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Essential Services Commission

Further review of expenditure forecasts

19 June 2009

Deloitte.

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Mr Marcus Crudden
Project Manager, Water
Essential Services Commission
2/35 Spring Street
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19 June 2009

Dear Marcus,

Final report: further review of expenditure by Melbourne water businesses

In accordance with your brief and our agreed scope of work, please find attached our final report on certain matters raised by the Melbourne water businesses' and the Commission following the Commission's draft decision and the Deloitte/Halcrow final expenditure reports.

Section 2 of this report addresses a number of common issues across the businesses and the following sections consider business-specific issues. As requested we have not addressed all the matters covered in the Deloitte/Halcrow final expenditure report and we note that there have been changes in economic conditions since this report. These include:

- more up to date information on general business conditions, unemployment levels and Government and private capital expenditure
- increases in the price of oil (although still well below 2007-08 levels)
- increases in the value of the Australian dollar.

Please contact me on 9671 6584 or Paul Liggins on 9651 6648 if you have any queries regarding this report.

Yours sincerely

Robert Southern, Partner

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Nature of report

This report was prepared for the Essential Services Commission for the purpose of its 2009 Melbourne metropolitan water price review.

In preparing this Report we have relied on the accuracy and completeness of the information provided to us by the Melbourne water businesses and from publicly available sources. We have not audited or otherwise verified the accuracy or completeness of the information.

The information contained in this Report is general in nature and is not intended to be applied to anyone's particular circumstances. This Report may not be sufficient or appropriate for your purposes. It may not address or reflect matters in which you may be interested or which may be material to you.

Events may have occurred since we prepared this Report which may impact on it and its conclusions.

No one else, apart from the Essential Services Commission, is entitled to rely on this Report for any purpose. We do not accept or assume any responsibility to anyone other than Essential Services Commission in respect of our work or this Report.

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1 Introduction

1.1 Approach

This report reflects our further investigation of some matters raised by the water businesses in response to the ESC's draft decision. As requested by the ESC, we have investigated a number of these matters in greater detail than was possible in our final report, and we have also taken into account the most recent information in relation to these matters.

This report is based on information provided by the water businesses in response to the ESC's draft decision. We have reviewed this information and sought additional information from the businesses to support their claims. We have also undertaken discussions with third parties including DSE and Mercer.

1.1.1 Criteria for review

Our recommendations for adjustments are based around two key questions:

1. **Does the case put forward by the businesses have merits?**

   In considering this question we have had regard to the following:

   - is the case put forward by the business supported by objective evidence including internal business documentation ? Are the arguments raised sound and consistent with reasonable expectations and changes in general economic conditions?
   - has the business raised any new information in its response compared to that provided earlier?
   - are there likely to be any offsetting cost reductions that the business has not identified which may offset those which have been identified ?

2. **Is the matter material?**

   Consistent with the Commission's suggestion, in the case of most adjustments sought we have recommended an adjustment only if the impact is greater than $1 per residential customer. This provides a materiality threshold of approximately $600,000 for South East Water and Yarra Valley Water, and $300,000 for City West Water. We have adopted a threshold of $1 million for Melbourne Water.

   Where an adjustments has been sought as a result of a demonstrated error or clear oversight in the draft decision or our previous work, we have recommended that it be approved regardless of size.

2 Generic issues

2.1 Defined benefits superannuation scheme

2.1.1 Background

Each of the businesses has a number of employees on defined benefits superannuation arrangements. Due to high levels of returns the businesses were not required to make contributions to these schemes in several years up to and including 2007-08 – hence no 'baseline' expenditure was incurred. However, following sharp reductions in the share market and advice from the relevant superannuation scheme, the businesses (with the exception of Melbourne Water) advised that high levels of contributions would be required in 2008-09 and over the forthcoming regulatory period. Following information provided by the businesses, our final report included the following total defined benefits superannuation contributions:

Final report – provision for defined benefits superannuation contributions ($m 2008-09[1])

Business	2008-09	2009-10	2010-11	2011-12	2012-13
City West Water	1.46	1.52	1.58		
South East Water	0.90	0.90	0.90	0.90	0.90
Yarra Valley Water	0.87	2.11	2.14	2.17	0.92
Melbourne Water	na	1.2	1.2	1.2	1.3

2.1.2 Business proposals

In their responses both City West Water and Melbourne Water raised further issues regarding superannuation contributions. Melbourne Water has sought additional funding for contributions over and above the levels assumed in its original Water Plan. Its Water Plan was based on contributions of 9% pa. City West Water has sought additional funding in 2011-12 as although it was advised by its fund manager that contributions needed to be increased over a three year period, only three months contributions were paid in 2008/09, hence requiring 9 months of payments in 2011-12.

Additional superannuation payments sought

Business	2008-09	2009-10	2010-11	2011-12	2012-13
City West Water					
Final report	1.46	1.52	1.58	-	-
Adjustment sought	-1.10			+1.05*	
Total now sought	0.36	1.52	1.58	1.05*	
Melbourne Water					
Final Report	na	1.2	1.2	1.2	1.3
Adjustment sought		1.9	1.9	2.0	0.7
Total now sought		3.1	3.1	3.2	2.0

* Note that City West Water indicated this figure was $1.14 in its response to the draft decision but later correspondence amended this amount to $1.05m

[1] In this report all financial figures in tables are in millions of dollars, expressed in January 2009 terms, unless stated otherwise.

2.1.3 Analysis

In reviewing this matter we sought detailed information from the businesses regarding their defined fund superannuation obligations. We also held discussions with Mercer who advises each of the businesses on superannuation matters. Mercer also provided us with information on recent fund returns.

Three of the four businesses have sought to include higher than ‘normal’ forecasts of superannuation payments based on advice from the fund manager (all businesses contribute to the same fund, Equipsuper). This is because fund assets are now less than fund liabilities. The contribution policy for the fund provides that where such a situation arises then contributions should be set at a level that is the greater of

- the amount required to target a ratio of assets to liabilities of 105% over 5 years
- the amount required to target a ratio of assets to liabilities of 100% over 3 years.

Contribution rates are reviewed twice annually based on fund assets and liabilities. Fund assets will change based upon the payments made by the businesses as well as investment returns and fees and charges. Fund liabilities change primarily based on employee salary levels and the number of employees that remain in the scheme.

The table below summarises the basis of the businesses’ superannuation projections for the forthcoming regulatory period.

Basis of projected superannuation contributions

Business	Contribution sought by fund %	Fund asset to liability ratio and date	Comment
City West Water	43.3%	79.9% at 6 March 2009	CWW’s forecast assumes 43.3% contributions for 36 months commencing in March 2009 then zero thereafter
South East Water	23.9%	91.9% at 6 March 2009 97.3% at end of April	SEW was advised by Equipsuper to contribute at 23.9% of salaries (approx $2.57m pa) but has based forecasts on 9% ($0.90m pa) on the basis that over time the fluctuations will even out
Yarra Valley Water	35.2%	86% at end Feb 2009	Forecast for regulatory period based on 35.2% for 3 years and 14.6% thereafter
Melbourne Water	24.2%	81.4% at 31 Dec 2008	Forecast for regulatory period based on 24.2% for 3 years and 14.6% thereafter

While all the businesses have had regard to fund advice, it is clear that the businesses have adopted different approaches when making projections. South East Water in particular has only included around one-third of its required payments in the forecasts (based on its 6 March position), on the basis that contributions should level out over the longer term.

Matters of timing are also relevant. The projections are also based on different dated advice from the fund. Melbourne Water’s projections are based on the 31 December 2008 fund position – since this time (to 29 May) investment returns have been +1.3%. The City West Water and South East Water projections are based on returns around the end of February 2009 – since this time fund returns have been +7.6%. (Returns in January and February were an aggregate -6.0%.)

Another issue to note is that the businesses have an incentive not to make payments to the fund in 2008-09, as they will not receive recompense for doing so, but to defer them to the next regulatory period and recover payments through higher tariffs.

We note that the Commission has a choice of three broad options when considering defined benefits contributions as part of a multi-year price review. The first option is to reflect the most recent estimates of contributions over the regulatory period in the forecasts. An alternative approach would be to assume a ‘normal’ level of contributions across each regulatory period (e.g. based on 9% of salaries) and accept that actual contributions will differ from this but that in the long run should equal out. While this second approach will most likely ‘underfund’ the businesses across the next regulatory period, it is worth noting that the businesses will have been significantly ‘overfunded’ across the current regulatory period. A third option is to adopt either option one or two but provide a pass-through or adjustment mechanism for defined benefit superannuation contributions.

If the Commission was to adopt option two (a 9% contribution) the contributions in each year of the forecast period would be as shown in the table below:

9% Superannuation contributions

Business	2009-10	2010-11	2011-12	2012-13
City West Water	0.3	0.3	0.3	0.3
South East Water	0.9	0.9	0.9	0.9
Yarra Valley Water	0.5	0.5	0.6	0.6
Melbourne Water	1.2	1.2	1.2	1.3

2.1.4 Recommendations

Does the case have merits?	Yes

Is the matter material?	Yes

Recommendation	That adjustments be made to superannuation contribution amounts as detailed below

Given the high level of investment returns over the last 2 months, we recommend reducing Yarra Valley Water’s superannuation contributions included in our final report. We estimate the adjustment required to be $0.46m for each of three years.

We also recommend adjusting City West Water’s superannuation payments downward for each of 2009-10 and 2010-11 to reflect the higher investment returns. We also recommend increasing the superannuation payment upwards in 2011-12 as sought by City West Water.

We recommend increasing the Melbourne Water superannuation amounts to the level sought in Melbourne Water’s response to the draft decision.

We recommend not adjusting the South East Water contributions, as the amounts provided are as requested by South East Water. Further, South East Water’s superannuation fund position is significantly better than that of the other businesses and any adjustments required using a revised methodology would be minor.

In the case of the changes to the Yarra Valley Water and City West Water superannuation contributions, we have recommended adjustments based on a number of simplifying assumptions. A more precise estimate would available from Equipsuper.

Recommendation - total superannuation contributions

Business	2009-10	2010-11	2011-12	2012-13
City West Water	1.27	1.33	0.86	0.00
South East Water	0.90	0.90	0.90	0.90
Yarra Valley Water	1.65	1.68	1.71	0.92
Melbourne Water	3.10	3.10	3.20	2.00

The above contribution amounts result in the following changes to the draft decision expenditure levels:

Recommendation – adjustments to superannuation contributions

Business	2009-10	2010-11	2011-12	2012-13
City West Water	-0.25	-0.25	0.86	0.00
South East Water	0.00	0.00	0.00	0.00
Yarra Valley Water	-0.46	-0.46	-0.46	0.00
Melbourne Water	1.90	1.90	2.00	0.70

2.2 Water conservation expenditure

2.2.1 Background

Each of the businesses proposes a substantial increase in water conservation activities across the regulatory period. Although we did not accept all the increases sought, our final report nevertheless provided for increases in expenditure in most years compared to base year levels.

Final report – water conservation expenditure

Business	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
City West Water	7.27	6.83*	8.14	7.29	6.78	6.59
South East Water	5.04	8.60	9.97	7.83	7.63	7.42
Yarra Valley Water	7.37	9.96	10.12	7.92	7.70	7.47
Melbourne Water	2.30	4.80	5.09	3.70	2.98	2.65

*Excludes Target 155 expenditure in this year

2.2.2 Business proposals

In their respective responses to the draft decision each business sought the reinstatement of reductions to their water conservation forecasts which were made in our final report.

- City West Water sought an additional $0.5m in 2009-10 to reflect T155 advertising costs
- South East Water sought an additional $0.3m in 2009-10 and $1.0m in 2010-11 to deliver the T155 program
- Yarra Valley Water sought an additional $1.19m in 2009-10 to reflect T155 costs associated with its internal programs

- Melbourne Water sought an additional $0.2m in 2011-12 and $0.4m in 2012-13 in relation to *Our Water Our Future* (OWOF) expenditure. It has also sought an additional $1.0m each year across the period to reflect payments to the Smart Water Fund.

2.2.3 Analysis

2.2.3.1 Target 155 expenditure

A significant component of the businesses' conservation expenditure is incurred in relation to joint advertising programs run by DSE. Each business has been contributing $1.5m to DSE to fund the general OWOF advertising program. In addition each business contributed an additional $0.925m in 2008-09, primarily to fund the T155 program.

In addition to funding a Melbourne wide awareness and behaviour change program the businesses have undertaken local initiatives targeting particular water uses and customer segments under the T155 program. In 2009/10 the businesses plan to undertake initiatives including:

- joint programs agreed between the retailers - notably a retrofit program to replace 25,000 inefficient toilets with dual flush toilets by offering a one-stop shop for replacement, as well as an efficient clothes washer program offering assistance and rebates for the introduction of 5,000 extra efficient clothes washers
- internal programs which differ between the retailers - for example Yarra Valley Water has a high residential user behavioural change program. South East Water and City West Water have similar programs with different names and different levels of funding.

It is difficult to compare T155 expenditure across the businesses, as different businesses classify expenditure in different ways and there are substantial overlaps with other conservation programs. In particular, South East Water and Yarra Valley Water classify different expenditure in different ways. For example, in 2008-09 Yarra Valley Water transferred its kiosk program to T155 (and removed it from general conservation) whereas kiosks are included in South East Water's general conservation expenditure. Yarra Valley Water has argued that this means that the benchmarking we undertook – which resulted in reductions to Yarra Valley Water's T155 expenditure and South East Water's non-T155 expenditure based on benchmarking T155 and non-T155 expenditure with each other – is invalid.

Noting these differences, the table below attempts to summarise the retailers' T155 proposals for 2009-10 (including the adjustments sought in response to the draft decision).

Retailer proposals – T155 expenditure in 2009-10

Expenditure item	City West Water	South East Water	Yarra Valley Water
Water conservation kiosks		Not included in T155	0.780 (10 kiosks for 20 weeks plus 70k marketing material)
Residential toilet retrofit	0.240 (3,800 units@$50 per unit plus 50k marketing)		0.600 (10,250 units @$50 per unit plus 88k marketing)
Non-residential toilet retrofit	0.240		
Clothes washer program	0.145 (950 units @ 100 per unit plus 50k marketing)		0.305 (2050 units@ 100 plus 100k marketing)
High residential user program			0.312 (2000 participants at $150 each plus 90k marketing)

Expenditure item	City West Water	South East Water	Yarra Valley Water
Contact centre support	0.033		0.070 (extra staff to respond to queries)
Business sector support			0.150 (on line portal)
Communications and mass media	0.963		1.063
Total sought	**1.62**	**2.3**	**3.28**
Amount provided for in draft decision	1.07	2.0	2.09
Increase sought by business over draft decision	0.55	0.3	1.19

In terms of water savings associated with the T155 internal programs, in response to our questions Yarra Valley Water has advised that, in relation to the toilet retrofit and clothes washer program:[2]

> *While the individual measures in themselves may not save vast quantities of water, the group of measures as a whole contribute to the realisation of the community that the water businesses are there to help them achieve the target, and offering solutions that address many of the barriers that thwart the achievement of water savings in the particular segment of use.*
>
> *The water businesses are already targeting shower use via target 155 messages for shorter showers and the showerhead exchange program, and outdoor use has been reduced via stage 3a water restrictions. This means toilets and clothes washers are logically the next areas of opportunity for water conservation programs. These programs are the first stages of what could be much larger programs should the extremely dry conditions continue.*
>
> *The cost per kilolitre saved needs to be considered in the context of extremely low storage levels, the prospect of another poor spring and the need to trial new programs should the need for even more savings eventuate. It should also be noted that during the development of the Central Region Sustainable Water Strategy (CRSWS) the showerhead and washing machine programs were identified as two of the most cost efficient water conservation programs available. Toilet retrofits were not one of the recommended programs at the time as the water supply situation was not as severe and it was thought that mandated efficiency standards would address inefficient toilets over time.*

We have spoken to DSE regarding the continuation of the T155 program. DSE's advice is that while the program has been confirmed to run through the 2009-10 summer period, no decisions regarding continuation of the program beyond this time have been made. Advice is also that in order for the communications program to be effective, new advertising will need to be commissioned. Thus it is likely that a similar level of contribution will be sought from the businesses in 2009-10 as in 2008-09.

Decisions on the level of funding to be permitted under T155 turn on the economic validity of the washing machine and toilet retrofit programs. We sought but did not receive detailed information on the economic justification for these projects. While we note Yarra Valley Water's view that the group of measures as a whole may contribute to reductions, this assertion makes the economic value of the programs difficult to test. However we would question the marginal benefit of these programs given the high existing level of expenditure, public awareness of water conservation, and the number of different programs already in existence.

If the retailers' programs (including toilet retrofit and washing machine) are deemed acceptable, then we are broadly satisfied that the revised T155 proposals submitted by the retailers are reasonable, with the

[2] Correspondence contained in an email from S Bumpstead to Paul Liggins dated 4 June 2009.

exception of Yarra Valley Water. In Yarra Valley Water's case the marketing costs appear slightly high and there appears to be an overstatement of mass communications expenditure.

T155 expenditure in 2009-10: recommendation if retailers' own programs are included

Expenditure item	City West Water	South East Water	Yarra Valley Water
Recommended expenditure	1.62	2.30	3.00
Increase over draft decision	0.55	0.30	0.91

However, if the retailers own programs are not considered acceptable then we believe that the T155 expenditure should be substantially lower and only incrementally higher than the $0.925m contribution made to the general advertising program. The exception is Yarra Valley Water where its kiosk program should be included in the expenditure.

T155 expenditure in 2009-10: recommendation if retailers' own programs are excluded

Expenditure item	City West Water	South East Water	Yarra Valley Water
Recommended expenditure	1.0	1.0	1.78
Decrease from draft decision	-0.07	-1.0	-0.31

South East Water has sought $1m funding for the T155 program in 2010-11. Given that the program is not currently scheduled to run in this year we do not believe this amount should be included in the forecasts.

Melbourne Water has sought an increase in funding in 2011-12 and 2012-13 to re-include amounts excluded in our final report. Given that the adjustments in our final report took Melbourne Water's expenditure below the $1.5m [3]contribution likely to be required for the general advertising program, we believe an adjustment is reasonable.

Adjustment to Melbourne Water general conservation expenditure

	2009-10	2010-11	2011-12	2012-13
Draft decision	1.50	1.50	1.27	1.05
Recommended revision	1.50	1.50	1.50	1.50
Increase	0	0	0.23	0.45

2.2.3.2 Smart Water Fund

Melbourne Water has raised the issue of Smart Water program funding. This program is a joint initiative which is funded equally by the four businesses. It was established to encourage and support innovative development of water, biosolids recycling and water saving projects.

Smart Water expenditure is included in the businesses' conservation forecasts. The table below sets out the funding assumptions proposed by the businesses in their original Water Plans:

Smart Water funding assumption in Water Plan

Business	2008-09	2009-10	2010-11	2011-12	2012-13
City West Water	1.13	1.10	1.06	1.03	1.18

[3] Note that we have assumed that the contributions to the OWOF and T155 advertising programs increase each year by CPI.

South East Water	1.20	1.02	0.95	0.93	0.88
Yarra Valley Water	0.76	0.76	0.76	0.76	0.76
Melbourne Water	na	0.80	0.40	0.10	0

A new round of Smart Water funding has typically been announced each year since 2002 with grants for round 6 being announced earlier in 2009. Each of the businesses provides $1m of funding for each round. This covers the cost of grants as well as the costs of a project office, which is run from South East Water. Although the fund is ultimately a year-by-year proposition, there is a general expectation that the program will continue.

Melbourne Water has sought additional funding for the scheme of $1m per year on top of its Water Plan forecasts.

Although the businesses commit $1m in nominal terms to each funding round, actual expenditure depends on the timing of individual projects. Therefore expenditure can be higher or lower than $1m in each year. Nevertheless, we consider it reasonable for each business to forecast on the basis of $1m, with the knowledge that the inter-year fluctuations will even out over time.

This results in the following adjustments to the businesses' forecast expenditure:

Adjustments to Smart Water funding

Business	2009-10	2010-11	2011-12	2012-13
City West Water	-0.12	-0.11	-0.10	-0.27
South East Water	-0.04	0.00	0.00	0.03
Yarra Valley Water	0.22	0.19	0.17	0.15
Melbourne Water	0.18	0.55	0.83	0.91

2.2.4 Recommendation

Does the case have merits?	Yes

Is the matter material?	Yes - for each business except South East Water

Recommendation	• That the ESC consider its position in relation to the retailers' own T155 programs and adjust the conservation forecasts accordingly • That the additional funding sought by Melbourne Water for conservation expenditure be accepted • That the ESC adjust the businesses' forecast for Smart Water expenditure as set out in the table above.

2.3 VCEC efficiency savings

2.3.1 Background

In our final report we made provision for certain savings as a result of implementing the VCEC recommendations. The savings were calculated on the following basis:

- total savings were at the midpoint of the VCEC recommendations of $8-10m
- 60% of savings were allocated to the retailers, with 40% to Melbourne Water. Retailer savings were allocated based on controllable operating expenditure
- it was reasonable to assume that the savings identified by VCEC should be net of implementation costs
- although VCEC called for the savings to be implemented in 6 to 12 months, it would be reasonable to provide for 50% of savings to be achieved in 2009-10 and 75% in 2010-11.

The Commission's draft decision accepted our recommendations, with the exception of 2010-11 where the Commission applied 100% of savings, rather than 75%.

The savings set out in the Commission's draft decision are set out below.

Draft decision – VCEC savings assumed

Business	2008-09	2009-10	2010-11	2011-12	2012-13
City West Water	-	0.70	1.40	1.40	1.40
South East Water	-	1.00	2.00	2.00	2.00
Yarra Valley Water	-	1.00	2.00	2.00	2.00
Melbourne Water	-	1.80	3.60	3.60	3.60
Total	**-**	**4.50**	**9.00**	**9.00**	**9.00**

2.3.2 Business proposals

In response to the Commission's draft decision Melbourne Water argued that few 'quick win' savings have been identified and that a report from an independent consultant on longer term savings will not be due until 30 June 2009. Melbourne Water also indicated that a more detailed review and implementation of viable projects will take at least one year to complete, resulting in savings starting in 2010-11 at the earliest.

South East Water indicated that there will be costs associated with implementing other VCEC outcomes (e.g. transition to a statutory authority, implementation of third party access and financial ring fencing). South East Water has estimated these costs at $1m. South East Water also considers that savings need to be scaled up to reach 100% by 2012-13, not within two years.

Yarra Valley Water reiterated that its original Water Plan forecast of net savings was appropriate. Amongst other things Yarra Valley Water argued that VCEC suggested that a timeframe for 6-12 months should be provided for the implementation of the recommendation – which does not imply that the savings would be achieved within that time limit.

City West Water did not raise this issue in its response to the draft decision.

Response to draft decision – net VCEC savings proposed by businesses

Business	2008-09	2009-10	2010-11	2011-12	2012-13	Total
City West Water (no change)	-	0.70	1.40	1.40	1.40	**4.90**
South East Water	-	-	1.00	1.50	2.00	**4.50**

Yarra Valley Water	-	-	0.50	1.50	2.00	**4.00**
Melbourne Water	-	-	1.80	2.70	3.60	**8.10**
Total	**-**	**0.70**	**4.70**	**7.10**	**9.00**	

2.3.3 Analysis

If accepted, the revisions proposed by the businesses would provide for a much lower level of savings than contemplated by the VCEC report. They would also lead to anomalies across the businesses, with the smallest retailer providing greater savings than the two larger retailers.

In our view the retailers' proposals are not consistent with their views, as expressed to VCEC, that savings of "at least $3 million per annum over two years" could be achieved. These views were expressed in 2007 and the VCEC report was finalised in February 2008, implying savings would be achieved by 2009-10. Further, while Yarra Valley Water has interpreted the VCEC report as only requiring that the recommendation be implemented in this time, this is not our view. We believe the document implies an expectation that savings will be achieved within 6-12 months.

Despite the above, in our final report we provided for a relatively generous transition period to achieving the savings, and much greater than the 6-12 months stated by VCEC.

We have reviewed the information regarding savings provided by the businesses, however we are of the view that nothing in this information provides any indication that the levels of savings targeted are not achievable.

We therefore believe there is no reason to change our original forecasts of potential savings.

2.3.4 Recommendation

Does the case have merits?	No

Is the matter material?	Yes

Recommendation	We do not believe the businesses have provided any new information to justify changes to the savings forecasts.

3 City West Water

3.1 Maintenance costs

3.1.1 Background

In the draft Deloitte/Halcrow report we reduced City West Water's maintenance expenditure forecasts to remove a real escalation factor of 2.5% used by City West Water in compiling its forecasts. City West Water did not make comment on this adjustment in its response to the draft report and we made the same adjustment in our final report.

3.1.2 Business proposals

City West Water has now indicated that maintenance expenditure, which is primarily incurred by its alliance partner PFM, includes a substantial labour component. City West Water also indicated that it has a cost pass through arrangement with PFM in respect of labour costs and hence is seeking the pass through of a 1.5% annual real wage increase.

Increase in maintenance costs sought*

	2008-09	2009-10	2010-11	2011-12	2012-13
Expenditure		0.28	0.43	0.57	0.72

* Note that the amounts in the table above are less than set out in City West Water's response to the draft decision. In responding to our queries City West Water identified two errors in its calculation methodology.

3.1.3 Analysis

As set out in our final report, our general view is that given the current economic climate, and unless specific circumstances exist, most of the water businesses' inputs (on a per unit basis) should not increase by more than CPI compared to base year levels. In making this statement we recognise that each cost input will reflect a number of different sub-inputs, including labour. While unit labour costs may increase, changes (including reductions) in the cost of other sub- inputs as well as changes in the mix of sub-inputs, should result, on average, in zero overall real change to that overall price input.

Under this theory no adjustment to the cost of maintenance services would be made, even if the cost of the contractor's labour was increasing in real terms. However we note that wages growth in the water businesses themselves and the public sector more generally is likely to be greater than that in the private sector in the short term. Workers in many private sector organisations are likely to experience real wages decline during 2009.

Nevertheless, we recognise that where water businesses have specific pass-though arrangements with their contractors or alliance partners, it would not be unreasonable to provide for a pass through of efficient costs.

It would therefore seem reasonable to allow the adjustment sought by City West Water.

We have checked City West Water's revised calculations and they appear to be correct.

3.1.4 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes

Recommendation	That City West Water's maintenance forecasts be amended as set out in the table below.

Recommended change to maintenance costs

	2008-09	2009-10	2010-11	2011-12	2012-13
Revised maintenance cost	9.48	9.62	9.77	9.91	10.06
Assumed cost in draft decision	9.34	9.34	9.34	9.34	9.34
Adjustment	0.14	0.28	0.43	0.57	0.72

3.2 Labour

3.2.1 Background

City West Water has the largest increase in staff numbers of the businesses in 2008-09 and across the regulatory period. This is due, in part, to the replacement of contract staff with permanent staff in City West Water's call centre, as well as a new technical officer development program. City West Water's technical officer development program is proceeding and is a joint initiative with Victoria University. New staff commenced in February 2009.

In calculating City West Water's labour costs in our final report we reflected advice from City West Water that it expected a 20% attrition rate for its technical officers. We gave effect to this advice by reducing technical staff numbers by 2 each year.

3.2.2 Business proposals

In response to our final report City West Water has suggested that we misinterpreted its advice and that in reality the two staff lost will be replaced each year, with the result that total technical officer numbers remain unchanged. City West Water has therefore sought the following adjustment to labour costs:

Increase in labour costs sought

	2008-09	2009-10	2010-11	2011-12	2012-13
Expenditure		0.18	0.19	0.19	0.20

3.2.3 Analysis

City West Water is correct that we interpreted its advice as meaning that technical officers who left the organisation would not be replaced. However, we removed an additional two staff each year – so that by 2012-13 eight technical officers had been removed. City West Water has only sought reinstatement of two technical officers in total.

In our final report we expressed some concern at the increase in staff numbers, that, despite our adjustments, were still higher than the increases for the other businesses. This is to some degree explainable by the number of vacant positions in the base year. However such a large number of vacancies would suggest that some positions do not need filling. Hence, we still hold these concerns.

Were we to re-include the additional technical officers that were omitted in our final report, using the labour cost calculation methodology adopted in our final report would result in the following increase to costs:

Increase in labour costs - final report methodology

	2008-09	2009-10	2010-11	2011-12	2012-13
Expenditure		0.18	0.37	0.56	0.76

However we believe it is also relevant consider that technical officers' wages are less than the average employee. Our final report assumed that all incremental employees started off at the same average wage as the remainder of the employees. However, this simplifying assumption may not be appropriate in this case where a large number of new employees have started at a relatively low wage. The technical officer positions have been advertised at a salary of $49,340. Assuming on-costs of 30%, that the continuing employees have real wage increases of 10% per annum, and reinstating the omitted officers, would result in the following adjustment to labour costs compared to the draft decision.

Alternate increase in labour costs

	2008-09	2009-10	2010-11	2011-12	2012-13
Expenditure		-0.18	0.07	0.32	0.56

The net effect of adopting this approach is almost identical to that of adopting the increased expenditure figures sought in City West Water's response to the draft decision.

3.2.4 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes
Recommendation	That the wages costs be adjusted by the amounts sought by City West Water.

3.3 Electricity and greenhouse gas

3.3.1 Background

In our final report we made substantial reductions in City West Water's electricity costs on the basis that the forecasts for the new West Werribee and Altona projects appeared high. In doing so we assumed that offset purchases would be made at the price nominated by City West Water - $10.80 per tonne – for the AGL 'green balance' product.

3.3.2 Business proposals

In response to our final report City West Water has argued that the current cost of greenhouse gas offsets is $40 per tonne. It has therefore sought an increase in electricity costs as shown in the table below. City West Water has not contested the other reductions made in our final report.

Increase in electricity costs sought

	2008-09	2009-10	2010-11	2011-12	2012-13
Expenditure			0.51	0.67	0.63

3.3.3 Analysis

City West Water's proposed adjustments are based on an assumption of a carbon offset price of $40 per tonne together with a CO_2 offset tonnage of 17,000 in 2010-11, 22,333 in 2011-12 and 21,000 in 2012-13.

In relation to the carbon offset price, City West Water has conceded that $40 per tonne is at the high end of the range and that it has received a quote for a price of approximately $31 per tonne. It has offered to provide us with a copy of the quote but we had not received as at the date of this report.

To test City West Water's assumptions we reviewed current prices offered by three offset providers via their web sites. Prices ranged between $15.00 and $17.25 per tonne, although it is likely that reductions would be possible for large volumes such as that purchased by City West Water. We also note that in response to the draft decision Yarra Valley Water has reported that the current value of accredited certificates is "between $12 and $20 per tonne of CO_2."

Secondly, the basis for City West Water's CO_2 tonnage is unclear and City West Water has also indicated that it represents the high end of the range. In our final report we calculated that the offset tonnages, taking into account green energy purchases and showerhead offsets would be 2,780 tonnes in 2010-11 rising to 6,200 tonnes in 2011-12 and 2012-13. CWW has confirmed that our calculation is correct, but that amongst other things its revised tonnage figures assume that no 'credit' will be earned for the showerhead savings.

In relation to the amount of offsets purchased several points are worth noting. Firstly, City West Water's proposal assumes offsets at a level that is well above the 10-20% that the ESC has previously noted is consistent with the Statement of Obligation requirements. There is no obligation on City West Water (or any of the other businesses) to offset their entire greenhouse gas emissions. Secondly, regardless of whether showerhead replacements are 'officially' credited or not, the net result of the showerhead program will be a reduction in greenhouse gas emissions across the community.

Finally, most of the water businesses' greenhouse gas emissions relate to the amount of energy they use. The government already has arrangements in place (e.g. the VRET and VEET schemes) to ensure that in the medium term at least 20% of the energy sold by retailers will come from renewable sources. If a water business offsets 100% of its energy purchases then arguably a total of 120% of emissions are being offset.

3.3.4 Recommendation

It would be reasonable to adjust City West Water's forecasts to reflect a slightly higher price for offsets ($12-15), however any adjustment would not be material.

Does the case have merits?	No
Is the matter material?	No
Recommendation	That no adjustments be made to City West Water's electricity forecasts.

4 South East Water

4.1 Plant costs

4.1.1 Background

Our final report made a number of adjustments to reduce South East Water's operating costs including those costs which were forecast to increase at rates above the CPI over the next regulatory period. This included plant costs.

4.1.2 Business proposals

South East Water has generally agreed with our adjustments, noting that "as this category predominately relates to contract labour based costs some of the adjustment is warranted".

However, South East Water has advised that plant costs include lease costs associated with its field maintenance/truck fleet and that a number of its vehicle leases are expiring in 2009. According to South East Water it has been advised that lease costs are likely to increase around 15% in 2009-10, resulting in an increase in cost of $80,000 over current prices.

4.1.3 Analysis

South East Water provided a spreadsheet which sets out likely price increases across a range of fleet vehicles.

We tested the theory that vehicle lease costs could reasonably be expected to rise 15% with Deloitte's motor industry specialists. We were advised that although this was the upper end of a likely range it was not implausible, and that some increases in lease costs would not be unexpected given that:

- general interest rate reductions have only been passed through to a limited degree in the motor vehicle industry
- although new vehicle costs were relatively low, resale values have also fallen.

At the same time, we note that this matter is relatively immaterial, it does not relate to a new regulatory obligation, and is again a matter that might be expected to be accommodated within the normal swings and roundabouts of business expenditure. There are likely to be other expenditure items where real cost reductions offset this increase. Our view is that the ESC should not adjust South East Water's expenditure for this item.

4.1.4 Recommendation

Does the case have merits?	No
Is the matter material?	No - total expenditure of $0.32m over the regulatory period
Recommendation	That South East Water's forecasts not be increased to accommodate this item.

4.2 Double counting and cost mix adjustments

4.2.1 Background

In our final report we reduced a number of South East Water's cost categories, including labour and electricity expenditure, as well as specific program costs.

4.2.2 Business proposals

In response to our final report South East Water has expressed concern about:

- double counting: in reducing labour costs and other cost escalations as well as specific program costs South East Water belives some double-counting may have occurred in respect of water conservation and Brainwaves Cup expenditure, and hence the reductions made are overstated
- cost –mix: South East Water's averaging methodology for forecasting the yearly change in certain cost categories means that some cost categories have been artificially overstated, with the result that the required reductions identified in our final report are overstated.

These matters are complicated and the adjustments proposed by South East Water have changed since its response to the draft decision. South East Water's most recent proposal, of 4 June 2009, seeks the following material adjustments:

Adjustments sought by South East Water

	2009-10	2010-11	2011-12	2012-13
Double counting – labour conservation	0.38	0.42	0.41	0.50
Double counting – labour Brainwaves Cup	0.25	0.25	0.25	0.25
Double counting – cost escalation	0.26	0.72	0.72	0.88
Cost mix - labour	2.47	2.09	2.08	1.93
Cost mix - electricity	0.23	0.24	0.33	0.55
Total	**3.59**	**3.72**	**3.79**	**4.11**

4.2.3 Analysis

4.2.3.1 Double counting

South East Water believes that the labour and cost escalation double counting issue affects the water conservation and Brainwaves Cup figures. It has assessed the impact of the double count by calculating the additional amount by which it had to reduce its forecasts in order to reconcile its model to the ESC's draft decision model.

Turning first to the Brainwaves Cup figures, in our final report we removed the entire amount of this program of $0.5m. The adjustment we made to labour costs was to remove South East Water's assumption of a 2.5% real increase, and replace it with a 1.5% assumption. Given that approximately half the Brainwaves Cup expenditure ($250,000) relates to labour, then South East Water is effectively seeking the reinclusion of this entire amount as a double –count. We do not consider that this is logical. In our view any double-counting of the labour cost adjustment for Brainwaves Cup would only relate to the reduction on per unit labour costs of 1% in 2008-09, approximately 2% in 2009-10, 3% in 2010-11 and so on. This is equivalent to a $2,500 adjustment in 2008-09, $5,000 in year 2009-10 etc. These are immaterial amounts and much less than the adjustment sought by South East Water.

Further, as set out below we have now recommended a change the Brainwaves Cup reduction from $0.5m pa to $0.35m p.a. Any minor double-counting issue related to this item will be further reduced.

In relation to the double counting of labour in respect of conservation expenditure, the labour cost adjustments made in our final report were as set out below. These adjustments were made to a wages forecast of approximately $40m per annum (note that these figures exclude the superannuation adjustment).

Final report – labour cost adjustments

	2009-10	2010-11	2011-12	2012-13
Labour adjustments	-3.0	-3.03	-3.11	-3.34

South East Water is seeking the re-inclusion of approximately 20% of this reduction on the basis of double-counting. This would imply that approximately 20% of South East Water's labour expenditure (equal to around $8m) is included in conservation expenditure. This is not the case as the entire conservation program is less than $8m in most years. In addition, a large proportion of expenditure in water conservation is related to external services including payments to government. Making the assumption that labour costs represent around one-third of conservation expenditure would imply that labour costs for conservation are around $2.7m per annum, and around 7% of South East Water's total labour expenditure. This would imply that around 7% of labour adjustments may be a double-count, or approximately $0.2m per annum.

We also consider it is likely that South East Water's estimate of the double counting is overestimated in respect of operating cost escalation. This is because the total operating cost escalation adjustments were made primarily to items (listed on page 17 of our final report) which are unlikely to be inputs to conservation expenditure. Of those items that are relevant to conservation expenditure, being consultancy costs and agency staff costs, no adjustments to these cost categories was ultimately made as the real increase sought by South East Water (1.5%) was consistent with our final report.

4.2.3.2 Cost mix adjustment

As noted above, South East Water is seeking the following 'cost-mix' adjustments to its forecasts:

Cost mix adjustment sought by South East Water

	2009-10	2010-11	2011-12	2012-13
Cost mix - labour	2.47	2.09	2.08	1.93
Cost mix - electricity	0.23	0.24	0.33	0.55
Total	**2.60**	**2.33**	**2.41**	**2.38**

South East Water believes the adjustments are necessary as certain costs - particularly labour - were artificially overstated in its forecasts due to the broad way in which certain cost categories were escalated. (A number of costs were correspondingly understated). This meant that the difference between the 'efficient' labour costs calculated by Deloitte, which were subtracted from the forecasts, was overstated.

South East Water has calculated the adjustment it believes is necessary to our final report by changing its operating cost model to reflect the report, and then escalating these costs proportionately to determine the labour costs that would result. The labour cost-mix adjustment also includes an adjustment of $0.9m for superannuation.

We have reviewed South East Water's calculations and believe that some cost-mix adjustment is required, however:

- we do not consider that the superannuation adjustment is necessary as it will already be included in the forecast amounts
- while South East Water has identified cost categories that were overstated in its initial submission, there will be a number of cost categories that are understated in its initial submission but which we did not review and adjust. Had the forecasts included the 'correct' expenditure for these items, then we may have subjected them to additional scrutiny and/or made larger reductions.

It is therefore difficult to accurately estimate the level of cost-mix adjustment required, however we believe it is likely to be no more than $1.0 million per year.

4.2.4 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes
Recommendation	That South East Water's forecasts be increased by • $0.2m pa to remove any double counting adjustments • $1.0m pa to reflect the cost-mix adjustment

4.3 Billing and collection

4.3.1 Background

In response to our draft report South East Water identified that its existing bill printing contract was awarded at less than market rates and that a 30% increase was expected when the new contract commenced in 2011-12. South East Water therefore sought an additional $0.3m in 2011-12 and 2012-13 to cover this higher cost.

In our final report we considered South East Water's request but recommended against increasing the expenditure forecast on the basis that:

- at least one independent observation suggested charges had continued to decline, at least until recently, in the printing industry
- changes such as this should be considered to be part of the 'swings and roundabouts' of a normal expenditure cycle.

4.3.2 Business proposals

South East Water has again sought the inclusion of $0.3m in 2011-12 and 2012-13 to reflect forecast higher bill printing costs. To support its case South East Water has again suggested that:

- the current contract was awarded at rates significantly lower than the service provider's competitors
- mergers in the printing industry since the last tender have resulted in less competition in the market place.

4.3.3 Analysis

South East Water has not raised any new information in its response. We continue to hold the view set out in our final report.

4.3.4 Recommendation

Does the case have merits?	No
Is the matter material?	Yes

Recommendation	No adjustment be made to the forecasts.

4.4 Brainwaves cup

4.4.1 Background

In its original Water Plan submission South East Water identified the costs associated with the 'Brainwaves Cup' as being $0.2m in 2008-09 and $0.5m thereafter.

In our final report we recommended against accepting this expenditure primarily on the basis that:

- at least three of the six initiatives approved in 2007 were of a not-prescribed nature
- against a background of large price increases, it was incumbent upon water businesses to constrain expenditure where possible and defer non-essential programs such as the Brainwaves Cup.

4.4.2 Business proposals

In response to the ESC's draft decision South East Water (p. 24) has argued that the $0.5m reflects:

- existing labour costs for the overall innovation program ($0.2m p.a.) which are already included in 2007-08 business as usual expenditure
- proposed additional seed funding ($0.3m p.a.) for the brainwaves program.

South East Water has accepted the decision to remove $0.3m seed funding, but has sought retention of the baseline amount of $0.2m p.a.

4.4.3 Analysis

South East Water's proposal appears appropriate given that the $0.2m expenditure is baseline expenditure and that it is not unreasonable for South East Water to continue its innovation program. It is likely that the other businesses will have similar programs included in their baseline and hence forward expenditure forecasts. However, we still have some concerns that the Brainwaves Cup and the innovation program more generally appear to address non-regulated matters although no costs have been allocated to non-regulated functions. We have therefore removed $50,000 from the baseline expenditure and re-instated $150,000 per annum.

4.4.4 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes – total expenditure of $0.6m over the regulatory period.
Recommendation	Reinstate $0.15m p.a. to reflect South East Water's ongoing innovation program expenditure.

4.5 Financial reporting obligations

4.5.1 Background

In its response to the draft decision South East Water has requested that the ESC's final decision include South East Water's forecast costs of complying with new financial reporting obligations. This expenditure was not included in South East Water's Water Plan.

Additional costs associated with financial reporting obligations

	2008-09	2009-10	2010-11	2011-12	2012-13
Expenditure		0.2	0.1	0.1	0.1

4.5.2 Analysis

It is correct that new financial reporting obligations have been imposed on the Melbourne water businesses. We also note that South East Water's forecasts of expenditure across the period on this item are half of Yarra Valley Water's. However, as we outlined in our final report on Yarra Valley Water's expenditure forecasts, we consider that these costs should be could be undertaken using existing resources and in accordance with the usual 'swings and roundabouts' of a normal business cycle.

4.5.3 Recommendation

Does the case have merits?	No
Is the matter material?	No - total expenditure of $0.5m over the regulatory period
Recommendation	That the amounts sought not be included in Recommendation

4.6 Increase in corporate costs

4.6.1 Background

Although not an issue raised by South East Water in its response, the ESC has asked us to review the increases in South East Water's corporate costs. As the table below shows (taken from page 81 of the Water Plan) South East Water's corporate costs increase substantially between 2006-07 and 2012-13. The main increase is in the area of 'corporate services' which rises $6.7m between 2008-09 and 2009-10. Further, because the 2007-08 corporate services costs includes a $6.4 superannuation adjustment, there is also a step-up in expenditure of approximately $3.0 million between 2007-08 and 2008-09.

South East Water operating costs

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Operations and Maintenance	13.50	13.80	13.20	13.50	13.60	13.80	14.00
Asset Planning	2.00	2.20	3.40	3.90	3.70	3.90	3.90
Customer Service and Billing	23.10	26.20	25.70	26.90	28.00	29.00	30.20
Corporate IT	3.70	4.10	3.60	3.70	3.90	4.10	4.20
Corporate Services	28.60	34.80	31.20	37.90	37.30	36.10	37.00
Government Contributions	17.40	17.10	18.10	17.60	17.10	16.60	16.10
Total corporate costs	**88.30**	**98.20**	**95.20**	**103.50**	**103.60**	**103.50**	**105.40**

4.6.2 Analysis

We asked South East Water to explain the key reasons for the $6.7m increase in corporate services costs. In response South East Water suggested the following (which total $6.2m):

- water conservation initiatives ($4.2m)
- graduate intake ($1.0m)
- Brainwaves Cup seed funding ($0.3m)
- VCEC savings implementation costs ($0.5m)
- development of a new CRSWS ($0.2m)

We have addressed the water conservation, Brainwaves Cup, and VCEC savings costs elsewhere in this report.

In respect of the graduate program, South East Water has previously indicated that it intends to take on 6 new graduates each year. A forecast cost of $1m for 6 graduates is excessive – however graduate costs will be reflected in our calculation of reduced labour costs.

We have reviewed the ‘operating expenditure by account’ figures provided by South East Water. These figures indicate that a large proportion of the increase between budgeted 2008-09 expenditure and forecast expenditure is due to number of ‘general consulting’ expenditure accounts in its forecasts. These general consulting costs increase from $4.5m budgeted in 2008-09 to $6.75m in 2009-10. Some of these represent expenditure items which are budgeted in 2007-08 and continue at a similar level across the forecast period. Others represent once-off items. Much of the consulting increases are related to water conservation expenditure and increase by 75% from 2008-09 to 2009-10 (with increases totalling over $1m) consistent with South East Water’s forecast of a 75% overall increase in water conservation expenditure. However, as South East Water has noted that while broad programs are planned, the cost estimates are not known with certainty.

We asked South East Water to confirm its 2008-09 expenditure on general consultancy services. South East Water has indicated that this is likely to be $3.7m, $0.8m below the budget of $4.5m. South East Water has indicated this is “mainly due to funds being reallocated to other areas e.g. to fund additional superannuation contributions not budgeted for”.

We accept that once-off expenditure requirements may well arise during the regulatory period which cannot be forecast at this time, and that it is reasonable to include a general provision for these costs. However it is not clear why, aside from conservation expenditure, the costs should increase over current levels. Further, it is reasonable to expect that some of the cost increases for ‘new obligations’ which South East Water has forecast - for example $30,000 per annum associated with the Terrorism Act, $0.1m per annum for an independent trade waste regulator, and $0.1m per annum for Bureau of Meteorology reporting, could be incorporated within this consultancy allowance or within the general ‘swings and roundabouts’ of a normal business cycle. This was the approach adopted for similar cost categories for Yarra Valley Water.

4.6.3 Recommendation

Based on the information provided by South East Water, including the most recent information available on corporate costs for 2008-09, we believe that the South East Water’s corporate cost forecasts may be overstated by up to $1.0m. This view is based on the following:

- the increase in corporate costs between 2007-08 and 2008-09
- actual 2008-09 expenditure is around $0.8m below budget
- some expenditure items could be expected to be absorbed in the normal ‘swings and roundabouts’ of the business cycle, as the ESC has requested other businesses (e.g. Yarra Valley Water) to do

- there is a gap of approximately $0.5m between the increase in expenditure and the reasons suggested by South East Water for the increase.

It would be incorrect to simply reduce forecasts by $1.0m as some of this expenditure reduction will relate to areas where reductions have already been made. It is difficult to estimate the degree of overlap, however based on our understanding of South East Water's figures the ESC may wish to consider a reduction of up to $0.5m pa.

Does the case have merits?	Yes

Is the matter material?	Yes

Recommendation	That South East Water's corporate cost expenditure be reduced by $0.5m per annum.

5 Yarra Valley Water

5.1 Electricity and greenhouse gas expenditure

5.1.1 Background

Yarra Valley Water's Water Plan was based on the assumption that it would generate large greenhouse credits from its showerhead exchange program. In its response to the draft decision Yarra Valley Water has advised that it now understands from the ESC that in order to achieve a credit the showerhead will have to be installed by Yarra Valley Water or its agent (rather than the customer). According to Yarra Valley Water this would increase the cost of earning credits beyond reasonable levels.

5.1.2 Business proposals

Yarra Valley Water now proposes to purchase offsets at a value of $16 per tonne, being the mid-point of its estimated range of $12 and $20. It proposes to achieve zero net emissions.

5.1.3 Analysis

Yarra Valley Water has previously indicated that its showerhead program will ensure that its greenhouse gas emissions are fully offset. However, it appears that these offsets will now not be officially credited. Yarra Valley Water now intends to ensure that its offsets are officially measured. On one hand this is not unreasonable, as official accreditation is important. On the other hand, as with City West Water's proposal, it does imply that its emissions are arguably being 'doubly' offset, at a proposed additional cost to its customers of almost $2 million.

As noted in section 3.3.3, there is no obligation on the water businesses to offset their entire greenhouse gas emissions and the ESC has previously noted that greenhouse gas reduction of 10-20% are consistent with their Statements of Obligations. Secondly, regardless of whether showerhead replacements are 'officially' credited or not, the net result of the showerhead program will be a reduction in greenhouse gas emissions across the community. Finally, most of the water businesses' greenhouse gas emissions relate to the amount of energy they use. The government already has arrangements in place (e.g. the VRET and VEET schemes) to ensure that in the medium term at least 20% of the energy sold by retailers will come from renewable sources. If a water business offsets 100% of its energy purchases then arguably a total of 120% of emissions are being offset.

In relation to the unit price of offsets it is not clear why Yarra Valley Water should base its cost forecasts on the mid-range of prices when cheaper options are clearly available. If Yarra Valley Water has identified that prices of $12 are available, it should access this price.

5.1.4 Recommendation

We understand that the ESC has formed a position on the degree to which it will permit the cost of CO_2 offsets to be included in prices. In applying this policy, we recommend that a price of $12 per tonne of CO_2 offset be adopted.

Does the case have merits?	Yes
Is the matter material?	Yes
Recommendation	That Yarra Valley Water's greenhouse emission offsets be based on a cost of $12 per tonne.

5.2 Billing and collections

5.2.1 Background

In our final report we reduced Yarra Valley Water's billing and collection costs primarily on the basis that increases in Yarra Valley Water's per customer costs were higher than South East Water's.

5.2.2 Business proposals

Yarra Valley Water has contested the reductions in the final report on two grounds. Firstly, it considers that its detailed billing and collection forecast should be assessed on its merits, and not benchmarked against the other water businesses. Secondly it considers that an error was made in the benchmarking and that a correct application of the benchmarking demonstrates that Yarra Valley Water's costs are closely comparable to South East Water's. Yarra Valley Water has sought the following increase in expenditure compared to the draft decision.

Additional costs associated with billing and collections

	2008-09	2009-10	2010-11	2011-12	2012-13
Expenditure		0.80	1.12	1.28	1.43

5.2.3 Analysis

5.2.3.1 Detailed consideration of Yarra Valley Water proposal

Yarra Valley Water has sought substantial increases in billing and collection expenditure compared to 2007-08 levels. The key increases at issue are in relation to merchant service fees, agency debt collection costs, bill payment costs, and printing and postage.

Yarra Valley Water has revised its original forecasts of cost changes in these items to take account of the prices announced in the draft decision. However it has not altered its other assumptions, which are summarised in the table below:

Assumptions underlying billing and collection cost increases

Expenditure category	Assumption
Merchant service fees (total cost of $0.52m in 2012-13)	Growth in costs related to price increase. Once-off reduction in costs of $55,000 in 2008-09 due to reduction in price charged by merchants
Debt collection costs (total cost of $2.34m in 2012-13)	Growth in debts outstanding to change according to price increase, as well as growth of 10% in 2009-10, 8% in 2010-11, 5% in 2011-12 and 3% in 2012-13. Once off increase in cost for debt collection contract of $155,000 in 2008-09
Bill payment costs (total cost of $3.52m in 2012-13)	Increase in costs of 10% in 2009-10, 8% in 2010-11, 5% in 2011-12 and 3% in 2012-13. Once-off increase in prices charged by payment channel providers of $126,000 in 2008-09, with $22,000 reduction thereafter spread across the period
Bill printing and postage (total cost of $2.2m in 2012-13)	Increase in costs in line with changes in customer numbers. Once-off increase in costs (mainly postage) of $135,000 in 2008-09 with $22,000 reduction thereafter spread across the period

Yarra Valley Water's assumptions regarding changes in merchant service fees and bill printing and postage costs are likely to be reasonable. However the majority of the increases are in respect of debt collection and bill payment. Changes in these costs are dependent on the assumption about the growth in payments through payment channel providers (e.g. Australia Post) and the growth in the number of accounts that require debt collection action to be taken.

In relation to increases in debt collection costs Yarra Valley Water has provided some evidence to suggest that the number of referrals has increased recently. We also note that the ESC has based its draft decision on the assumption that bad debts will double. However:

- the proposed move from the Water Industry Act to the Water Act will provide the businesses with a better ability to recover debts from customers
- increases in the water and sewerage concessions rebate amount were announced by the Victorian government in its May budget statement, which should reduce the number of bad debts compared to the original forecast
- if utility bills would otherwise be unpaid as a result of circumstances such as unemployment then assistance is available for some low income customers through the Utility Relief Grant Scheme (URGS).

(Although we have not considered the issue in any detail it is likely that the increase in costs associated with hardship cases assumed for the draft decision may also be overstated with prices being lower than initially envisaged and with the increase in the concessions rebate.)

In relation to bill payment costs the volume of payment channel transactions to December 2008 was similar to that in December 2007, suggesting that Yarra Valley Water's forecast of increases is overstated. Yarra Valley Water is effectively assuming that the number of payment channel transactions will increase by 36% across the period, which seems high. However Yarra Valley Water has argued that as customers move into a cycle of debt the number of payments usually increases from 4 to 12 each year, which will increase the number of transactions made. However, we note that the number of payments made under these debt arrangements will still be small compared to the total number of payments. Further, we understand that often payments under debt arrangements are made via direct debit, which is the cheapest form of payment channel

We therefore consider it unlikely that the number of payment channel transactions will increase at the rate suggested by Yarra Valley Water. A more reasonable (although relatively arbitrary) assumption would be an annual increase of around 3%.

5.2.3.2 Benchmarking

In relation to benchmarking, we maintain the view that it is a useful exercise to benchmark Yarra Valley Water's billing and collection costs against South East Water's. There are a number of ways this can be done. One approach is to use Yarra Valley Water's 2007-08 cost per customer as the starting point, and increase it at the same rate as South East Water's cost per customer increase (a variant of this approach was used in our final report). Another is to simply multiply South East Water's cost per customer by Yarra Valley Water's number of customers.

5.2.3.3 Conclusions

We consider there is some merit in Yarra Valley Water's arguments that its billing and collection costs set out in our final report are low. The benchmarking approach we used resulted in total billing and collection costs that were materially lower than for South East Water.

However, we believe that Yarra Valley Water's forecasts may be overstated, particularly in relation to bill payment costs, but also in respect of debt collection.

We have considered three alternative approaches to setting Yarra Valley Water's billing and collection costs. They result in the following increases in costs compared to our final report:

Additional costs associated with billing and collections - options

	2009-10	2010-11	2011-12	2012-13
Adopt Yarra Valley Water detailed forecast but reduce annual increase in merchant collection fees to 3%	0.74	0.86	0.86	0.93
Benchmarking 1 – use Yarra Valley Water 2007-08 cost/customer and increase at same rate as South East Water increase in cost/customer	-0.04	0.13	0.28	0.51
Benchmarking 2 – use South East Water cost/customer	0.66	0.88	1.09	1.38

Having reviewed the options, and taking into account the fact that debt collection costs may be overstated we believe that it is reasonable to increase Yarra Valley Water's billing and collection costs by $0.75m per annum.

5.2.4 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes
Recommendation	That Yarra Valley Water's billing and collection costs be increased by $0.75m per annum.

5.3 IT costs

5.3.1 Background

Yarra Valley Water proposed significant increases in IT expenditure in its original Water Plan over 2006-07 levels. Much of this increase is associated with a number of projects collectively known as the 'COMPASS' program, which includes a new customer care and billing system, a property information system, enterprise reporting and other satellite systems. Although Yarra Valley Water subsequently reduced the forecast after it discovered an error with the base year amounts, the increases are still sizeable. In our final report we recommended reductions to forecast expenditure to:

- remove $0.15m p.a associated with a 'business excellence program'
- remove a provision of $0.25m p.a for the use of consultants and administrative support
- remove the net increases in operating costs associated with the new billing system of approximately $0.8m p.a.

Final report - Yarra Valley Water IT operating expenditure

Title	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Yarra Valley Water proposal	11.39	13.55	14.11	14.57	14.74	14.78
Final report reductions			- 1.25	- 1.20	- 1.21	- 1.20
Final report recommendation			12.86	13.37	13.53	13.58

5.3.2 Response to the draft decision

In response to the draft decision Yarra Valley Water has accepted the removal of the business excellence program but has sought the re-inclusion of the $0.25m provision for consultants and the increase in operating costs associated with the new customer care and billing system. In its response to the draft decision Yarra Valley Water:

- identified a number of tasks and projects that may be conducted by external consultants
- explained the additional operating costs need to be incurred and that it will be necessary to incur licence costs associated with the old billing system for the remainder of the regulatory period, due to the need to retain data.

In its response to the draft decision Yarra Valley Water has sought the following increases:

Yarra Valley Water additional IT operating expenditure

	2009-10	2010-11	2011-12	2012-13
Draft decision	12.86	13.37	13.53	13.58
External consultants and administrative staff	0.25	0.25	0.25	0.25
COMPASS system costs	0.85	0.80	0.80	0.80
Total	13.96	14.42	14.58	14.63
Increase over draft decision	1.10	1.05	1.05	1.05

5.3.3 Further response

We asked Yarra Valley Water to provide further information on its IT costs including the costs of introducing its new billing system. In response to this request on 4 June 2009 Yarra Valley Water indicated that:

- the April 2009 board meeting approved new timetables for a number of its IT projects, including a new ‘go live’ date for key elements of the billing system of February 2010
- Yarra Valley Water has now re-estimated its IT operating costs and that the costs estimated in February 2009 were understated by approximately $3.6m.

Additional expenditure, compared to that estimated earlier by Yarra Valley Water, in relation to COMPASS projects is as follows:

Additional IT operating expenditure outlined in Yarra Valley Water further response ($’000)

	2008-09	2009-10	2010-11	2011-12	2012-13
Customer Care and Billing	-513	310	697	803	454
Property Information System	-37	128	119	119	119
Enterprise reporting	-100	51	15	15	15
IBIS Satellite Systems	2	-88	9	9	9
Total increase to COMPASS costs	**-648**	**401**	**840**	**946**	**597**

Yarra Valley Water did not provide any additional information to us on capital costs associated with the COMPASS systems, but we understand these have also increased.

It was not clear from Yarra Valley Water’s response whether it was seeking recovery of these additional costs through the price review process. We have not considered them here.

5.3.4 Analysis

Yarra Valley Water has an extensive IT capital works program. Spread over a number of different projects, the IT capital program for 2009-10 to 2012-13 totals $49.8m. Another $28.6m is being spent in 2008-09 giving a total of $78.4m across the 5 years (and excluding any cost increases that may have now arisen in relation to COMPASS expenditure). This compares with approximately $30.4m IT capital spending by South East Water over the 5 year period.

It is usual to expect IT programs of this nature and size to result in reductions in operation expenditure. However, Yarra Valley Water has justified most of its capital spending not on the basis of cost reductions, as these clearly do not exist, but on the basis of reduced risk. For example, in relation to its existing IBIS (billing) system, Yarra Valley Water has argued that 'the tangible (or apparent) cost of the existing IBIS system is very low, however its contingent costs in terms of risk exposure are unsustainably high, and they justify the replacement of the existing system with one that entails higher tangible operating expenditure but prudent and efficient levels of risk exposure.'

Given the timing of the information supplied, we have not been able to review the revised forecasts provided by Yarra Valley Water or seek additional information (for example, a copy of the Board paper approving the revised project timing and expenditure). We suggest that the ESC does so.

IT expenditure is complex area and we have not reviewed expenditure on a project-by-project basis. However the following factors are worth noting:

- anecdotal evidence suggests IT management and consultancy prices have dropped approximately 15-20% over the last 9-12 months (i.e. since Yarra Valley Water's forecasts were prepared)
- given the high level of capital expenditure there may be opportunities for the other businesses to share systems – we would expect this to be reviewed as part of the VCEC efficiency project
- Yarra Valley Water's IT program has been subject to time delays and cost increases. We have not been provided the reasons for the delays or increases, other than that the operating costs were 'under-estimated'.

In relation to the specific adjustments sought by Yarra Valley Water in response to the draft decision, we have reviewed the additional information provided and are satisfied with Yarra Valley Water's explanation that the additional COMPASS costs are likely to be required due to the need to retain the existing billing system.

Yarra Valley Water has justified the additional consultant and administrative costs on the basis of the need to develop the following specific outputs and services:

- specialist consultants to develop a comprehensive business continuity plan and disaster recovery plan
- updates to the IT strategic plan
- the development of acknowledge management strategy as a precursor to the adoption of an electronic records and document management system
- resources to document and implement improved IT infrastructure processes
- periodic benchmarking studies of outsourced IT Facility providers
- the development of a strategic sourcing strategy
- undertaking a security health review.

We expect that similar one-off projects will have been carried out in the current regulatory period and included in base year expenditure. The projects listed above appear to be of the type associated with the usual 'swings and roundabouts' of a normal IT expenditure cycle. Further, given reductions in the cost of IT consultants in recent months, we do not believe that the additional $0.25m per annum should be included in the forward forecasts.

5.3.5 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes
Recommendation	That Yarra Valley Water's IT forecasts be increased to reflect additional operating costs associated with the COMPASS project as set out in the table below.

	2009-10	2010-11	2011-12	2012-13
Draft decision	12.86	13.37	13.53	13.58
Additional COMPASS system costs	0.85	0.80	0.80	0.80
Total	13.71	14.17	14.33	14.38

5.4 Minor items

5.4.1 Background

In the final Deloitte/Halcrow report we recommended the exclusion of a number of minor cost items identified by Yarra Valley Water as requiring additional expenditure on the basis that the expenditure either:

- did not represent 'new obligations' or
- could be undertaken using existing resources and in accordance with the usual 'swings and roundabouts' of a normal business cycle or
- represented non-operational expenditure that could be deferred postponed or eliminated entirely.

5.4.2 Business proposals

In its response to the draft decision Yarra Valley Water has accepted most of the adjustments, but argued for the following changes:

- an additional $1.03m to correct a transpositional error in our final decision
- the re-inclusion of $0.53m across the regulatory period to develop HACCP22000 accreditation and to undertake a trade waste pricing impact assessment.

5.4.3 Analysis

We agree with Yarra Valley Water that an error was made in relation to the risk ranking adjustment and that the forecasts should be adjusted in the following manner:

Yarra Valley Water trade waste risk ranking expenditure relative to Water Plan

	2008-09	2009-10	2010-11	2011-12	2012-13
Final report reduction	-	-	-0.830	-0.160	-0.160
Correct reduction	-	-	-0.083	-0.016	-0.016
Recommended increase			0.747	0.144	0.144

to draft decision					

In relation to the HACCP22000 accreditation and the trade waste pricing assessment, although we have not reviewed these matters in detail we have no reason to dispute Yarra Valley Water's assessment that work needs to be undertaken . However, we remain of the view that such programs should be able to be undertaken using existing resources and in accordance with the usual swings and roundabouts of a normal expenditure cycle.

Does the case have merits?	Yes - identification of error

Is the matter material?	Yes

Recommendation	That an adjustment should be made to the trade waste risk ranking expenditure as set out in the table above. No adjustment should be made in respect of the other changes sought by Yarra Valley Water.

6 Melbourne Water

6.1 Tarago operating expenditure

6.1.1 Background

In our final report we reduced forecast expenditure associated with the Tarago treatment plant, commensurate with lower volume forecasts. This did not reflect any major concerns regarding the unit costs. Rather, while Melbourne Water based its projections on 15GL throughput each year, our understanding was that throughput would be 20GL in 2009-10 and 8GL thereafter.

6.1.2 Business proposals

Melbourne Water has submitted revised forecasts of Tarago treatment and operating costs and is seeking the re-inclusion of the amounts removed in our final report. Melbourne Water believes the volume assumptions in our final report are 'out of date' and that 15GL per annum is the correct assumption. Melbourne Water has also sought a small adjustment for increased chemical costs associated with the slightly higher total volumes in the ESC's draft decision compared to the original forecasts.

Melbourne Water's additional operating and chemical costs

Title	2009-10	2010-11	2011-12	2012-13
Tarago - chemicals	-0.1	0.1	0.1	0.2
Tarago – operating expenditure	-0.3	0.3	0.4	0.3
Chemicals	0.0	0.1	0.1	0.1
Total	**-0.4**	**0.5**	**0.6**	**0.6**

6.1.3 Analysis

This matter turns on the volume of water that is expected to be treated at the Tarago plant. In the absence of any information to the contrary, we have accepted Melbourne Water's position that the revised volume is 15GL per annum. On this basis the adjustments sought by Melbourne Water are appropriate.

6.1.4 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes
Recommendation	That Melbourne Water's expenditure forecasts be adjusted upwards as set out in the table above.

6.2 Bushfire expenditure

6.2.1 Background

Our final report, and the ESC's draft decision, did not include any additional expenditure for costs associated with the February bushfires that affected Melbourne Water's catchments and involved Melbourne Water staff and assets in the bushfire suppression effort. This was because Melbourne Water did not have cost estimates available at the time our final report and when the Commission's draft decision was being prepared.

6.2.2 Business proposals

In its response to the draft decision Melbourne Water estimated the following additional costs as a result of the bushfires.

Melbourne Water bushfire expenditure

	2008-09	2009-10	2010-11	2011-12	2012-13
Additional operating expenditure	3.1	1.1	1.3	-	-

Melbourne Water has explained that the additional costs are due to:

- involvement in the prevention, detection and suppression of bushfires
- remedial action in catchments to protect water quality
- assessing damaged caused by the bushfires
- developing and implementing a recovery program.

6.2.3 Analysis

We asked Melbourne Water to provide additional information about their forecasts of bushfire-related operating expenditure. This was primarily in order to understand whether the figures provided were high level estimates (and therefore likely to be subject to substantial future revision) or represented a more considered assessment of costs. In response Melbourne Water provided relatively detailed breakup of its operating (and capital) expenditure, which is set out in Appendix A.

We have not reviewed the individual expenditure items set out in Melbourne Water's response. However, the level of detail set out in the response suggests to us that it is likely the estimates are based on a relatively rigorous assessment of costs. The only issue we have with the Melbourne Water forecasts is in relation to a cost item of $0.5m in 2010-11 for O'Shannassy Bridge. Melbourne Water's response to the draft decision suggested this was operating expenditure however following questioning Melbourne Water agreed that it was actually capital expenditure.

6.2.4 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes
Recommendation	That the Commission accept Melbourne Water's forecast of bushfire related operating expenditure with the exception of $0.5m in 2010-11 which should be classified as capital expenditure

6.3 Land tax

6.3.1 Background

In our final report we reduced Melbourne Water's projections of land tax primarily on the basis that Melbourne Water's future forecasts of increases in land values were high. We also noted that the ESC may wish to review the forecasts of land tax when Melbourne Water's 2009 land tax assessment was received.

6.3.2 Analysis

Melbourne Water has provided the ESC with its 2009 land tax assessment, which provides for tax of $14.5m. After apportionment to the drainage function (13.48%), this leaves $12.56m. Our final report was based around a 2009 bill of approximately $17.1 million.

It is not clear why the assessed land tax is so much less than that forecast, although it appears to be due to lower average property value growth rates than assumed by Melbourne Water. Notably, Melbourne Water has also indicated that it has identified a number of errors and adjustments in its assessment, including in relation to property valuation. Melbourne Water believes these errors will increase its total land tax payable to approximately $18 million (or $15.57 million for water and wastewater).

It is possible to recalculate our final report's land tax projections by 'backsolving' a 2009 property value consistent with a 2009 total land tax bill of $18 million. This results in the following reductions in land tax over the outlook period compared to our final report (keeping all other assumptions the same).

Recalculation of Melbourne Water land tax payment

	2009-10	2010-11	2011-12	2012-13
Recalculated land tax for water and wastewater based on total $18m bill for 2009	15.84	16.59	17.08	17.55
Final report land tax forecast	17.35	18.13	18.64	19.15
Reduction	-1.51	-1.54	-1.56	-1.60

In relation to the assumption about further increases in land tax, according to page 43 of the Victorian government's *Budget 2009-10 Strategy and Outlook* the land tax assumption in its budget is growth (on average) in (nominal) land tax revenue of 0.9 per cent a year. According to the government this reflects expectations of 'only modest' growth in land valuations over the forward estimates (2010-11 to 2012-13) period, offset by the ongoing disaggregation of land holdings which reduces the land tax base. There is no indication of what the government considers to be 'modest growth' in land valuations, but we suggest that our assumption of a 2% real increase is not inconsistent with what might be considered 'modest'.

6.3.3 Recommendation

Does the case have merits?	Yes
Is the matter material?	Yes
Recommendation	That in light of Melbourne Water's 2009 land tax bill the forecasts of future land tax be reduced consistent with the figures in the table above.

Appendix A

Melbourne Water Response – bushfire funding

Bushfire Funding Requirements	08/09		09/10		10/11		Total	
	Capex	Opex	Capex	Opex	Capex	Opex	Capex	Opex
Operations								
Silt fencing and Make safe works	$170,000		$200,000				**$370,000**	
Automatic samplers	$100,000						**$100,000**	
Catchment security (minor repairs)	$100,000						**$100,000**	
Equipment for algae scanning	$50,000						**$50,000**	
Install curtains on the Yarra and Silvan inlets at Silvan	$100,000						**$100,000**	
Emergency Power and Water Treatment Plant works		$200,000						**$200,000**
Weekly WQ moniting		$150,000		$540,000		$370,000		**$1,060,000**
Chemical Dosing units		$100,000						**$100,000**
Labour Overtime		$600,000						**$600,000**
Contract Staff		$1,130,000						**$1,130,000**
Catchment road drainage		$100,000						**$100,000**
Desilting Tarago Weir		$150,000						**$150,000**
Desilting Bunyip Weir				$20,000				**$20,000**
Desilting Wallaby Weir						$50,000		**$50,000**
Bushfire Emergency Response Cabinet Funding		-$100,000						**-$100,000**
Waterways								
Hydrograpic Sites	$60,000	$30,000	$170,000	$85,000			**$230,000**	**$115,000**
Increased monitoring WQ		$20,000		$50,000		$20,000		**$90,000**
Increased monitoring platypus		$20,000		$10,000				**$30,000**
Increased monitoring Geomorphology		$15,000		$20,000				**$35,000**
Stream Frontage Managent Program (riparian fencing, ossw, weed control)		$591,000						**$591,000**
Inspections to assess rehabilitaiton potential		$50,000						**$50,000**
Bushfire Emergency Response Cabinet Funding		-$600,000						**-$600,000**
Strategic Planning								
Research into Forest Recovery after Bushfire		$200,000		$200,000		$200,000		**$600,000**
Asset Planning								
Consultancy services quality and quantity & research		$200,000		$200,000		$200,000		**$600,000**
Reinstate Wallaby Water Supply system from Wallaby Weir to Toorourrong Res and Road Culverts	$350,000						**$350,000**	
Fencing (42Km)	$250,000		$334,000				**$584,000**	
Building - Cleanup Wallaby (Asbestos Removal)		$100,000						**$100,000**
Wallaby Bridge			$200,000				**$200,000**	
O'Shannassy Bridge (2 Bridges)		$5,000				$500,000		**$505,000**
BMR Bridge (1 Bridge)			$100,000				**$100,000**	
Shed Removal Maroondah		$50,000						**$50,000**
Pine Removal Maroondah		$50,000						**$50,000**
Pine Removal Wallaby				$100,000				**$100,000**
Structural Assessment - 2 Fire Towers				$20,000				**$20,000**
Additional Wallaby Work - eg. Grates			$200,000				**$200,000**	
Wallaby Heritage lodge			$50,000				**$50,000**	
D4 Replacement (Insurance $120k)			$230,000				**$230,000**	
People & Safety								
Carfi Services		$60,000						**$60,000**
Additional safety and training related expenses		$10,000						**$10,000**
Communications								
Communications		$50,000		$10,000		$10,000		**$70,000**
Capital Projects								
Sugarloaf	$1,741,885						**$1,741,885**	
Other Projects	$155,000						**$155,000**	
TOTAL	**$3,076,885**	**$3,181,000**	**$1,484,000**	**$1,255,000**		**$1,350,000**	**$4,560,885**	**$5,786,000**
NET TOTAL EXCLUDING WATERWAYS (ADDITIONAL FUNDING REQUESTE	**$3,016,885**	**$3,055,000**	**$1,314,000**	**$1,090,000**		**$1,330,000**	**$4,330,885**	**$5,475,000**

DSE Funded	08/09		09/10		10/11		Total	
	Capex	Opex	Capex	Opex	Capex	Opex	Capex	Opex
Roads - 80km			$1,200,000					