substantial trend

Source: Victorian Auditor-General's Office.

4.6.3 Conclusion

Figure 4W summarises the results of the five financial sustainability indicators at a sector and individual entity level, based on data for the past four years.

The impact of prices approved under the water plans and the level of borrowings two key factors influencing the financial performance and financial position of the 19 entities. The indicators clearly indicate contrasting results for the metropolitan water sector compared with the regional urban and rural water sectors.

Eleven entities have been assigned a high-risk rating. A liquidity ratio of less than one is the contributing factor in eight instances and, as previously indicated, the entities generally have approval to refinance maturing debt and are able to draw upon new borrowings (up to an approved limit) to meet obligations as and when they fall due within the next 12 months. As a result, liquidity risk is reduced in the short-term. The other three entities have a negative underlying result.

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 its 2008–09 financial report. 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.

Figure 4W
Four-year average financial sustainability risk assessment

	Underlying result (%)	Liquidity	Debt-to-equity (%)	Self Financing (%)	Capital replacement	Overall risk assessment
	4-year average	4-year average	4-year average	4-year average	4-year average	4-year average
Wholesaler						
Melbourne Water	26.8%	0.14	85.2%	35.3%	5.0	●
Retailers						
City West Water	20.0%	0.50	83.5%	15.9%	3.4	●
South East Water	18.2%	0.50	66.6%	17.8%	2.7	●
Yarra Valley Water	8.2%	0.34	147.8%	13.5%	4.1	●
Metropolitan – retail average	**14.9%**	**0.42**	**99.5%**	**15.7%**	**3.4**	
Regional Urban						
Barwon Water	9.4%	0.88	10.7%	26.6%	2.0	●
Central Highlands Water	-10.8%	1.55	11.3%	17.3%	4.9	●
Coliban Water	-42.8%	0.34	24.2%	-6.1%	3.2	●
East Gippsland Water	13.8%	1.06	5.8%	27.7%	2.8	●
Gippsland Water	4.2%	1.43	13.5%	30.3%	4.1	●
Goulburn Valley Water	2.8%	1.28	10.0%	23.1%	1.7	●
Grampians Wimmera Mallee Water	-50.7%	2.27	1.9%	24.5%	5.3	●
Lower Murray Water	0.5%	3.75	0.3%	27.7%	1.5	●
North East Water	0.9%	1.01	2.1%	22.6%	1.1	●
South Gippsland Water	-2.8%	0.36	11.2%	18.9%	1.8	●
Wannon Water	-1.6%	1.39	7.5%	16.6%	2.2	●
Western Water	19.1%	0.60	10.0%	16.1%	2.6	●
Westernport Water	11.6%	1.04	3.1%	33.2%	1.5	●
Regional urban average	**-3.2%**	**1.18**	**9.5%**	**21.3%**	**3.0**	
Rural						
First Mildura Irrigation Trust *	-12.6%	3.15	5.0%	5.3%	2.3	N/A
Goulburn-Murray Water	-9.3%	2.30	0.9%	18.9%	2.9	●
Southern Rural Water	-10.8%	2.05	0.3%	11.6%	2.1	●
Rural Average	-9.6%	**2.29**	**0.9%**	**17.3%**	**2.7**	
Total						
Industry average	**11.9%**	**0.53**	**32.5%**	**22.1%**	**3.5**	

* The First Mildura Irrigation Trust ceased operations on 19 August 2008. The net assets were transferred to Lower Murray Water, who has assumed responsibilities for the functions of the Trust.

Source: Victorian Auditor-General's Office.

Additional commentary by sector follows.

Metropolitan sector

The net result for Melbourne Water, which bills the three retailers for water and sewage services, is more favourable than the retailers, primarily because of its capacity to charge drainage rates. On the other hand, its liquidity has been impacted by the need to borrow more compared to the retailers, to fund the significant capital works program, which commenced in 2007–08 and which will be expected to peak in 2010–11.

Over the five-year period from 2008–09 to 2012–13, expenditure on infrastructure assets by Melbourne Water will amount to $2.8 billion, which will represent a doubling of the carrying value of infrastructure assets that they held at 30 June 2008.

The level of borrowings by Yarra Valley Water is comparatively higher than the other two retailers. As a consequence its operating result is impacted by a much higher borrowing cost.

Regional urban sector

In addition to Coliban Water, the operating results of Central Highlands Water and Grampians Wimmera Mallee Water have also been unfavourable over the four-year period.

Central Highlands Water has been adversely affected by the drought conditions. It has enacted its Drought Response Plan which focused on demand management and a tightening of water restrictions, which reduced consumption and affected the revenue being generated. The requirement to purchase water in recent years due to below average rainfall has also contributed to higher operating expenses. The plan also involved the commissioning of new infrastructure assets. Whilst the Goldfields Superpipe project has assisted the corporation to secure water for the Ballarat community the cost of pumping the water from Bendigo has resulted in its electricity costs increasing by approximately $3 million or 199 per cent in 2008–09.

Grampians Wimmera Mallee Water has experienced growth in its operating expenses over the four-year period which has not been matched by increases in revenue generated. The Grampians Wimmera Mallee pipeline project has driven an increase in expenses with a number of infrastructure assets subject to accelerated depreciation during the period 1 July 2005 to 30 June 2008. Furthermore, the requirement to decommission channels has resulted in the corporation recognising a provision and an expense of $12 million in 2008–09. The entity has also increased its borrowings which have increased from $17 million at 30 June 2008 to $41 million at 30 June 2009, resulting in higher finance costs into the future.

Rural sector

Goulburn-Murray Water and Southern Rural Water over the four-year period have predominately generated operating losses. Both entities have responsibility for substantial infrastructure assets. In accordance with a determination made by the Minster for Water, assets of rural water authorities acquired or constructed prior to 1 July 2004, or funded by government since 2004 have been assigned a zero regulatory asset value, and therefore depreciation and capital charges associated with those assets are not funded under the pricing principles established by the Water Industry Regulation Order (WIRO). Accordingly, Goulburn-Murray Water and Southern Rural Water expect to continue to report operating losses as revenue will continue to be insufficient to recoup these expenses.

Recommendation

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.

5 Performance reporting

At a glance

Background

The 13 regional urban water corporations and the two rural water corporations prepare and submit for audit a performance report. This forms part of the annual report that is tabled in Parliament within four months of the end of the financial year.

Findings

- 15 of the 19 entities prepare and submit for audit a performance report.
- Melbourne Water prepares 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 no requirement for the three retail distribution companies to prepare a performance report.
- 14 of the 15 performance reports submitted for audit included indicators where no target had been set.
- There are performance indicators included in an entity's corporate plan that are not included in the performance report.
- The commentary within the performance report in relation to significant variations between actual performance outcomes compared with the targets and the performance of the prior year was quite varied and often focused on the quantum of the change rather than the factors contributing to the variation in performance. There are opportunities to improve the quality and relevance of the explanations.
- The current performance reporting arrangements do not facilitate comparison of performance across the industry.

Recommendation

- 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.

5.1 Overview of current performance reporting requirements

Financial Reporting Direction (FRD) 27A *Presentation and Reporting of Performance Information* specifies the 15 entities within the water industry that are required to prepare and submit for audit a performance report, with the responsible portfolio minister to determine the information to be included in the performance report. The 15 entities comprise the:

- 13 regional urban water corporations
- two rural water corporations.

The Minister for Water under section 51 of the FMA requires 16 water corporations to prepare a performance report, with the performance report to form part of an entity's annual report to be tabled in Parliament within four months of the end of the financial year. The 16 entities are:

- 13 regional urban water corporations
- two rural water corporations
- Melbourne Water.

Whilst Melbourne Water is required to prepare a performance report, there is no obligation for the corporation to have the report audited.

There is currently no requirement for the three retail distribution companies to prepare a performance report that is subject to audit. Their annual reports nevertheless, contain information in relation to various financial, social and environmental matters.

The regional urban water corporations have prepared and submitted for audit a performance report since 2003–04, with the rural water corporations following suit in 2005–06.

5.2 Form and content of performance reports submitted for audit

The Minister for Water issues a number of performance reporting directives under section 51 of the FMA during the month of May each year. The directives specify the performance indicators to be included in the performance report and the requirement to compare the actual results achieved for the year against the target, where set, and performance of the prior year.

Where there is a significant variation between the actual performances for the current year relative to the target or the performance in the prior year, the minister requires the reason for the variation is to be explained within the report.

The performance report is to be presented as a single consolidated part of the annual report. It may not be split among other parts of the annual report or be separated by sections that do not form part of the performance report.

5.2.1 Financial performance indicators

The 13 regional urban water corporations and the two rural water corporations are required to report against a range of financial performance indicators. Figure 5A summarises the financial performance indicators.

Figure 5A
Financial performance indicators

Indicator
Long-term profitability (percentage)
Owner's investment (percentage)
Long-term financial viability (percentage)
Liquidity and debt servicing (interest cover) (times)
Immediate liquidity and debt servicing (cash cover) (times)
Operating efficiency (water supply and wastewater collection (dollar)

Source: Victorian Auditor-General's Office.

The operating efficiency indicator is only applicable for the regional urban water corporations.

5.2.2 Service and environmental performance indicators

The 13 regional urban water corporations are also required to report against a range of service and environmental performance indicators. Figure 5B summarises the indicators.

Figure 5B
Service and environmental performance indicators

Indicator
For the whole of the corporation
Water supply interruptions (number)
Interruption time indicators (minutes)
Restoration of water supply (percentage)
Reliability of sewerage collection service indicators (number)
Reliability of sewerage collection service indicators (percentage)
Containment of sewer spillages (percentage)
Customer complaints indicators (number)
For each treatment plant
Reuse indicators (percentage)
Sewage treatment standards (percentage)

Source: Victorian Auditor-General's Office.

5.3 Analysis of performance reports submitted for audit

The 15 performance reports submitted for audit received a clear opinion. Nevertheless, the following matters were noted during the audit cycle of 2008–09:

- 14 of the 15 performance reports included indicators where no targets were set
- there are performance indicators included in an entity's corporate plan that are not included in the performance report
- the commentary in relation to significant variations was quite varied and often focused on the quantum of the change rather than the factors contributing to the variation in performance
- a change in the EPA licence arrangements, where the EPA issued a corporate licence rather than a separate licence for each wastewater treatment plant meant certain performance indicators included in the performance report of the regional urban water corporations were not applicable.

The usefulness of information within the performance report and the performance report is reduced where performance indicators have no targets set or the required indicator is not applicable as a comparison of actual performance against a target is unable to occur.

5.4 Other observations

5.4.1 Melbourne Water

The Minister for Water requires the annual report of Melbourne Water to include, as part of its report of operations, a performance report detailing actual results achieved compared with targets for the performance indicators specified in the corporation's 2008-09 business plan.

For each performance indicator the corporation is required to report the business plan target, the actual performance achieved for the current year, and the variation in percentage terms. Significant variations between the planned and actual performance are to be explained.

The corporation has traditionally reported the information in relation to the performance indicators throughout the individual areas of operational responsibility rather than present such information in a single continuous part of the annual report.

As mentioned above, the performance indicators are not subject to audit.

5.4.2 Retail distribution companies

While there is no statutory obligation on the three retail distribution companies to prepare a performance report, that is subject to audit and ultimately included in the entity's annual report, each retailer does include performance information throughout its annual report.

Our review of the annual reports and sustainability reports reveals:

- the performance information and presentation of such information varies from retailer to retailer
- performance targets are not always specified and the commentary in relation to variations between the current and prior year outcomes at times is limited
- financial performance indicators are included as part of each retailer's five-year financial summary, however, only one indicator is common to all three
- there is limited commentary on the variations in financial performance over the five-year period, however, the financial summary itself provides an overview of recent trends
- service and environmental performance indicators are presented as time series data throughout the annual report
- environmental incidents and compliance with the EPA licence is mentioned.

The performance information is not subject to audit.

5.4.3 Benchmarking studies

In recent times the Australian Productivity Commission and the Water Services Association of Australia (WSAA) have issued reports that aim to provide a basis for comparison of performance across government trading enterprises. While a suite of indicators has been analysed, the reports provide an insight into an array of indicators that can be used to benchmark performance.

The Australian Productivity Commission issued a research paper in July 2008 in relation to the financial performance of government trading enterprises 2004–05 to 2006–07. The report covered many key sectors of the Australian economy.

The National Performance Report 2007–08 (urban water utilities) issued by WSAA compares the performance of urban water entities around Australia with particular emphasis on asset management, the environment, finance and pricing.

5.5 Conclusion

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.

Since the introduction of the current performance reporting requirements, there have been developments in Australia in relation to indicators used in benchmarking the performance of government trading enterprises.

It is timely that the relevance, appropriateness and usefulness of the indicators in Victoria be reviewed.

Recommendations

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.

6 Sector developments

At a glance

Background

Two major projects are underway, the Food Bowl Modernisation Project and the Wonthaggi Desalination Plant Project.

Overview

- Stage one of the Food Bowl Modernisation 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 the Northern Victoria Irrigation Renewal Project (NVIRP), they will be transferred to Goulburn-Murray Water (G-MW) who has responsibility for the Goulburn-Murray Irrigation District. There have been no assets transferred to G-MW to date.
- There is no longer a requirement for Melbourne Water to contribute $300 million towards the cost of 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 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.
- 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 were yet to be finalised.

6.1 Major capital projects

6.1.1 Introduction

This section of the report provides a high-level overview of two major capital projects given their reliance to the water industry. Further details can be found in our report titled Auditor-General's Report on the Annual Financial Report of the State of Victoria, 2008–09.

The *Our Water Our Future – Securing Our Water Future Together* (2004) and the *Central Region Sustainable Water Strategy* (2006) identified a range of initiatives seeking to provide water to meet growing demand.

The *Our Water Our Future – The Next Stage of the Government's Water Plan* was released in June 2007. The two major initiatives announced by the government are the Food Bowl Modernisation Project and the Wonthaggi Desalination Plant Project.

6.1.2 Food Bowl Modernisation Project

The State Owned Enterprise for Irrigation Modernisation in Northern Victoria trading as the Northern Victoria Irrigation Renewal Project (NVIRP) was established in December 2007 and is responsible for delivering the modernised irrigation system.

Stage one of the project has planned expenditure of $1.0 billion. Figure 6A provides a summary of the original funding arrangement.

Figure 6A
Project funding

Entity	Contribution ($mil)
Department of Sustainability and Environment	604
Melbourne Water	300
Goulburn-Murray Water	100
Total	**1 004**

Source: Victorian Auditor-General's Office.

During 2008–09 a decision was made by the state, whereby there is no longer a requirement for Melbourne Water to make a contribution. The three retail distribution companies will now contribute $100 million each to the project.

At 30 June 2009 each retailer had made a contribution of $15 million ($45 million total) and had a commitment to pay a further $85 million over the next four years, in line with an agreed payment schedule. The retailers have made the contributions on the basis that two new bulk water entitlements will be finalised, approved and issued by the state government during November and December 2009 following parliamentary approval.

The estimated long-term annual water savings of 225GL are to be shared equally between irrigators, the environment and Melbourne via the Sugarloaf Pipeline.

Stage two, which is expected to deliver a further 200GL of water savings, is to be funded by the Commonwealth Government. The Commonwealth has agreed in-principle to contribute up to 90 per cent of the project costs up to $1.0 billion.

Ownership and responsibility for the operation of the infrastructure will transfer to the Goulburn-Murray Water (G-MW) upon completion as G-MW manages water-related services in the Goulburn Murray Irrigation District (GMID). There have been no assets transferred to G-MW to date.

6.1.3 Desalination Plant Project

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.

The Department of Sustainability and Environment (DSE) has been managing the project. Costs incurred by 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 were yet to be finalised.

As at 30 June 2009, DSE had incurred expenditure of $159 million and expects to spend a further $162 million over the next two years.

6.1.4 Impact on conduct of financial audit

These major capital works projects will be monitored from an auditing perspective to confirm that accounting treatments and associated disclosures within the financial reports are appropriate.

Key audit considerations into the future will be the checking of the accuracy of asset transfers from NVIRP to G-MW (Food Bowl Modernisation) and the recognition of the asset and liability under the PPP arrangements (desalination plant).

Appendix A. Acronyms and glossary

Acronyms

AASB	Australian Accounting Standards Board
BIPA	*Borrowings and Investment Powers Act 1958*
DSE	Department of Sustainability and Environment
DTF	Department of Treasury and Finance
ESC	Essential Services Commission
FMA	*Financial Management Act 1994*
FRD	Financial Reporting Direction
KPI	Key Performance Indicator
VAGO	Victorian Auditor-General's Office

Definitions

Accountability

Responsibility on public sector entities to achieve their objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties.

Acquisition

Acquisition, in relation to assets, means establishing control over the asset, assuming the risks and receiving the right to future benefits, as would be conferred with ownership, in exchange for a cost of acquisition.

Asset

A resource controlled by an entity as a result of past events, and from which future economic benefits are expected to flow to the entity.

Auditor's opinion

Positive written expression within a specified framework indicating the auditor's overall conclusion on the financial report based on audit evidence obtained.

Capital contributions

Additions to net assets, which have been designated as contributions by owners.

Capital expenditure

Amount capitalised to the balance sheet for contributions by a public sector entity to major assets owned by the entity, including expenditure on:

- capital renewal of existing assets that returns the service potential or the life of the asset to that which it had originally
- capital expansion, which extends an existing asset at the same standard to a new group of users.

Commitments

Commitments include those operating, capital and other outsourcing commitments arising from non-cancellable contractual or statutory sources.

Construction in progress

The classification of costs incurred to date, including materials, labour and overhead on a fixed asset, which are to be capitalised on completion of the fixed asset.

Corporations Act 2001

The *Corporations Act 2001* is the principal legislation regulating companies in Australia.

Depreciation

The systematic apportionment of an asset's capital value as an expense over its estimated useful life to take account of normal usage, obsolescence, or the passage of time from the moment it is in a condition ready for use, as intended by management.

Developer contributions

Water infrastructure assets built by developers in new land subdivisions that on completion are provided to the corporation or fees paid by developers to connect new developments to the corporation's existing water supply and sewerage systems are recognised as revenue when the contributions are received.

Employee benefits expense

Employee benefits expenses include all costs related to employment including wages and salaries, leave entitlements, redundancy payments and superannuation contributions.

Employee benefits provision

The liability recognised including all costs related to employment comprising of wages and salaries, leave entitlements, redundancy payments and superannuation contributions.

Entity

Is a body whether incorporated or unincorporated that has a public function to exercise on behalf of the state or is wholly owned by the state, including departments, statutory authorities, statutory corporations and government business enterprises.

Environmental contribution

The *Water Industry (Environmental Contributions) Act 2004* amended the *Water Industry Act 1994* to make provision for environmental contributions to be paid by water supply authorities.

The purpose of the environmental contribution is set out in the Act, and the funding may be used for the purpose of funding initiatives that seek to promote the sustainable management of water or address water-related initiatives.

Expenses

Outflows or other depletions of economic benefits in the form of incurrence of liabilities or depletion of assets of the entity, other than those relating to contributions by owners, that results in a decrease in equity during the reporting period.

Fair value

The amount for which an asset (financial or non-financial) could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Financial Management Act 1994

The *Financial Management Act 1994* was developed to improve financial administration and accountability and provide for annual reporting to the Parliament by all Victorian public sector agencies.

Financial report

Structured representation of the financial information, which usually includes accompanying notes, derived from accounting records and intended to communicate an entity’s economic resources or obligations at a point in time and changes therein for a period in accordance with a financial reporting framework.

Financial Reporting Direction

Financial reports are prepared in accordance with Australian Accounting Standards and Interpretations (AASs) as issued by the Australian Accounting Standards Board (AASB). Where an AASB standard provides accounting treatment options the Department of Treasury and Finance issues a Financial Reporting Direction (FRD) to make sure consistent application of accounting treatment across the Victorian public sector in compliance with that particular standard.

Financial sustainability

An entity's ability to manage financial resources so it can meet spending commitments, both at present and into the future. For water bodies this refers to charging sufficient water charges over the long term, to maintain infrastructure assets and associated services in the supply of water.

Financial year

The period of 12 months from which a financial report is prepared ending on 30 June each year.

Grants and transfer payments

Transactions in which one entity provides goods, services, assets (or extinguishes a liability) or labour to another entity without receiving approximately equal value in return. Grants can be either operating or capital in nature.

Going concern

An entity which is expected to be able to pay its debts as and when they fall due, and continue in operation without any intention or necessity to liquidate or otherwise wind up its operations.

Hard close

An audit visit undertaken near the end of the financial year with the intention of substantiating figures to be provided in the financial statements that are available at that time.

Independent auditor's report

Issued after an audit and contains a clear expression of the auditor's opinion on the entity's financial report.

Infrastructure assets

Encompass substructures or underlying systems held by water entities to facilitate the harvesting, storage, treatment and transfer of water to meet customer needs/requirements; and that underlie sewerage and drainage systems.

Intangible assets

Represent identifiable non–monetary assets without physical substance. An emerging intangible in the water sector is the allocation of water entitlements or rights.

Internal control

A process affected by an entity's structure, work and authority flows, people and management information systems, designed to assist the entity accomplish specific goals and objectives. Internal control is a means by which an entity's resources are directed, monitored and measured. It plays an important role in preventing and detecting fraud and protecting the entity's resources.

Liability

A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Materiality

In relation to information, information that if omitted, misstated or not disclosed has the potential to adversely affect decisions about the allocation of scarce resources made by users of the financial report or the discharge of accountability by management or the governing body of the entity.

Material entity

Material entities represent those entities, which are collectively deemed to have a significant effect on the transactions and balances reported in the state's annual report. The selection of these entities follows a detailed analysis of the financial operations of all controlled entities and takes into account any major risk factors that are attached to specific entities or portfolios.

Net result

The net result is calculated by subtracting an entity's total expenses from total revenue, to show what the entity has earned or lost in a given period of time.

Public sector entity

A department; local government; statutory body; an entity controlled by government body, or public sector entity.

Qualification

A qualification is issued when the auditor concludes that an unqualified opinion cannot be expressed due to one of the following reasons:

- disagreement with those charged with governance
- conflict between applicable financial reporting frameworks
- limitation of scope.

A qualified opinion shall be expressed as being except for the effects of the matter to which the qualification relates.

Revenue

Inflows or other enhancements, or savings in outflows, of service potential or future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners that result in an increase in equity during the reporting period.

Risk

The chance of a negative impact on the objectives, outputs or outcomes of the entity.

Shell financial report

A financial report provided in the desired format for the designated reporting period without the audited financial figures of the entity for the designated reporting period.

Useful life

The estimated period of time over which a depreciable asset is expected to be able to be used, or the benefits represented by the asset are expected to be able to be derived.

Valuation

The process of applying a value to an asset. As required by FRD 103D revaluations have been required for all non-current physical assets held by water corporations. This process is undertaken by the Valuer General of Victoria.

Water entitlement or rights

An entitlement to an allocation of water, which is transferable on the open Victoria Water Register. These entitlements are commonly traded by water authorities, irrigators and farmers.

Auditor-General’s reports

Reports tabled during 2009–10

Report title	Date tabled
Local Government: Results of the 2008–09 Audits (2009–10:1)	November 2009
Public Hospitals: Results of the 2008–09 Audits (2009–10:2)	November 2009
Towards a ‘smart grid’—*the roll-out of Advanced Metering Infrastructure* (2009–10:3)	November 2009
Responding to Mental Health Crises in the Community (2009–10:4)	November 2009
Management of the Community Support Fund (2009–10:5)	November 2009
Auditor-General’s Report on the Annual Financial Report of the State of Victoria, 2008–09 (2009–10:6)	November 2009

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