

8 May 2018

Dr Ron Ben-David
Chairperson
Essential Services Commission
Level 37/2 Lonsdale Street
MELBOURNE VIC 3000

Sent via email to: to water@esc.vic.gov.au

Dear Ron,

RE: RESPONSE TO ESC DRAFT DECISION FOR CENTRAL HIGHLANDS WATER

CHW is responding to the ESC's Draft Decision released 28 March 2018. The key impacts of this draft decision for CHW relate to a reduction in Operating Expenditure for the following expense categories:

- Labour
- Energy
- Water efficiency.

Before detailing our response to these items individually it is important to add some broader context to our response.

In the 2018 Water Price Review Guidance Paper (Guidance Paper) issued by the ESC in November 2016 the ESC notes the following in the key messages section:

The 2018 price review will be the first under the Commission's new water pricing approach. The new approach places a greater emphasis on the role of customer engagement to influence price submissions. It also includes a new incentive mechanism called PREMO that links the returns earned by a water business to the ambition expressed in their price submission and successful delivery on that ambition.

CHW believes the introduction of the new pricing approach has driven improved outcomes for customers and the ESC should be commended for initiating such a bold reform with the introduction of the PREMO model. The improvements are evident through the increased engagement with customers which has resulted in a set of service outcomes truly based on customer feedback. This is a marked change from the previous framework where a set of technical service standards were agreed between the ESC and the water businesses.

The key messages section of the Guidance Paper also included the following points:

- *Price submissions will more clearly and succinctly identify and explain how a business's proposals demonstrate value for money for customers — that is, what outcomes will be*

delivered to customers in return for the prices they pay, and how this reflects what customers value most.

- *The Commission expects that, because of the PREMO changes, price submissions for the 2018 price review will be different to those submitted in past reviews*

In handing down the draft decision the ESC has relied heavily on the expenditure review undertaken by Deloitte. The operating expenditure component of the review was based on a simple cost benchmarking approach across the industry, which is consistent with previous price reviews.

As noted in the Guidance Paper key messages the price submissions must identify *what outcomes will be delivered to customers in return for the prices they pay*. It is clearly evident from the Deloitte expenditure review that the approach taken has been selective by limiting the benchmarking to costs only. Deloitte acknowledged in their report that they were not asked to review pricing outcomes. Likewise it is clear from the Deloitte review that there was no review of customer outcomes. CHW believes the absence of analysis and benchmarking of both prices and customer outcomes highlights an improvement opportunity in the process to give full effect to the PREMO model.

To demonstrate this point CHW has conducted a benchmark analysis of the price paths for all water businesses. This data was extracted from the publicly available fact sheets produced by the ESC. This analysis shows CHW as having the 5th best (i.e. lowest) pricing outcome across the industry. However, this strong position does not appear to have been taken into consideration during the Deloitte review.

In completing the labour cost analysis Deloitte commented as follows:

We also note that most businesses have effectively 'absorbed' their above-CPI wage increases within their overall opex forecasts through productivity increases or other cost reductions, meaning that these increases are not passed on to customers.

While this observation is accurate when taking a narrow view of labour it fails to consider the broader package submitted by water businesses. For example, the majority of the businesses praised by Deloitte for absorbing above-CPI wage increases are showing higher price paths for customers than CHW. This is where CHW believes there is a need for a broader and deeper analysis of the price submissions.

The simple cost benchmarking approach was more relevant in previous price reviews when customer outcomes were standardised across the sector. An unintended consequence of the reformed pricing approach appears to be that the simple and selective cost benchmarking approach is at best less effective and at worst potentially misleading. CHW acknowledges the need for benchmarking to play an important role in the submission assessment. Indeed our response indicates that additional benchmarking is required to provide a more robust assessment of water businesses submissions.

For these reasons CHW has some concern around the reliance placed on the Deloitte approach in regard to labour and energy.

In addition we offer the following considerations for these key expense items.

Labour

CHW took the approach of holding FTE levels flat to demonstrate strong cost control. This approach was accepted for the current regulatory period where labour costs increases up to the level of Enterprise Agreements were approved. The change in approach for this pricing period was

not telegraphed by the ESC. On the contrary the Guidance Paper flagged wage and salary escalations as potential cost variations. At the outset there appears to be some confusion in the messaging in relation to labour.

As mentioned above, under the PREMO model customer service outcomes vary significantly across the industry. In CHW's case we are one of the few businesses targeting a significant improvement in network performance measures (e.g. 20-50% reduction in timeframes for unplanned water and sewer interruptions, repair of leaking services). While CHW will leverage technology advances to improve efficiency, some of the improvement in these areas will ultimately come from increased human resource. In holding FTE levels flat this will require a rebalancing of resources across the business by achieving efficiencies in other parts of the business to fund the increases required to meet the network performance targets.

CHW believes these cost increases can be justified through a broader lens looking at all elements of the submission in accordance with the PREMO model, particularly when assessing CHW's significant improvement in network performance measures when compared to our peers.

Other factors we believe that are important for the ESC to consider include CHW's historical performance (FTE have been held around the 187 level since 2009), the increasing mix of higher skilled roles as we move into the digital age and gender pay gaps.

Energy

The ESC's draft decision allowed CHW's increased energy price assumptions for the first two years of the pricing period only.

The ESC's draft decision included the following commentary:

Deloitte recommended an indicative reduction of \$2.50 million as it did not agree with Central Highlands Water's forecasted higher electricity prices continuing beyond 2019-20 through to 2022-23, particularly considering the investment that Central Highlands Water has proposed for emissions reductions. This adjustment removes both the increase from forecast higher electricity prices (\$4.50 million) and the proposed savings from the solar energy projects. We accept Deloitte's recommendation as we consider it reflects a more accurate forecast of efficient electricity costs during the 2018-23 regulatory period. However we do acknowledge that there is currently uncertainty in forecasting electricity prices and Central Highlands Water's electricity contract expires in July 2018. We request that Central Highlands Water proposes a revised electricity forecast based on its new contract prices in response to our draft decision

While CHW's energy prices were based on two independent forecasts there is clearly significant uncertainty in the market with a wide variety of views available.

CHW has revised one of these independent forecasts with the most current data and the results show average prices across the five year regulatory period reducing by 9% compared to the forecasts used by CHW in the pricing submission. The ESC draft decision reduced CHW's energy forecast over the five year period by 10%. Given the revised forecast is largely in line with the ESC adjustment CHW is comfortable with the ESC's position.

Water Efficiency Initiatives

The ESC's draft decision reduced CHW's expenditure related to water efficiency initiatives by \$1.1m.

The ESC's draft decision included the following commentary:

Deloitte considered the costs associated with the behavioural change program and community rebates should be able to be managed within the growth-adjusted baseline, and recommended removing \$1.10 million from the additional expenditure for new initiatives.

We have accepted Deloitte's recommendation for our draft decision. However we would consider further information from Central Highlands Water to demonstrate how these are additional to activities normally undertaken by a water corporation as part of its water efficiency program.

CHW's proposed expenditure relating to these initiatives is required to deliver the Water for Victoria policy document which contains the following action:

- *Action 5.3 Reinvigorate water efficiency programs for Melbourne and regional Victoria.*

The Department of Environment, Land, Water and Planning (DELWP) has developed a suite of initiatives required to be undertaken by water businesses under the program named Target Your Water Use. In early April 2018 DELWP released a draft of the Pilot Water Sector Climate Change Adaption Action Plan. Commentary in this Plan relating to Target 155 states the following:

- *The Government has revived the successful Target 155 and Target Your Water Use efficiency programs. It is also expanding the Schools Water Efficiency Program. These programs improve our ability to adapt to climate change and reduce the pressure on our scarce water resources by improving water efficiency. By using less water now, our storages are fuller for when the next climate change induced drought starts.*

Use of the words 'revived' and 'expanding' in the Plan clearly demonstrates that expenditure on these initiatives is over and above current baseline spend levels. Furthermore, recent coverage of the state budget reinforced the additional efforts government is making in this area above business as usual levels.

To complement this policy directive CHW customer feedback has been strong in the area of driving water efficiency and specifically providing rebates. This customer feedback is clearly detailed in our pricing submission (p 29, 100-101) and supporting information provided to the ESC as part of an information request on 19 October 2017. The statistic noted on page 29 of our price submission very clearly demonstrates customer support for rebates:

- *90% of respondents believe water suppliers have a responsibility to provide community rebates to encourage water efficiency.*

Other factors to consider in regard to CHW in particular include the following:

- Large regional footprint. Our customers prefer face to face or have limited digital access or ability to travel these distances therefore we are increasingly travelling to meet customers in their homes.
- OHS/Safety requires that we send two people on these visits.
- Festivals, local events etc require printed collateral and localised engagement to promote demand management strategies, engagement on current and future projects.
- Educational programs – at schools, with community groups, associations etc requires face to face discussions. We generate ideas from these sessions and build progress based on co-design principles.

The key criteria for expenditure to qualify as a variation to the baseline is that it is either mandatory (costs associated with new or revised regulatory obligations) or supported by customer outcomes. Therefore we believe this expenditure on water efficiency initiatives comfortably meets not just one but both of the key criteria for expenditure variations.

In completing our response to the draft decision please also find attached a revised financial model which takes into the account the following:

- Tariffs updated to reflect the draft decision,
- Updated cost of debt, and
- Victorian State budget impacts from a reduction in payroll tax.

CHW is happy for the ESC to determine a consistent method across the industry to adjust prices to reflect movements in the cost of debt.

CHW notes the ESC's commentary in regard to New Customer Contributions (NCC's). CHW will shortly be updating our NCC Negotiation Framework to reflect the principles to apply where standard NCC's are not fair and reasonable or outside areas designated as eligible for standard NCC's.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Paul O'Donohue', with a horizontal line extending to the right.

Paul O'Donohue
Managing Director