

10th May 2018

Our Ref: 641/005/003

Essential Services Commission
Level 37, 2 Lonsdale Street
MELBOURNE VIC 3000



RE: Response to Price Review 2018: South Gippsland Water Draft Determination

I write in response to the Water Price Review 2018: South Gippsland Water Draft Determination recently released by the Essential Services Commission (ESC).

Further review of South Gippsland Water Price Submission has been undertaken following release of the Draft Determination. The review process has been completed taking into account feedback provided to the Executive Management Team, and the Essential Services Commission Community Engagement session held on the 19th April 2018.

The attached report outlines South Gippsland Water's response to key elements of the Essential Services Commission Water Price Review 2018: Draft Determination and includes the Corporation's revised financial models. These models have been subject to detailed peer and third party review.

South Gippsland Water accept that the ESC draft determination will provide pricing relief necessary to meet our customer's expectations and start to provide for a more financially sustainable business. Having said this, the draft determination will result in a customer price rise of approximately 9% above CPI over the next two years. South Gippsland Water recognises that this price change is not aligned with the customer affordability objectives of the Water Plan for Victoria, that are reflected in the 2017 Minister for Water, Letter of Expectations

Given that the price determination will be for two years the Corporation has committed that prices will be held at the 2017/18 prices plus CPI until the next ESC pricing determination. Over the next two years the Corporation will be reviewing our business and expenditure plans to align with the State Government objective of affordability and provide for the Corporation's financial sustainability. We have requested State Government assistance to deliver key projects that are required to meet our customer expectations.

The attached response to the draft determination is aligned with the ESC view on maximum pricing necessary to support services for our customers in a financially sustainable manner and is not aligned with a CPI only pricing pathway. The Corporation has taken this approach to clearly signal that CPI only price increases are not sustainable beyond two years unless one of two things happen; the business is provided with substantial pricing relief or there is a material transformation to our business that improves our economies of scale.

Should you require any further information on this matter please do not hesitate to contact me on 5682 0429.

Yours Sincerely,

A handwritten signature in black ink, appearing to read "Mark Lynch".

Mark Lynch
Managing Director (Acting)

RESPONSE TO THE DRAFT DETERMINATION	
Topic	Commentary
General:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Latest available information	Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, South Gippsland Water must update its revenue requirement and prices to reflect our April 2018 updates to estimates for the cost of debt and inflation.
	SOUTH GIPPSLAND WATER RESPONSE
	<i>In responding to the draft decision, South Gippsland Water (The Corporation) has updated its revenue requirement and prices and submitted a price schedule in line with the Commission's April 2018 update to estimates for the cost of debt and inflation.</i>
General:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Changes in law or government policy	There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination, and impact on the revenue requirement, South Gippsland Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.
	SOUTH GIPPSLAND WATER RESPONSE
	<i>As far as The Corporation is aware, there have been no changes in laws or government policy between the draft decision and this response and therefore no changes to the calculated revenue requirement. The Department of Environment Land Water and Planning (DELWP) has provided advice to the Corporation with respect to affordability. South Gippsland Water has committed to working with DELWP to manage customer affordability.</i>
Capital Expenditure:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Reduced capital expenditure	Our draft decision requires South Gippsland Water to prepare a new price submission for 2020-21 to 2022-23, which will allow it to address any capital forecasting issues raised in our assessment and Deloitte's review.
	SOUTH GIPPSLAND WATER RESPONSE
	<i>The Corporation accepts the Commission's draft decision to reduce capital expenditure given that two of the three projects affected occur in the period 2020/21 to 2022/23. The risks associated with deferral of the expenditure can be managed by the business in the short term. A two year determination will allow the Corporation to review business cases for these projects. A revised capital plan will be presented as a part of a price submission for the period 2020/21 to 2022/23.</i>

<p>Capital Expenditure:</p> <p>Reporting measures and targets</p>	<p>ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION</p> <p>Deloitte did not recommend any adjustment to the sewer renewal program, and noted the recorded sewer blockage data shows a clear trend of increasing blockages and spills to customer property. However, it did note South Gippsland Water has proposed to renew significantly more sewer main than in previous years, at a lower unit price. We accept Deloitte’s recommendation to retain the proposed sewer renewals expenditure, but we require South Gippsland Water to establish clear reporting measures and targets to demonstrate to customers that it is achieving its proposed higher, and more efficient, sewer renewal rates.</p> <p>SOUTH GIPPSLAND WATER RESPONSE</p> <p><i>The Corporation commits to working with the community and the commission to establish clear reporting measures and targets to demonstrate to customers that it is achieving its proposed efficiency and renewal rates for sewers.</i></p>
<p>Capital Expenditure:</p> <p>Prudent and efficient costs</p>	<p>ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION</p> <p>South Gippsland Water will need to demonstrate the prudence and efficiency of any additional (<i>capital</i>) costs if they are indeed incurred during the 2018–20 period and if South Gippsland Water is seek to include them in the regulatory asset base.</p> <p>SOUTH GIPPSLAND WATER RESPONSE</p> <p><i>South Gippsland Water will demonstrate the prudence and efficiency of any additional costs incurred during the 2018–20 period.</i></p>
<p>Tariffs:</p> <p>New Customer Contributions</p>	<p>ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION</p> <p>Because we have not approved South Gippsland Water’s proposed tariff structures, we cannot approve its proposed new customer contributions. South Gippsland Water must resubmit new customer contributions in response to our draft decision, along with its updated tariff structures.</p> <p>We invite South Gippsland Water to re-forecast revenue from customer contributions in response to our draft decision on its revenue requirement and tariff structures.</p> <p>SOUTH GIPPSLAND WATER RESPONSE</p> <p><i>The Commission has expressed in-principle support for a cost recovery approach for New Customers Contributions with respect to pressure sewer systems. The Corporation has proposed a process similar to that of South East Water. That is, a region wide uniform charge for New Customer Contributions for water and sewer, with a negotiated infrastructure charge with each developer in areas served by pressure sewerage systems. The infrastructure charge will directly cover the cost incurred by the Corporation for installation of on property equipment (individual pump stations, control boxes and connections). That is, the Corporation will install the pressure sewer system infrastructure, with costs to be borne by the developer or property owner as part of construction (i.e. a pass through cost recovery in the form of a negotiated customer contribution, in addition to the standard NCC).</i></p> <p><i>South Gippsland Water has re-forecast revenue from New Customer Contributions in response to the draft decision, along with its updated tariff structures.</i></p>

	<p><i>Proposed standard NCC charges:</i></p> <ul style="list-style-type: none"> <i>i. have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection;</i> <i>ii. have regard to the incremental future revenues that will be earned from customers at that connection;</i> <i>iii. be greater than the avoidable cost of that connection and less than the standalone cost of that connection.</i>
<p>Tariffs:</p> <p>Demand</p>	<p>ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION</p> <hr/> <p>South Gippsland Water must respond to our draft decision with updated demand forecasts reflecting the lower revenue requirement (and therefore prices), and consistent with the requirements set out in our guidance.</p> <p>SOUTH GIPPSLAND WATER RESPONSE</p> <p><i>The Corporation has revised its demand forecasts in line with KPMGs demand review (growth of 1.63% for residential, 0.75% for non-residential and 0.47% for trade waste customers). The Corporation will not apply a reduction in demand (price elasticity) due to the overall price increases that will occur in the next two years. That is, South Gippsland Water will take on the risk of lower demand that may result from tariff increases.</i></p>
<p>Tariffs:</p> <p>Tariff structures / rebalancing</p>	<p>ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION</p> <hr/> <p>Prior to our final decision and price determination, South Gippsland Water must submit updated tariff structures and prices in response to our draft decision revenue requirement, that also reflect the requirements of the WIRO and our guidance. These must also reflect our updates to cost of debt and inflation estimates.</p> <p>SOUTH GIPPSLAND WATER RESPONSE</p> <p><i>Proposed changes to tariff structures reflect:</i></p> <ul style="list-style-type: none"> - <i>Proportionate distribution of price increase to all tariff categories*;</i> - <i>Miscellaneous fees to reflect at cost pass through and therefore subject to CPI uplift only**;</i> - <i>No change to non-residential waste water tariff restructure proposed for 2020/21***.</i> - <p><i>* Due to the potential for significant price impacts for tenants and other high water consumption customers, The Corporation will retain the current relativity (as per Regulatory Period 3) of fixed and volumetric charges for water.</i></p> <p><i>**The Commission indicated support for proposed price increases for some miscellaneous tariffs and the introduction of new trade waste penalty fees on the basis that they are cost reflective. The Corporation has reviewed these tariffs and confirms that they are cost-reflective. Updated tariff structures and prices have been submitted to reflect this.</i></p> <p><i>*** The change to non-residential waste water tariffs will be subject to rigorous customer engagement process noting that this change will cause price shock to a number of customers.</i></p>

Tariffs:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Cost of Debt adjustment	We reviewed South Gippsland Water's proposed cost of debt adjustment mechanism and found it requires minor corrections. We invite South Gippsland Water to work with the commission on a revised price adjustment formula that allows prices to adjust to changes in the cost of debt.
	SOUTH GIPPSLAND WATER RESPONSE
	<i>Working with the ESC the Corporation has revised the proposed methodology and will apply the cost of debt adjustment to only the Water and Wastewater fixed tariff component.</i>
Customer Engagement	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
	In our view SGW could have done more to ensure customer groups most affected by its proposed price increases had the opportunity to participate, and could have made greater effort to ensure their views were taken into account.
	SOUTH GIPPSLAND WATER RESPONSE <i>The Corporation believes that the customer consultation process sought and received views from a very representative cross section of customers, including tenants who would be affected by any change in the proportion of revenue raised through fixed and volumetric water prices. The Corporation accepts that further engagement with specific customers likely to be affected by tariff structure changes will be benefit development of the next Pricing Submission due in approximately two years.</i>
Customer Outcomes: Measures and targets	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
	We will engage with South Gippsland Water to finalise the measures and targets used to assess performance against its outcomes, and how it will report this publicly. Performance against these measures will inform our assessment during future price reviews.
	SOUTH GIPPSLAND WATER RESPONSE <i>The Corporation commits to working with the community and the commission to finalise the measures and targets used to assess performance against outcomes, and how it will report this publicly.</i>
Expenditure: Price submission costs	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
	We consider asking customers to pay for the costs of preparing a new price submission is not consistent with an efficient business, and we have therefore removed the full \$0.28 million from the baseline.
	SOUTH GIPPSLAND WATER RESPONSE <i>The Corporation accepts the Commission's proposed approach.</i>
Expenditure: Efficiency improvement rate	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
	For the purposes of making our draft decision, we have accepted South Gippsland Water's proposed average efficiency improvement rate and growth rate.
	SOUTH GIPPSLAND WATER RESPONSE <i>The Corporation nominated an average efficiency of 1.5% across the period (1% in year 1 rising to 2% in year 5). The Commission has adjusted this to an average of 1.5% across two years. The Commission has also indicated that South Gippsland Water absorb contracted (EBA) increases to labour rates</i>

	<i>over this period. The Corporation accepts the Commission proposed approach.</i>
Expenditure:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Expenditure Maintenance costs	<p>Deloitte considered that South Gippsland Water had not provided evidence to support such a large increase in maintenance, and had not demonstrated that these were all new costs outside of the growth-adjusted baseline. Deloitte recommended allowing half of the increase sought by South Gippsland Water, removing \$1.57 million. However, consistent with our draft decision approach to only allow new and unavoidable expenditure above the baseline, we have removed the full amount proposed by South Gippsland Water from the forecast.</p>
	SOUTH GIPPSLAND WATER RESPONSE
	<p><i>While South Gippsland Water accepts the Commission's decision regarding maintenance expenditure, the Corporation maintains the position that an increase in preventative maintenance is required to inform the business about the condition of assets and to optimise asset life. This approach will maintain service standards while minimising costs to customers in the longer term.</i></p> <p><i>The Commission's reliance on lag indicators (e.g. water main breaks) to reject the increased bid for water main replacement, did so on the basis that there were no condition assessments to support. The best condition assessments come from preventative maintenance. This is new expenditure that will not immediately see a reduction to reactive maintenance. The Corporation will work to review and reinforce the business case around maintenance costs in the price submission for the period 2020/21 to 2022/23.</i></p>
Expenditure:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Labour costs	<p>South Gippsland Water sought \$0.12 million for labour increases above inflation, all in the first two years of the period. Deloitte recommended no adjustment because South Gippsland Water's FTE forecast is flat and there is only a modest wage increase. However, consistent with our draft decision approach, we have removed this expenditure from the forecast.</p>
	SOUTH GIPPSLAND WATER RESPONSE
	<p><i>The Corporation accepts the Commission's proposed approach. The Corporation reiterates that to absorb the contracted (EBA) rate increases efficiency savings over and above the prescribed rate of 1.5% must be achieved.</i></p>
Expenditure:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Electricity costs	<p>However we do acknowledge that there is currently uncertainty in forecasting electricity prices and South Gippsland Water's electricity contract expires on 30 June 2018. We request that South Gippsland Water proposes a revised electricity forecast based on its new contract prices in response to our draft decision.</p> <p>We request that South Gippsland Water proposes a revised electricity forecast based on its new contract prices in response to our draft decision</p>
	SOUTH GIPPSLAND WATER RESPONSE
	<p><i>The Corporation has updated the electricity forecast to include the impact of contracted rates for 2018/19, 2019/20 and 2020/21. This forecast has been reduced by the impact of solar initiatives. The forecast for 2017/18 has also been updated. The corresponding adjustment to baseline expenditure reflects the differential between the forecast for 2017/18 and future years to 2022/23.</i></p>

	<i>This differential has not been applied as a baseline adjustment for regulatory period five due to the uncertainty of electricity rates beyond 2022/23.</i>
Expenditure:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Expenditure Customer support programs	<p>South Gippsland Water sought \$0.25 million above the baseline for customer support programs.</p> <p>We have therefore removed this amount from operating expenditure. We have increased the allowance for non-collected revenue from \$0.06 million to \$0.10 million per year, to reflect the increase in bills and the customer support for these programs.</p>
	SOUTH GIPPSLAND WATER RESPONSE
	<i>The Corporation accepts the Commission's proposed approach.</i>
Expenditure:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Other costs	<p>Deloitte has assessed the following proposed new costs and recommended their removal as they were not considered new obligations on the business. Rather, they are normal ongoing activities for a water corporation and should be absorbed within the growth-adjusted baseline or funded through efficiency gains resulting from the new initiatives. This includes:</p> <ul style="list-style-type: none"> – \$0.66 million to develop out-dated hydraulic models and develop organisation processes around asset costing – \$0.25 million for catchment management – \$0.33 million for stakeholder collaboration and partnership – \$0.33 million for a secure water supply. <p>We agree with Deloitte's view, except for the additional allowance for stakeholder collaboration and partnership. We have allowed this amount (\$0.22 million in the proposed two-year period) in lieu of removing the full cost of preparing a price submission from the baseline.</p>
	SOUTH GIPPSLAND WATER RESPONSE
	<i>The Corporation accepts the Commission's proposed approach.</i>
Expenditure:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Biosolids management	<p>South Gippsland Water has forecast \$0.8 million additional expenditure for biosolids management.</p> <p>We agree with Deloitte, and we have allowed this expenditure above the baseline as we consider it represents a new obligation for the corporation.</p>
	SOUTH GIPPSLAND WATER RESPONSE
	<i>The Corporation accepts the Commission's proposed approach.</i>
Expenditure:	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
Ecological Risk Assessments	<p>South Gippsland Water has forecast \$0.25 million for ecological risk assessments for its wastewater treatment plants.</p> <p>We accept Deloitte's view, and have allowed this additional expenditure to remain.</p>
	SOUTH GIPPSLAND WATER RESPONSE
	<i>The Corporation accepts the Commission's proposed approach.</i>

<p>Expenditure: Information Technology costs</p>	<p>ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION</p> <p>Deloitte observed that South Gippsland Water’s IT systems and capabilities do appear to be low when compared to other businesses and Deloitte accepts that some ‘catch-up’ expenditure is necessary.</p> <p>And while we accept South Gippsland Water may need to improve its IT systems, we consider this is avoidable in the short term and have therefore removed the \$1.55 million proposed additional expenditure (\$0.48 million over the first two years of the period), consistent with our draft decision approach.</p> <p>SOUTH GIPPSLAND WATER RESPONSE</p> <p><i>While The Corporation accepts the commission's decision regarding IT costs, it points to the observations by Deloitte that were generally dismissed as "avoidable in the short term" by the Commission. Deloitte observed that a benchmarking report for 28 water businesses undertaken by Third Horizon in 2016 concluded that South Gippsland Water had low expenditure in some corporate areas – such as communications and IT costs (per employee) and that South Gippsland Water’s IT systems and capabilities do appear to be low when compared to other businesses and that they accepted that some ‘catch-up’ expenditure is necessary. The Corporation will revisit expenditure on IT for the 2020 Pricing Submission.</i></p>
<p>Expenditure: Lance Creek water connection additional costs</p>	<p>ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION</p> <p>\$0.63 million for operating costs for the new Lance Creek connection to the northern towns. Given the size and scope of the project, Deloitte considers the additional operating costs are reasonable additions to the baseline.</p> <p>We accept that the new Lance Creek connection introduces new unavoidable operating costs, and we have included these costs for our draft decision.</p> <p>SOUTH GIPPSLAND WATER RESPONSE</p> <p><i>The Corporation accepts the Commission's proposed approach.</i></p>
<p>Expenditure: Non- controllable costs</p>	<p>ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION</p> <p>For non-controllable operating expenditure, we have verified South Gippsland Water’s forecasts and adjusted these, where required, based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. The values we have adopted for our draft decision are set out in Table 2.3.</p> <p>For the environment contribution, we have used the 2018-19 value provided by the Department of Environment, Land, Water and Planning and assumed that this will remain flat in nominal terms (decline in real terms) across the 2018–23 regulatory period.</p> <p>We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.</p> <p>We have verified South Gippsland Water’s forecast external bulk water charges against the current price determination for Melbourne Water.</p> <p>SOUTH GIPPSLAND WATER RESPONSE</p> <p><i>The Corporation accepts the Commission's proposed approach.</i></p>

Response to draft decision	ESSENTIAL SERVICES COMMISSION DECISION / OBSERVATION
	South Gippsland Water must submit a response to our draft decision and provide an updated financial model by 8 May 2018 (via email to water@esc.vic.gov.au). The response will be published on our website. We also invite other interested parties to make a submission. We intend to make a price determination for South Gippsland Water in June 2018.
	SOUTH GIPPSLAND WATER RESPONSE
	<i>South Gippsland Water has provided this response, an updated financial model and a revise new customer contribution model, by 10 May 2018 (via email to water@esc.vic.gov.au).</i>