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2008 WATER PRICE REVIEW

DRAFT DECISION VOLUME II:
SOUTH GIPPSLAND WATER

MARCH 2008

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1. Purpose of volume II of the draft decision

The Commission is required to issue a Draft Decision that proposes either to:

- (a) approve all of the prices which a regulated entity may charge for prescribed services, or the manner in which such prices are to be calculated or otherwise determined, as set out in the regulated entity's water plan, until the commencement of the next regulatory period or
- (b) refuse to give the approval referred to above and specifies the reasons for the Commission's proposed refusal (which may include suggested amendments to, or action to be taken in respect of, the Water Plan that, if adopted or taken, may result in the Commission giving that approval) and the date by which a regulated entity must resubmit a revised Water Plan or undertake such action as to ensure compliance.

This Volume of the Draft Decision summarises for each business the suggested amendments or actions that if adopted or taken may result in the Commission giving its approval to the relevant business's proposed prices or the manner in which such prices are to be calculated or otherwise determined. The main reasons for suggested amendments or actions are summarised. More detailed reasons for the Commission's suggested amendments are outlined in Volume I of the Draft Decision.

2. Actions to be taken in response to this draft decision

In response to this Draft Decision, South Gippsland Water should by 9 May 2008 resubmit:

- (a) its proposed schedule of tariffs to apply for each year of the regulatory period commencing 1 July 2008 that reflects:
 - (i) the revised revenue requirement set out in Table 3
 - (ii) the revised demand forecasts set out in Tables 12–16 and
 - (iii) any changes to tariff structure suggested by the Commission.
- (b) the service standards to apply over the regulatory period consistent with any revisions suggested by the Commission set out in Tables 1–2.

If a business does not submit a revised schedule of tariffs and/or the service standards to apply, or otherwise make a submission as to why it has not adopted the Commission's suggested amendments by the due date, the Commission will specify the prices, or manner in which prices are to be calculated or otherwise determined and the service standards to apply for the regulatory period 2008-09 to 2012-13 as part of its Final Determination.

3. Service standards

The Commission proposes to approve each of the service standards proposed in South Gippsland Water's Water Plan, except as indicated in table 1.

Table 1 Approved service standards

<i>Service standard</i>	<i>Draft decision – service standards</i>					
	<i>3yr Avg 2003-06</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Water						
Unplanned water supply interruptions (per 100km)	28.2	28.0	28.0	28.0	28.0	28.0
Average time taken to attend bursts and leaks (priority 1) (minutes)	16.3	30.0	30.0	30.0	30.0	30.0
Average time taken to attend bursts and leaks (priority 2) (minutes)	36.1	40.0	40.0	40.0	40.0	40.0
Average time taken to attend bursts and leaks (priority 3) (minutes)	45.1	1440.0 ^a	1440.0 ^a	1440.0 ^a	1440.0 ^a	1440.0 ^a
Unplanned water supply interruptions restored within 5 hours (per cent) - proposed	98.4	99.0	99.0	99.0	99.0	99.0
Planned water supply interruptions restored within 5 hours (per cent)	72.6	99.0	99.0	99.0	99.0	99.0
Average unplanned customer minutes off water supply (minutes)	39.3	33.0 ^a	33.0 ^a	33.0 ^a	33.0 ^a	33.0 ^a
Average planned customer minutes off water supply (minutes)	162.4	150.0 ^a	150.0 ^a	150.0 ^a	150.0 ^a	150.0 ^a
Average frequency of unplanned water supply interruptions (number)	0.3	0.3	0.3	0.3	0.3	0.3
Average frequency of planned water supply interruptions (number)	0.5	0.5	0.5	0.5	0.5	0.5
Average duration of unplanned water supply interruptions (minutes)	114.5	100.0	100.0	100.0	100.0	100.0
Average duration of planned water supply interruptions (minutes)	302.4	300.0	300.0	300.0	300.0	300.0
Number of customers experiencing 5 unplanned water supply interruptions in	0.0	0.0	0.0	0.0	0.0	0.0

<i>Service standard</i>	<i>Draft decision – service standards</i>					
	<i>3yr Avg 2003-06</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
the year (number)						
Unaccounted for water (per cent)	12.0	14.0	14.0	14.0	14.0	14.0
Sewerage						
Sewerage blockages (per 100km)	15.8	18.0	18.0	18.0	18.0	18.0
Average time to attend sewer spills and blockages (minutes)	26.4	30.0	30.0	30.0	30.0	30.0
Average time to rectify a sewer blockage (minutes)	142.0	120.0	120.0	120.0	120.0	120.0
Spills contained within 5 hours (per cent)	100.0	100.0	100.0	100.0	100.0	100.0
Customers receiving 3 sewer blockages in the year (number)	0.0	0.0	0.0	0.0	0.0	0.0
Customer Service						
Complaints to EWOV (per 1000 customers)	0.9	1.1	1.1	1.1	1.1	1.1
Telephone calls answered within 30 seconds (per cent)	99.0	98.0	98.0	98.0	98.0	98.0
Minimum Flow Rates						
	<i>20mm</i>	<i>25mm</i>	<i>32mm</i>	<i>40mm</i>	<i>50mm</i>	
Flow rate (litres per minute)	20.0	35.0	60.0	90.0	160.0	

Note Data rounded to one decimal place. **n.p.** = Not provided. **a** amended by the business in the lead up to the Draft Decision

Where the proposed service standard target deviated from Western Water's actual three year average performance or did not appear to make sense, the Commission sought further information from the business. The table above indicates which of the standards were amended by the business in the lead up to the Draft Decision.

The Commission also notes that South Gippsland Water has proposed the additional service standards outlined in table 2.

Table 2 Additional service standards

<i>Service standard</i>	<i>3yr Avg 2003-06</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Recycled water target (per cent)		2.0	2.0	2.0	2.0	2.0
Biosolids reuse (per cent)		0.0	0.0	0.0	2.0	5.0
Small Town Sewerage Scheme connections (no. of)		0.0	0.0	206.0	519.0	8.0
Environmental discharge indicator (per cent)		100.0	100.0	100.0	100.0	100.0
Drinking water quality indicators (per cent)		100.0	100.0	100.0	100.0	100.0

Note Data rounded to one decimal place.

4. Guaranteed service level scheme

The business has not proposed to introduce a GSL scheme in the forthcoming period.

5. Revenue requirement

The Commission has adopted the following assumptions in relation to the revenue required over the regulatory period.

Table 3 Breakdown of revenue requirement implied by ESC draft decision

\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-2012</i>	<i>2012-13</i>
Operating expenditure	12.70	12.30	12.50	12.39	12.51
Return on existing assets	3.90	3.73	3.55	3.38	3.23
Return on new investments	0.29	0.74	1.14	1.73	2.44
Regulatory depreciation	2.57	2.72	2.86	2.91	2.93
Tax liability	0.00	0.00	0.00	0.00	0.00
Total	19.47	19.50	20.05	20.41	21.10

6. Rolled forward regulatory asset base

The regulatory asset base as at 1 July 2005 has been rolled forward to reflect approved capital expenditures net of customer contributions (new customer and shareholder contributions) and disposals for the 2005-06 to 2007-08 period less

any approved allowance for regulatory depreciation. The rolled forward values are shown in table 5.

Table 4 Updated regulatory asset base
\$ million in January 2007 prices

	<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>
Opening RAB	39.56	50.93	59.03
<i>Plus</i> Gross Capital expenditure	14.28	12.33	10.04
<i>Less</i> Government contributions	0.39	1.40	0.82
<i>Less</i> Customer contributions	0.60	0.61	0.57
<i>Less</i> Proceeds from disposals	0.31	0.37	0.46
<i>Less</i> Regulatory depreciation	1.61	1.85	1.90
Closing RAB	50.93	59.03	65.33

The regulatory asset base as at 1 July 2007 will be rolled forward to reflect approved estimates of capital expenditure net of customer contributions (new customer and shareholder contributions) and disposals for the 2007-08 to 2012-13 period less any approved allowance for regulatory depreciation.

The Commission has adopted the following assumptions in relation to regulatory asset base over the regulatory period:

Table 5 Rolled forward regulatory asset base
\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Opening RAB	65.3	72.1	74.5	79.5	88.1
<i>Plus</i> Gross Capital expenditure	10.4	6.2	9.4	14.6	13.5
<i>Less</i> Government contributions	0.0	0.0	0.0	2.0	0.0
<i>Less</i> Customer contributions	0.6	0.8	1.1	0.7	0.6
<i>Less</i> Proceeds from disposals	0.3	0.3	0.4	0.3	0.3
<i>Less</i> Regulatory depreciation	2.6	2.7	2.9	2.9	2.9
Closing RAB	72.1	74.5	79.5	88.1	97.7

7. Weighted average cost of capital

The Commission has adopted a weighted average cost of capital (WACC) of 6.1 per cent for all water businesses. The table below outlines the individual components for the WACC.

Table 6 Real post-tax WACC

<i>Real risk free rate</i>	<i>Equity beta</i>	<i>Market risk premium</i>	<i>Debt margin</i>	<i>Financing structure</i>	<i>Franking credit value</i>	<i>WACC</i>
<i>(per cent)</i>	<i>(β)</i>	<i>(per cent)</i>	<i>(per cent)</i>	<i>(per cent)</i>	<i>(%)</i>	<i>(per cent)</i>
3.41	0.65	6.00	1.95	60	0.5	6.1

8. Operating expenditure

The Commission has made the following assumptions about operating expenditure forecasts over the regulatory period:

Table 7 Proposed and approved operating expenditure assumptions
\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Proposed operating expenditure	12.41	12.02	12.22	12.25	12.38
Revisions and adjustments	0.29	0.28	0.27	0.27	0.26
Draft decision – operating expenditure	12.70	12.30	12.50	12.52	12.64

The Commission's assumptions reflect the following adjustments to South Gippsland Water's proposed operating expenditure forecasts:

Table 8 Adjustments to operating expenditure
\$ million in January 2007 prices

<i>Expenditure item</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Poowong, Loch, Nyora sewerage scheme	0	0	0	-0.13	-0.13
Environmental contribution adjustment	0.29	0.28	0.27	0.27	0.26
DHS licence fee adjustment	-0.001	0	0	0	-0.001
Total	0.29	0.28	0.27	0.14	0.13

- (a) No business revisions were proposed after the submission of the Water Plan.
- (b) SKM's recommendation the completion of the Poowong, Loch and Nyora sewerage scheme be changed to the end of the regulatory period results in the removal of operating expenditure from the regulatory period (SKM section 6.2.7).

- (c) Advice was received from the Department of Human Service on their licence fees and the Department of Sustainability and Environment on the environmental contribution for the regulatory period. Adjustments were made so operating expenditure reflected the Department's advice (Draft Decision section 4.7).

9. Capital expenditure

The Commission has made the following assumptions about capital expenditure forecasts over the regulatory period:

Table 9 Proposed and approved capital expenditure assumptions
\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Proposed capital expenditure	12.07	10.24	9.86	8.55	7.18
Draft decision – capital expenditure	10.36	6.24	9.36	14.55	13.48

The Commission's assumptions reflect the following adjustments to South Gippsland Water's proposed capital expenditure forecasts:

Table 10 Adjustments to capital expenditure
\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Poowong Loch Nyora Sewerage Scheme	-1.7	-4	-0.5	6.0	6.3
Total ESC Adjustment	-1.7	-4	-0.5	6.0	6.3

- (a) Poowong/Loch Nyora Sewerage Scheme - Due to the increased forecast costs of the Poowong/Loch Nyora sewerage scheme, SKM consider that further justification is required for this project. For the draft decision an increased allowance of expenditure for this project has been deferred until the later in the period (SKM, section 5.2).

South Gippsland Water has identified the following key capital projects to be undertaken during the regulatory period.

Table 11 Key capital projects

	<i>Expected completion date</i>
Poowong/Loch Nyora Sewerage Scheme	2010-11
Tarra River off-stream storage	2011-12
Meeniyah Sewerage Scheme	2009-10
Vehicle replacement	ongoing
Battery Creek Dams Risk	2012-13
Coalition Creek Dams Risk	2008-09
Water Renewals/Replacement	ongoing
Wonthaggi Wastewater Strategy Works	2011-12
Agnes River Augmentation – Construction of Off Stream Storage	2011-12
Reticulation Sewer Replacement/Rehabilitation	ongoing

10. Demand forecasts

- (a) The Commission has made the following assumptions about demand for various services over the regulatory period.
- (b) The Commission has adjusted proposed demand forecasts where shaded or otherwise indicated.

Table 12 Number of water connections

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-2013</i>
Residential					
Proposed connections	15,425	15,660	15,899	16,142	16,380
Draft decision — connections	15,603	16,024	16,457	16,902	17,358
Non-residential					
Proposed connections	3,171	3,193	3,216	3,239	3,262
Draft decision — connections	3,223	3,300	3,378	3,458	3,540
Total	18,596	18,853	19,115	19,381	19,642
Draft decision — total connections	18,827	19,324	19,835	20,359	20,898

The number of water connections has been adjusted on PWC's advice (see PWC, Assessment of Demand Forecast Report).

Table 13 Number of sewerage connections

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-2013</i>
Residential					
Proposed connections	14,181	14,380	14,789	15,514	15,723
Draft decision – connections	14,181	14,380	14,789	15,514	15,723
Non-residential					
Proposed connections	1,239	1,249	1,259	1,268	1,278
Draft decision – connections	1,239	1,249	1,259	1,268	1,278
Total	15,420	15,629	16,048	16,782	17,001
Draft decision – total connections	15,420	15,629	16,048	16,782	17,001

Table 14 Residential water consumption
ML

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-2013</i>
Proposed average consumption (kL)	136	135	134	133	132
Draft decision – average consumption (kL)	134	131	129	126	124
Proposed total residential consumption	2,098	2,114	2,130	2,147	2,162
Draft decision – total residential consumption	2,086	2,102	2,118	2,135	2,150

PwC recommended reducing the anticipated savings that South Gippsland Water expected from restrictions and thus increased their water demand forecasts. South Gippsland Water assumed that the water savings made from imposing usage restrictions would accelerate over time. In contrast, PwC suggested that the savings from water restrictions would present a step reduction in water use and not accelerate over time.

PwC recommended adjusting for price elasticity which was not included in South Gippsland Water's forecasts.

Table 15 Non-residential water consumption
ML

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-2013</i>
Proposed non-residential consumption	2,958	2,949	2,943	2,938	2,934
Draft decision – non residential consumption	2,941	2,932	2,926	2,921	2,918

Non-residential consumption has been adjusted on PWC's advice (see PWC, Assessment of Demand Forecast Report).

Table 16 Total water consumption
ML

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-2013</i>
Proposed total consumption	5,055	5,063	5,073	5,084	5,096
Draft decision – total consumption	5,027	5,034	5,044	5,056	5,067

Adjustments to total water consumption reflect PWC's advice as noted above.

11. Form of price control

- (a) The Commission proposes to approve individual price caps for South Gippsland Water.
- (b) South Gippsland Water should submit a schedule of prices to apply from 1 July 2008, as well as a process in which tariffs can be adjusted on an annual basis.
- (c) South Gippsland Water may apply for an adjustment to its prices or tariff strategy at the time of the annual price review. It would have to demonstrate in its application to the Commission that it has clearly articulated a new tariff strategy (or explained how the proposed price changes are consistent with its existing tariff strategy), undertaken appropriate customer consultation and addressed customer impacts. The average annual price increase across the range of tariffs could not be greater than the average increase calculated under a tariff basket approach. The Commission may then approve amended individual price caps for the remainder of the regulatory period.

12. Pass through mechanisms

Businesses may apply to the Commission to adjust their prices either at the end of the regulatory period or during the regulatory period for specified costs where these are materially different from the costs included for the purposes of the Determination. Pass through mechanisms may apply in the following cases:

- (a) Prices will be adjusted at the end of the regulatory period to reflect any difference between assumed and actual licence fees levied by the EPA,

DHS and the ESC. To avoid any doubt, the assumed licence fees payable for each year of the regulatory period are set out in Table 17.

Table 17 Approved licence fee assumptions^a
\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-2012</i>	<i>2012-2013</i>
Essential Services Commission	0.01	0.01	0.01	0.01	0.02
Environment Protection Authority	0.12	0.12	0.13	0.15	0.15
Department of Human Services	0.01	0.01	0.01	0.01	0.01

^a Included in forecasts of business as usual operating expenditure.

- (b) Prices will be adjusted at the end of the regulatory period to reflect the additional net operating costs associated with meeting changes in legislative obligations during the regulatory period where:
- (i) the impact on costs is equivalent to at least 5 per cent of the business's revenue over the regulatory period
 - (ii) changes in costs relate to changes in primary Acts and legislative instruments, including regulations; in taxes (or fees or similar charges) excluding income tax, penalties and interest on taxes, stamp duty, financial institutions duty or similar taxes and levies; to EPA licence requirements; and/or to the Statement of Obligations
 - (iii) the change in legislative obligation was unforeseen and not already reflected in expenditure forecasts
 - (iv) additional capital costs will be rolled into the regulatory asset base at the beginning of the next regulatory period where the expenditure is assessed as being prudent and efficient, and prices will be adjusted to reflect any associated financing costs.
- (c) Prices may be adjusted during the regulatory period to reflect costs associated with catastrophic events, such as fire, earthquake or act of terrorism, where:
- (i) the impact on costs is so significant as to prevent the business meeting its service requirements and obligations without compromising its financial viability during the period
 - (ii) the business can demonstrate that it had taken appropriate steps to plan for or manage the potential impact of such an event.
- (d) Prices may be adjusted during the regulatory period to reflect expenditure relating to major capital projects where:
- (i) the business has separately identified any uncertain major capital projects and excluded those projects from its expenditure forecasts

- (ii) the Commission has identified the project as an uncertain major capital project in the Final Determination
 - (iii) the application process for determining the amount, nature and timing of any adjustment will be set out in the Final Determination.
- (e) Prices may be adjusted during the regulatory period to reflect any significant differences between actual and forecast demand levels where:
- (i) the Commission determines that actual demand levels are significantly different from those forecast for the purposes of the Final Determination
 - (ii) the Commission finds a material impact on the business's revenues.

13. Retail water tariffs

The Commission proposes to approve South Gippsland Water's proposed tariff structure on the basis that it is consistent with the WIRO.

14. Retail sewerage tariffs

The Commission proposes to approve South Gippsland Water's proposed tariff structure on the basis that it is consistent with the WIRO.

15. Trade waste charges

- (a) The Commission proposes to generally approve South Gippsland Water's proposed trade waste tariff structure on the basis that it is consistent with the WIRO and the Commission's trade waste pricing principles.
- (b) South Gippsland Water is required to set out and apply specific trade waste pricing principles to apply to those customers for whom scheduled prices do not apply. The principles should be consistent with the following principles:
 - (i) volumetric and load based prices should, to the extent practicable, reflect the long run marginal cost (LRMC) of trade waste transfer, treatment and disposal
 - (ii) the total revenue received from each customer should be greater than the cost that would be avoided from ceasing to serve that customer, and (subject to meeting avoidable cost) less than the stand alone cost of providing the service to the customer in the most efficient manner
 - (iii) the methodology used to allocate common and fixed costs to that customer should be clearly articulated and be consistent with any guidance provided by the Commission
 - (iv) prices should reflect reasonable assumptions regarding the volume and strength of trade waste produced by that customer
 - (v) depreciation rates and rates of return used to determine prices should be consistent with those adopted by the Commission in this Determination.

- (vi) Customers should be provided with full details of the manner in which prices have been calculated. Where applying these principles results in significant changes to prices or tariff structures, arrangements for phasing in the changes may be considered and any transitional arrangements should be clearly articulated.

16. Recycled water

- (a) The Commission is proposing to approve South Gippsland Water's proposed pricing principles on the basis that they are consistent with the principles set out below.
- (b) The Commission considers that South Gippsland Water should set its recycled water prices according to a set of principles that ensure that prices:
 - (i) have regard to the price of any substitutes and customers' willingness to pay
 - (ii) cover the full cost of providing the service (with the exception of services related to specified obligations or maintaining balance of supply and demand)
 - (iii) include a variable component.
- (c) Where a business does not propose to fully recover the costs associated with recycled water, it must demonstrate to the Commission that:
 - (i) it has assessed the costs and benefits of pursuing the recycled water project
 - (ii) it has clearly identified the basis on which any revenue shortfall is to be recovered
 - (iii) if the revenue shortfall is to be recovered from non-recycled water customers, either that the project is required by 'specified obligations' or that there has been consultation with the affected customers about their willingness to pay for the benefits of increased recycling.

17. Customer contributions

- (a) The Commission proposes to approve South Gippsland Water's proposed new customer contributions.
- (b) Approval is subject to an adjustment clarifying that recycled water services, due to their unique nature, will not be subject to a scheduled charge but rather will be regulated by the Commission's proposed pricing principles for recycled water.

Table 18 New customer contributions charges
\$ per lot

	<i>Category 1^a</i>	<i>Category 2^b</i>	<i>Category 3^c</i>
Water	550.00	1,100.00	2,200.00
Sewerage	550.00	1,100.00	2,200.00

^a For developments which are designed in a manner that will have minimal impacts on future water resource demands (lot sizes typically no greater than 450 square meters). ^b For water sensitive urban developments which will require further investment in infrastructure within a six year period to service these developments (lot sizes typically between 450 and 1,350 square metres). ^c For developments that will create demand for water resources over and above high-density, water efficient homes (lot sizes typically exceeding 1,350 square metres).

18. Miscellaneous charges

- (a) The Commission proposes to not approve the inclusion of administration developer fees in South Gippsland Water's core miscellaneous services. These are calculated as a percentage of project cost and would be better classified as a non-core service.
- (b) The Commission proposes to approve all other core miscellaneous services proposed by South Gippsland Water, including proposed definitions and price adjustments over the regulatory period.
- (c) In response to this Draft Decision, South Gippsland Water is required to clarify how much of its miscellaneous revenue it expects to generate from its core set.
- (d) If required, South Gippsland Water should propose additional core miscellaneous services, so that the core set would be expected to generate at least 75 per cent of miscellaneous revenue.