City West Water

response to

ESC Draft Decision (March 2008)

for

Regional and Rural Businesses Water Plans

2008 Water Price Review

9 May 2008

1. Introduction

The Essential Services Commission (ESC) has been advised by the Department of Sustainability and Environment[1] that any decisions it makes with regard to new customer contributions, recycled water and miscellaneous charges as part of this price review process for the Regional and Rural water businesses will apply to the metropolitan businesses also, despite the deferred metropolitan price review.

City West Water (CWW) is therefore an interested party to the ESC decisions in this review, including decisions on bulk charges that may be applied by Goulburn Murray Water to future bulk water entitlements in the Goulburn catchment.

This response also addresses the proposed treatment of demand variations and uncertain capital projects, on the assumption that this approach will be applied to CWW and the other metropolitan businesses also.

2. New customer contributions (NCC)

The Draft Decision on page 186 has amended the scheduled charges for recycled water in the VicWater proposal, introduced the concept of shared reticulation-size assets and proposed "time-blocks" for the calculation of bring forward costs.

<u>Recycled water</u>

The ESC proposes there be no scheduled fee for recycled water; instead new customer contributions would be assessed on a case-by-case basis using pricing principles.

CWW recommends to the ESC that a scheduled charge should apply to new customer contributions for recycled water (as proposed in the amended VicWater submission), and that the ESC proposed principles be used to decide when this scheduled charge is <u>not</u> applicable. This provides administrative simplicity for water businesses and certainty for developers in the majority of cases. It will allow for both higher and lower charges depending on the specific recycling proposals, providing the charges are based on the pricing principles.

"Mandated" appears on the bottom of page 183 of the Draft Decision as a <u>factor</u> to be accounted-for in assessing the appropriate recovery of costs for dual-pipe developments. It does not, however, appear in the pricing <u>principles</u>. CWW supports its exclusion from the principles because mandating is an administrative process used for water and sewerage services as well as for dual-pipe schemes. Mandating is unrelated to whether or not the dual pipe scheme is being promoted by the developer or required by water authorities to meet Government targets.

[1] ESC Draft Decision, 2008 Water Price Review, page 1

Reticulation-size assets

In relation to reticulation-size assets, ESC notes (page 184) that it is not seeking to amend the current classification of assets. However, the proposal to allocate the costs of reticulation-size assets (page 186) based on the proportion of infrastructure required to service each development, begins to confuse the concept of shared assets and reticulation assets. It would seem to follow that if reticulation assets were apportioned between developments, then in essence they should be shared assets which are to be paid-for by the water authority.

The “150/225” rule for defining reticulation assets is an important issue. It enables a clear distinction to be explained to developers and avoids considerable administration if those assets were to be addressed case-by-case.

The current ESC guidelines for reticulation assets define them as those assets not requiring to be upsized to support other future developments, and the 150/225 sizes are “generally considered to be reticulation” assets although there may be some situations where “these sizes are inappropriate”. CWW believes these qualifications give sufficient guidance for a sensible application of the “150/225” rule and that anything other than incidental connection should be regarded as shared assets.

CWW recommends no change to the treatment of reticulation assets.

Bring-forward calculations

For bring-forward calculations, ESC is proposing “time blocks” (0-5 years, 6-10 years, 11-15 years, >15 years) on the basis that the estimation of the bring-forward period is “imprecise”. CWW’s service area is fairly compact, so CWW has had little experience with negotiating with developers the inputs to these calculations. However, CWW can foresee that the time block approach will shift debate to the block interfaces.

For example, if there is debate about bring-forward being 5 years or 6 years under the current NCC regime (using a WACC of 6.1%), the difference is whether the developer pays 26% or 30% of capital costs. Under the time block approach assuming a mid-point is used, the difference is whether the developer pays 16% or 38% of capital costs. Greater debate will be encouraged because a 4% difference will be replaced by a 12% difference.

CWW recommends the time-block amendment not proceed.

3. Miscellaneous Charges

CWW supports the ESC approach to miscellaneous charges which involves charges based on actual costs and a set of core prices[2] which will be set-out in the ESC approved price schedule. However there are some elements which should be amended or clarified, as set out below.

The ESC has proposed there should be a 25% contribution to overheads. It is unclear why 25% has been selected and it is unclear if this is to be applied to total actual costs, or applied to the labour component only.

CWW applies overheads based on the labour component. The percentage overhead rate is total costs, excluding items like bulk charges and depreciation expense as well as costs directly charged to jobs, divided by total labour costs. Applying this percentage overhead rate ensures the proportion of corporate overheads borne by miscellaneous charges is in proportion to the labour committed to that work.

CWW's goal is to apply overheads in a way that will result in the cost to the customer differing little if the service is delivered internally or externally through a sub-contractor. This is important in peak activity periods when some jobs will be sub-contracted, through no choice by the customer.

It is also important that any cost differences between similar jobs can be readily explained. This is particularly relevant for repeat customers like Councils which pay for repairs to damaged Council fire hydrants, and which compare the cost of one job to the next. Applying overheads on total job costs is seen by customers as a "mark-up" on materials used by contractors, which is viewed as unfair where a job has a high component of material costs.

For "internally" delivered jobs, the overhead costs for CWW employees will be different to the overhead costs applicable to personnel employed by its maintenance service provider. In the latter case, direct job costs do not include any fixed management fee that may be a characteristic of the contract. They do however, unlike the direct labour costs for CWW employees, include on-costs like superannuation, leave, payroll tax etc.

In its current prices, CWW has applied different overhead contribution rates, ranging from 4% to 84% of labour costs, depending on who delivers the job or service, and what costs have been included in the calculation of the base, direct labour cost. This aims to achieve a consistent price for customers, irrespective of who delivers the service.

To accommodate these differences and to price at 'actual' cost, CWW proposes that the ESC replace "a 25% contribution to overheads" with "a fair share of overheads".

[2] Core prices to appear in the schedule will represent at least 75% of the total revenue received from all miscellaneous services.

4. Goulburn Murray Water's Bulk Charges

Goulburn Murray Water (GMW) has proposed a "regional urban storage ancilliary fee" of $8.24 per megalitre. Despite its title, CWW believes this charge will be applied to its future metropolitan bulk entitlement.

GMW in its Water Plan[3] treated this fee as a non-prescribed service.

CWW supports the ESC seeking justification of this fee and believes that by its perceived nature and by its magnitude it is a prescribed service according to clause 6(d) of the Water Industry Regulatory Order 2003.

5. Demand variations

In principle the ESC proposal for dealing with uncertainty associated with demand forecasts/restrictions has merit; however CWW does not support it because in practice it will be extra work for no change.

The metropolitan retail water businesses will have to meet the Government requirements for uniformity of prices and a cap on increases of 14.8% (i.e. no more than double over the next 5 years) no matter what result emerges from the within period review.

If demands are less than forecast, the 14.8% cap will prevent any consequent increase in price.

If demands are greater than forecast, a consequent price reduction should be possible only after reversing the temporary measures put in place to meet the 14.8% cap. For example, one option being considered by CWW is to reduce regulatory depreciation by an average of about $21m per annum. Demands would need to exceed forecasts by about 20%[4] before the depreciation was returned to normal levels and price reductions could begin to apply. Differences to forecast of this magnitude are unlikely.

If the ESC does proceed with the within period reviews, it is not clear how, or if, the ESC proposes to distinguish between weather-related demand variations and those attributable to other affects such as water restrictions, behavioural change and population growth. CWW seeks clarification of the ESC's proposed approach.

[3] Goulburn Murray Water 2008 Water Plan, page 76
[4] At the expected 2008-09 tier two price of $1.202 per kilolitre and demand of 94 gigalitres.

6. Uncertain capital projects

The ESC approach to variations in licence fees and demands can be contrasted with its approach to uncertain capital projects. For licence fees and demands, adjustments are made for variations from forecasts. For uncertain capital projects, the ESC approach appears to be suggesting adjustments to be made from a zero base. That is, uncertain capital projects would not be included in revenue determinations until "more certain".

CWW believes this approach will lead to greater price changes than if the best estimates of cost and timing were included at the beginning. The materiality will of course depend on the size of the project, but something like the desalination plant is a contemporary example of a project that will be quite significant for metropolitan water businesses.

CWW believes the ESC approach to uncertain capital projects could be improved by including the best estimates of cost and timing in the revenue requirement (to be reviewed by ESC auditors) and then making adjustments arising from variations to forecast, and including any adjustments for the past year and remaining years of the regulatory period in its annual price adjustment for demand variations and PPM movements.

7. Summary of recommendations

New customer contributions

- a scheduled charge should apply to new customer contributions for recycled water (as proposed in the amended VicWater submission), and that the ESC proposed principles be used to decide when this scheduled charge is not applicable
- no change to the treatment of reticulation assets
- the time-block approach not proceed

Miscellaneous fees and charges

- replace "a 25% contribution to overheads" with "a fair share of overheads"

GMW bulk water charge

- the ESC seek justification of this fee
- it is a prescribed service according to clause 6(d) of the Water Industry Regulatory order 2003

Demand variations from forecast

- within-period reviews are not supported because no change is likely within the constraints of Government requirements for uniformity of prices and a cap on increases of 14.8% (i.e. no more than double over the next 5 years) in the metropolitan area
- clarify how, or if, to distinguish between weather-related demand variations and those attributable to other affects

Uncertain capital projects

- include the best estimates of cost and timing of these projects in the revenue requirement and then make adjustments arising from variations to forecast for both cost and timing