

30th April 2004

Essential Services Commission
Level 2, 35 Spring Street
MELBOURNE 3000

By email: water@esc.vic.gov.au

RE: SUBMISSION ON CONSULTATION PAPERS

The Authority is pleased to submit its comments on the Commission's discussion papers regarding:

- Information Requirements
- Estimating a Return on and of Capital Investments
- Customer Service Arrangements
- Performance Monitoring and Reporting
- Demand Forecasting
- Service Standards and Incentive Mechanisms
- Pricing Issues
- Bulk Service Arrangements

The breadth and width of the issues requiring comment are significant and the Authority has chosen to focus its comments on the issues it considers most significant in the following sections.

Information Requirements

The delivery of information templates to the Authority needs to occur soon to enable coherent and accurate completion of the templates prior to Water Plan approval by the Board and submission to the Minister on 30th June.

Estimating a Return on and of Capital Investments

The Authority has joined the syndicate of water authorities that have engaged Marsden Jacob Associates to help formulate a coordinated response to the current ESC proposals in key areas, being:

- the management of risk; and
- the weighted average cost of capital.

The submission from Marsden Jacob Associates is intended to serve as the basis of the Authority's comments on this topic.

Customer Service Arrangements

The Authority agrees with the Commission's preference for a standard Customer Service Code and individualised Customer Charter. Although, in some circumstances the content of Code seems to overlap into what the Authority considers a Charter issue. For instance;

1. When bills are sent. The timing of the issue of bills should not be included in the Code. South West Water (SWW) issues three bills a year – not quarterly.

2. Payment methods. Depending on what methods are required – the Commission should not specify methods that are not widely adopted already.
3. Installation of meter. SWW has just changed the meter installation responsibility from the owners plumber installing the meter to SWW staff installing the meter. The reason for the change was the correct matching of meter and property information in the billing system, especially problematic where plumbers were undertaking multiple meter installations. The Code should not specify who is responsible for installing the meter.
4. Plumbing and pipes: If the Code is to specify maintenance requirements of the different section of the service pipe, there is a requirement to liaise with water authorities as water authorities have adopted differing practices over time. SWW does not require customers with galvanised service pipes to replace the service pipe with a conforming service pipe – rather SWW will not accept the maintenance responsibilities of galvanised pipes.

In respect to Guaranteed Service Levels (GSLs) the Authority prefers that the Commission defers the introduction of GSLs to the second period of regulation commencing July 2008. This would allow time for historical data to be formed and impact of a GSL scheme assessed, particularly for the small non-metropolitan regional water authorities where data collection systems are not as sophisticated.

It is also pointed out that the number of blockages (per 100 kilometres) for small towns is not a useful indicator. For example, in Simpson where the total length of sewers is 3.6 kilometres, one blockage equates to an increase from 0 to 27.8 blocks per 100 kms.

The Authority has 1,250 rural customers of which 600 are “supply-by-agreement”. These customers are historically supply-by-agreement because they are supplied raw water from a transfer main going past the property and supply quality and reliability can be variable. The Authority is planning to have a customer charter with two sections (or two charters), being rural and urban water supply. It is important that the code allow the differentiation of service quality to rural and urban customers.

Performance Monitoring and Reporting

The Authority has a significant rural customer base. It is imperative that a performance indicator template has three categories of performance for water services being:

- Domestic (ie residential)
- Non-Domestic (ie Commercial and industrial)
- Rural (ie Rural gazetted districts and supply-by-agreement customers from transfer mains)

Appendix A – Potential Performance Indicators of the Workshop Discussion Paper on this topic has only the first two categories above. The Authority does not wish to include rural performance (where service standards will be different) within its urban performance indicators, particularly due to performance by comparison use of the data.

Similarly, SWW harvests and transports its water (wholesale functions) to its urban districts. Many authorities purchase bulk water from another water business. For performance indicators such as unaccounted water and bursts and leaks it is desirable for this data to be reported in a retail and wholesale context to ensure comparison is valid.

As stated in its response to the Consultation Paper No. 1, South West Water does not currently collect or have systems in place to efficiently collect data relating to the number of interruptions per customer and does not have an emergency call centre. It is important that the Commission recognise that not all performance data will be able to be provided.

The Authority recommends that the frequency of auditing performance indicators be set on the basis of the benefits outweighing the costs per business. Auditing frequency would then reflect the size of the business. Smaller businesses that have fewer customers will benefit less from data auditing.

The Authority has concerns with the interpretation of what constitutes a complaints and an enquiry by the various businesses. It is important that the Commission provides a clearer direction on the interpretation (and definition) of a complaint. The Authority suggests that complaint data not be published until the Commission is satisfied that the same interpretations are being used by all businesses.

Demand Forecasting

South West Water understands the importance of accurate demand forecasting in the price setting process. It also understands that whatever demands are established will be wrong. As such, the level of detail and analysis of demand assessment should have regard to the number of customers in a particular group. For example, it is more important that demand forecasts are accurate for Warrnambool (11,665 customers) than for Caramut, Darlington, Purnim and Simpson (all less than 100 customers).

The Authority is intending to establish customer growth (or decline) rates and consumption growth (or decline) rates for residential and non-residential for each supply zone. Major customer and trade waste forecasts will be based on individual discussion with those customers.

The Authority presents the following case study regarding price elasticities.

Warrnambool Residences from 1996/2004

	96/97	97/98	98/99	99/00	00/01	01/02	02/03
Customer Costs (based 250 kL)	\$545	\$545	\$461	\$461	\$461	\$479	\$498
Average Annual Usage (kL)	270	250	261	246	231	213	209

Note: There is no CPI adjustment of customer costs.

The table indicates costs have significantly reduced and at the same time average annual consumption has decreased significantly. This case study demonstrates that price elasticities have had a minor effect on water consumption in comparison to other factors.

Service Standards and Incentive Mechanisms

As stated previously, the Authority is currently unable to measure the number of customers receiving a specified number of multiple (water or sewer) interruptions and wishes to differentiate between urban and rural activities and opposes the introduction of Guaranteed Service Levels in the first period of regulation.

The Authority agrees with the Commission position that an S-factor type approach may be warranted at the next regulatory review.

The Authority understands the reasons for the Commission's preference for an efficiency carry over mechanism and looks forward to being involved in the design of such mechanism. In designing incentive mechanisms the Commission needs to have regard to the different ownership structures and profit motives that are existent in the Victorian water industry as compared to privatised gas and electricity companies.

Given the significantly lower profit margins in the non-privatised water sector (particularly in the non-metro sector) a financial penalty is less able to be accommodated from profits or reduced dividend payments, particularly where no dividend has been paid for some time. In this case, a financial penalty is eventually adsorbed by customers, through higher tariffs at the next round of regulation for the water business to remain viable.

Pricing Issues

South West Water has deviated from traditional tariff structures that reflect short term cost drivers to tariff structures that motivate water conservation (more akin to long run marginal cost principles) and other outcomes such as customer satisfaction regarding customer control over their costs. Further, the setting of foundation water service charges (in the mid 1990's) sought to achieve social equity outcomes via a maximisation of dollar benefit to customers eligible for a pensioner rebate (currently 23.3% of all customers).

The Authority understands that it may be at greater risk of demand and supply side variations because of its tariff structures. Given the history of the absence of water restrictions in the south west and reliable water supplies and positive growth outlooks the risk is deemed acceptable.

A Long Run Marginal Cost (LMRC) analysis seems a useful tool in designing tariff structures but given the high costs and time constraints is not proposed to undertake such a study. Given that the Authority already has two-part volumetric (inclining block) tariffs for all customers (excepting eight major customers) there is no intention to modify tariff structures.

With respect to trade waste charges (large trade waste customers) the discussion paper omits two considerations that are important to South West Water, being:

1. Major trade waste customers in Warrnambool are a significant component of the load on the wastewater treatment plant and generate a high portion of total revenue. The consequence of the loss of one of these customers is financially significant, hence pricing closer to marginal costs (than proportional costs) is preferred as a risk control measure.
2. The Warrnambool wastewater treatment infrastructure was designed for a higher strength wastewater due to trade waste loads from the major customers. There is a risk that if trade waste reduced in strength that the treatment plant operation will fall outside design parameters and be unable to treat wastewater to the appropriate standards without significant modification (and cost). As such, the pricing signals to be sent to the major trade waste customers need to ensure that they do not overly pre-treat wastes.

The Authority agrees that for the first period of regulation that setting individual prices is preferred followed by a tariff basket approach in the next period of regulation subject to materiality for pass-through costs is sensibly designed and includes events other than just legislative changes.

The Authority sees that dealing with unforeseen events is a critical factor in regulation of the water industry due to the low profit levels arising from past pricing decisions and low ability to carry the financial impact of an unforeseen financial impost. The alternative is for water authorities to build risk into expenditure projections to deal with unforeseen events – resulting in higher tariffs for events that may not occur.

The proposed change from the industry adopted IPART principles for developer charges (as adapted from authority to authority) to the proposed long run incremental approach will have a large impact on customers and tariffs. Although economic theory may favour the treatment of existing assets as sunk costs – this approach will not be able to support development and is not pragmatic and will result in significant cost transfer from new customers (willing to meet the costs of infrastructure take-up) to existing customers.

Gas and electricity industries are different to the water industry due mainly to the higher operational and capital expenditure required to transport the product (water/wastewater/gas/electricity). For example:

- Water is an incompressible fluid that has high friction factors and therefore pipe sizes are large and energy requirements for transport are high.
- Gas is a compressible substance that has low friction factors therefore pipe sizes are much smaller and energy costs for transport are much lower than for water.
- Electricity is the transport of electrons through a conductor conceptually similar to water and gas, it can be compressed (by higher voltage) friction is lower and energy transportation requirement lower resulting in lower transportation costs and capital costs.

This is further demonstrated in the practical sense – electricity is transported all around the country and generally made available to all the population – gas is less widespread than electricity but is transported from state to state with very long pipelines – water use is very localised to the source. There are not many long pipelines. Historically, towns and cities were built (and still are) around reliable water supplies – recognising the high costs of water transportation. Infrastructure costs associated with water assets are magnitudes greater than gas and electricity and therefore methods for dealing with infrastructure contributions need to be vastly different than for gas and electricity assets.

Over time, the water industry has developed a method of recouping infrastructure costs that enables development to occur – modification of these principles to consider existing assets as sunk costs will result in the stifling of development and investment in strategic assets. The Authority urges the Commission to consider the economic theory in context to the practical realities and form a pragmatic approach to development costs. The Authority further suggests that in this first period of regulation that authorities be required to establish the existing basis of developer costs in their Water Plans and for the Commission to further develop the preferred model over the next three years.

The Commission should also note many authorities have made changes to the development charges over recent years via consultation processes and obtained acceptance of the current charges.

Bulk Service Arrangements

South West Water is a “headworks to tailworks” Authority and is not effected by the issues covered in the discussion paper.

I trust that the Authority’s comments contained within this response are useful and will be thoughtfully considered by the Commission.

Yours faithfully

RUSSELL WORLAND
CHIEF EXECUTIVE OFFICER