



PRICE REVIEW 2013: GREATER METROPOLITAN WATER BUSINESSES

Final Decision

June 2013

SUMMARY

BACKGROUND AND COMMISSION'S TASK

In October 2012, Melbourne Water, City West Water, South East Water, Yarra Valley Water and Western Water submitted Water Plans to the Essential Services Commission (the Commission) for assessment.

The businesses' Water Plans were for the five year regulatory period commencing on 1 July 2013. The Water Plans set out each business's expected costs of delivering water and sewerage services, planned capital works programs, the forecast volumes of water to be delivered and the levels of service promised to customers. Each business also proposed prices that they considered would raise sufficient revenue to recover expected costs. The water businesses were required to consult their customers when developing their Water Plans.

The Commission is required to assess proposed prices and revenue against the regulatory principles set out in the Water Industry Regulatory Order (WIRO) issued by the Minister for Water. The WIRO principles require that prices are set to:

- generate a business's revenue requirement and allow it to meet the costs of efficiently delivering services to customers
- ensure the business's financial viability, including a reasonable return on capital
- reflect the costs of and provide incentives for sustainable water use and
- account for the interests of customers.

The Commission's task is to approve the proposed prices or alternatively to specify prices to apply if it is not satisfied they were calculated or determined consistent with the regulatory principles.



In reaching its final decision, the Commission consulted widely and undertook an extensive analysis of the proposals included in the businesses' Water Plans. The Commission's consultation process included:

- releasing a summary paper (November 2012) and a draft decision (March 2013) for public comment
- conducting public meetings in November and December 2012, and in April and May 2013 to obtain feedback from stakeholders
- conducting two further workshops in May 2013 with water businesses, the Property Council of Australia, the Urban Development Institute of Australia and individual developers on developer charges and
- forming and meeting with a Customer Reference Panel to obtain further information and feedback.

The Commission also engaged consultants with technical expertise to assess whether the businesses' proposed expenditures were reasonable.

In April 2013, the Commission released a draft decision for the greater metropolitan water businesses setting out the Commission's detailed analysis, its proposed adjustments and requests for further information from the businesses. Each of the businesses was given the opportunity to submit a revised pricing proposal in response to the draft decision. Generally, the greater metropolitan water businesses agreed with the substantial elements of the draft decision, but proposed some modifications or clarifications.

This paper sets out the Commission's final decisions on the prices to apply from 1 July 2013. The prices or manner in which prices are determined over the regulatory period are set out in a determination specific to each business. The determinations take effect from 1 July 2013. For City West Water, South East Water, Western Water and Yarra Valley Water, the determinations will apply to 30 June 2018 or when the Commission makes a new determination. For Melbourne Water the determination will apply to 30 June 2016 or when the Commission makes a new determination. Table 1 shows the regulatory period that applies for each business. This final decision also contains the reasons and analysis supporting the Commission determination for each business.



TABLE 1 LENGTH OF REGULATORY PERIOD

Water business	Length of regulatory period	Dates
City West Water, South East Water, Western Water and Yarra Valley Water	5 years	1 July 2013 – 30 June 2018
Melbourne Water	3 years	1 July 2013 – 30 June 2016

All documents associated with the Commission's price review can be found at:

www.esc.vic.gov.au

KEY ISSUES

The second regulatory period was overshadowed by a period of drought that resulted in major investments in new sources of water supply.

The key issues for this price review have include the:

- price impacts on customers, particularly in light of the already substantial increase in prices over the past five years. A major cost driver in the third regulatory period is the commencement of payments for the desalination plant which was commissioned formally on 17 December 2012
- ensuring water businesses continue to deliver services valued by customers and improve efficiency
- understanding customers' expectations and their willingness to pay for different service offerings.

Specific concerns raised by customers, and community and business groups include:

- the impact of past and proposed price increases, particularly for vulnerable and low income customers
- whether any price increases should be 'smoothed' over a number of years rather than implemented as a one-off step increase in 2013-14
- the mix of fixed and variable water charges and the consequences for different customer groups such as tenants (who directly pay the variable charge)
- expectations that service levels should at least be maintained
- the manner in which the costs associated with the desalination plant will be reflected in prices and



- the magnitude of developer charges proposed by water businesses and the impact on housing affordability.

Unless otherwise specified, all values shown in this final decision and supporting material are nominated in \$2012-13, that is, the Commission has excluded the effects of inflation.

FINAL DECISION OUTCOMES

This final decision is largely consistent with the Commission's draft decision in April 2013. Discussed below are the key outcomes of the final decision.

INTERPERIOD PRICE SMOOTHENING

The Commission has confirmed the need to capitalise a portion of the desalination costs and accepted the assessment by Melbourne Water that the capacity to do so lie in the later years in the five year regulatory period. However, the Commission was not in the position to decide on the amount to be capitalised in these years given insufficient information. In particular, this was due to material but unclear changes to the modelling assumptions made by Melbourne Water following the draft decision. Accordingly, the Commission has shortened the regulatory period for Melbourne Water to three years so that these matters can be properly examined and decided in the interests of customers in Melbourne Water's fourth regulatory period. The regulatory period for the other businesses has remained the same, namely five years, with the last two years' bulk charges based on the indicative estimates for Melbourne Water had a five year regulatory period decision been made for Melbourne Water.

SERVICE STANDARDS

The Commission has approved all service standard targets proposed by the metropolitan water businesses and Western Water for the coming regulatory period. These generally reflect historical performance achieved by the businesses over the previous five years. The Commission has also approved all Guaranteed Service Levels and rebate amounts proposed by the businesses and will reflect these in the Customer Service Code.



REVENUES

In their Water Plans, the businesses identified their revenue requirements for the third regulatory period. These revenue forecasts reflect their expected operating expenditure, a return on assets (existing and new assets) and regulatory depreciation (return of assets).

Melbourne Water sought revenue totalling \$8611.9 million for a five year regulatory period. Due to reasons outlined in chapter 3, the Commission has shortened the next regulatory period for Melbourne Water to three years. As a result the Commission has approved revenue of \$4786.0 million (table 2) for the period 2013-14 to 2015-16.

TABLE 2 MELBOURNE WATER'S REVENUE REQUIREMENT 2013-14 TO 2015-16 — FINAL DECISION
\$m 2012-13

	2013-14	2014-15	2015-16	Total	2016-17 <i>estimate</i>	2017-18 <i>estimate</i>
Final decision	1 563.3	1 599.1	1 623.6	4 786.0	1 618.9	1 643.0

Note: Melbourne Water charges the retailers for services (and to a lesser extent Western Water), to recover its revenue requirement. The last two years revenue requirements are indicative estimates for Melbourne Water had the Commission approved a five year regulatory period.

The other four water businesses covered in this final decision (City West Water, South East Water, Yarra Valley Water and Western Water) sought combined revenues totalling \$13 059.3 million over the next five years. The Commission's final decision results in a lower revenue for those businesses of \$12 065.7 million. This is \$993.6 million (or 7.6 per cent) lower than that proposed by the businesses (table 3). The revenue requirements for these four businesses incorporate estimates of Melbourne Water's bulk charges for 2016-17 and 2017-18.



TABLE 3 BUSINESSES REVENUE REQUIREMENT – FINAL DECISION
gross of Melbourne Water’s bulk charges ^a
\$m 2012-13

	Proposed by business	Final decision	Difference	
			\$m	per cent
City West Water	3 157.2	2 917.5	-239.7	-7.6
South East Water	4 560.5	4 210.1	-350.4	-7.7
Yarra Valley Water	4 936.6	4 569.7	-366.9	-7.4
Western Water	405.1	368.4	-36.7	-9.1
Total retail businesses	13 059.3	12 065.7	-993.6	-7.6

^a The greater metropolitan retailers and Western Water charge end-use customers for services to recover their revenue requirements. In turn, the retailers (including Western Water) pay Melbourne Water for bulk water and sewerage services.

This downward adjustment to the water businesses’ proposed revenue reflects the Commission’s assessment of the efficient costs of delivering services. The major proposed areas of adjustments to the businesses’ costs, include:

- lower financing costs
- operating expenditure reductions for costs such as labour, energy and licences
- required productivity improvements
- reduced or deferred capital programs
- Melbourne Water’s revised estimates for desalination costs.

By way of comparison, in the last price review, the comparable amount approved by the Commission was \$8634.4 million for the four water retail businesses. Over 80 per cent of the increase in this period is due to commencement of payments for the desalination plant. Revenue requirements are discussed more fully in chapter 6.



OPERATING EXPENDITURE

The Commission has approved \$2979.1 million of operating expenditure for Melbourne Water over the next three years.

For the other four businesses, the Commission has approved \$9135.6 million over the five year period from 2013-14. This is \$85.4 million (or 0.9 per cent) lower than the draft decision, or \$567.1 million (or 5.8 per cent) lower than proposed by the businesses.

CAPITAL EXPENDITURE

The Commission has approved \$1549.6 million of capital expenditure for Melbourne Water over the next three years.

For the other four businesses, the Commission has approved \$3193.1 million over the next five years from 2013-14. This is almost the same as the draft decision and \$135.5 million (or 4.1 per cent) lower than that proposed by the businesses.

The final approved capital expenditure reflects changes to the timing of delivery of certain projects and the removal of some projects.

FINANCING COSTS

Based on current market conditions, the Commission has approved a real post tax weighted average cost of capital of 4.5 per cent. This is lower than the WACC estimate applied in the draft decision (of 4.7 per cent) and the 5.1 per cent that applies in the current regulatory period.¹

PRICES

The Commission is responsible for approving the maximum prices each water business can charge its customers in each year during the outlook period and lower than was proposed in the draft decision.

¹ The WACC applied in the current regulatory period to Western Water and Melbourne Water's drainage and waterways revenue requirements is 5.8 per cent.



As a result of downward revision to the water businesses' expenditure and revenue requirements, the Commission has approved maximum price increases that are lower than those proposed by each of the water businesses.

Excluding the impact of inflation, the price increases over five years proposed by the four greater metropolitan water businesses ranged from 31.7 per cent to 35.8 per cent. Much of this increase reflected Melbourne Water's proposed bulk services (wholesale) price increase. Following the adjustments made by the Commission, these price increases have been moderated. The Commission has approved price increases that range from 12.3 per cent for Western Water, to 19.2 per cent up to 24.6 per cent for the metropolitan retailers (table 4).

In most instances, the proportional reduction in prices exceeds the reduction in revenues because of some upward revisions the Commission has made to the water businesses' forecasts of growth in water consumption over the next five years (chapter 10).

TABLE 4 AVERAGE PRICE INCREASES – FINAL DECISION
compared with business proposals — average 2013-14 to 2017-18

	Proposed by business	Final decision	Difference
City West Water	31.7	19.2	-12.5
South East Water	34.9	22.8	-12.0
Yarra Valley Water ^a	35.8	24.6	-11.3
Western Water	35.6	12.3	-23.3

^a Prices shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control. Maximum allowable prices may change during the regulatory period.

Melbourne Water provides waterways and drainage services to end-use customers. The business proposed to increase prices for those services by 14.1 per cent over 5 years. The Commission's final decision is to allow these prices to increase by 4.7 per cent over three years. This is higher than the 0.5 per cent provisionally approved in the draft decision and reflects more detailed information submitted by Melbourne Water following the draft decision on the cost of delivering waterways and drainage services. This has a minimal impact on Melbourne Water's total revenue as there is a corresponding reduction in prices for its water and sewerage services.



TABLE 5 MELBOURNE WATER WATERWAYS AND DRAINAGE PRICES – FINAL DECISION
 compared with business’s proposal — average 2013-14 to 2015-16

	Proposed by business <i>per cent</i>	Final decision <i>per cent</i>	Difference <i>per cent</i>
Waterways and drainage 5 years	14.1	na	na
Waterways and drainage 3 years	8.2 ^a	4.7	3.5

^a This figure is the equivalent of Melbourne Water’s five year proposal of 14.1 per cent, but for a three year period to enable comparison. **na.** Not applicable.

HOUSEHOLD BILLS AND CUSTOMER SUPPORT

The revised tariffs in this final decision result in increases in household water and sewerage bills lower than those sought by the businesses in their Water Plans. For Melbourne household, there will be a one off significant increase in the first year (2013-14). The bill increases will then plateau and will only move in line with inflation for the rest of the regulatory period. Western Water’s bills will increase slightly each year under its proposal to smooth the price increase over the five year regulatory period. Table 6 compares indicative bills for owner-occupiers in 2012-13 and 2017-18, based on the prices proposed by the businesses and prices resulting from the Commission’s final decision. Table 7 compares indicative bills for tenants. These indicative bills shown are based on typical consumption figures for owner-occupiers and tenants serviced by each water retailer. Outcomes will vary for individual customers.

Because the Commission has approved Yarra Valley Water’s proposal to adopt a revenue cap as its price control mechanism, the typical bills shown in tables 6 and 7 for that retailer may change slightly, but by no more than its annual rebalancing constraint of 2 per cent.

Tables 8 and 9 show residential owner-occupier and tenant bills, respectively, in 2013-14 as they appear to customers – that is in actual or nominal dollars.



TABLE 6 INDICATIVE ANNUAL RESIDENTIAL OWNER-OCCUPIER BILLS^a
\$2012-13

	Current bill 2012-13	Bills based on businesses' proposals		Bills based on final decision	
		2013-14	2017-18	2013-14	2017-18
City West Water	848	1 091	1 091	991	991
South East Water	863	1 166	1 166	1 058	1 058
Yarra Valley Water ^b	949	1 272	1 272	1 143	1 143
Western Water	975	1 035	1 330	997	1 092

Note: real values. ^a Based on the businesses' proposed prices and final decision prices. Bills are calculated using each business's average consumption. Bills are based on average consumption of: City West Water (150 kL per year), South East Water (150 kL per year), Yarra Valley Water (155 kL per year), Western Water (180 kL per year). These consumption amounts are different to those used in the draft decision. Comparable bill tables using the same consumption as the final decision are available in appendix F. ^b Bills shown for Yarra Valley Water are indicative because the Commission has approved a revenue cap form of control, therefore prices may change during the regulatory period.

TABLE 7 INDICATIVE ANNUAL RESIDENTIAL TENANTS BILLS^a
\$2012-13

	Current bill 2012-13	Bills based on businesses' proposals		Bills based on final decision	
		2013-14	2017-18	2013-14	2017-18
City West Water	461	600	600	538	538
South East Water	445	625	625	579	579
Yarra Valley Water ^b	508	698	698	636	636
Western Water	264	287	410	272	310

Note: real values. ^a Based on the businesses' proposed prices and final decision prices. Bills are calculated using each business's average consumption. Bills are based on average consumption of: City West Water (150 kL per year), South East Water (150 kL per year), Yarra Valley Water (155 kL per year), Western Water (180 kL per year). These consumption amounts are different to those used in the draft decision. Comparable bill tables using the same consumption as the final decision are available in appendix F. ^b Bills shown for Yarra Valley Water are indicative because the Commission has approved a revenue cap form of control, therefore prices may change during the regulatory period.



TABLE 8 INDICATIVE ANNUAL RESIDENTIAL OWNER-OCCUPIER BILLS

	Current bill	Approved 2013-14 <i>including inflation</i>	Difference
City West Water	848	1 016	167
South East Water	863	1 085	222
Yarra Valley Water ^a	949	1 171	222
Western Water	975	1 022	47

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: City West Water (150 kL per year), South East Water (150 kL per year), Yarra Valley Water (155 kL per year), Western Water (180 kL per year). ^a Bills shown for Yarra Valley Water are indicative because the Commission approved a revenue cap form of price control, so prices may vary slightly during the regulatory period.

TABLE 9 INDICATIVE ANNUAL RESIDENTIAL TENANT BILLS

	Current bill	Approved 2013-14 <i>including inflation</i>	Difference
City West Water	461	552	91
South East Water	445	593	148
Yarra Valley Water ^a	508	652	144
Western Water	264	279	15

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: CWW (150kL per year), SEW (150kL per year), YVW (155kL per year), WW (180kL per year). ^a Bills shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period.



The Commission's final decision to moderate price increases will go some way to addressing concerns about affordability. However, the Commission recognises that the final increases are still material. The Commission has allowed an additional \$5 million for the metropolitan retailers to help them assist customers in managing the impact of the proposed price increases over the five year period (instead of confining it to just 2013-14 as in the draft decision). This is in response to the views expressed by a joint submission about the ongoing need to assist hardship customers.² The Commission has also separately approved \$250 000 over five years for Western Water in its final decision for similar reasons. The businesses are required to continue to consult with customer and welfare groups and put in place improved measures to support customers who may have difficulty paying their bills, particularly low income and vulnerable customers. Businesses will be required to update the Commission regularly (and make public) on how the additional allowances are being spent during the third regulatory period.

REPORTING OF OUTCOMES OVER THE REGULATORY PERIOD

The Commission will monitor the progress of each water business in delivering the outcomes outlined in its Water Plan. The businesses will have an opportunity, through the annual performance report, to explain to customers where and why projects have been delayed or replaced by other projects. It is important to note that expenditure assumptions made by the Commission to determine prices do not represent amounts the businesses are required to spend or direct to particular activities or projects. Over the regulatory period, it is reasonable to expect that businesses may need to reprioritise or alter their capital programs in response to changing circumstances. The Commission's annual performance report will provide an opportunity for businesses to explain any changes as well as implications for any outcomes committed to in their Water Plans.

² Consumer Action Law Centre (CALC), Consumer Utilities Advocacy Centre (CUAC) and the Victorian Council of Social Service (VCOSS) 2013, *Submission to the Water Price Review draft decision 2013-18*, May.



The Commission will also continue to monitor the following areas during the regulatory period:

- desalination costs (chapter 3)
- customer support funding (chapter 4)
- major projects reporting (chapter 8)
- trials of customer choice (chapter 13)
- new customer contributions framework implementation (chapter 18).

