2008 WATER PRICE REVIEW

MELBOURNE WATER'S RESPONSE TO THE ESC'S DECEMBER 2006 CONSULTATION PAPER

February 2007

2008 Water Price Review Consultation Paper – Melbourne Water's response

In December 2006 the Essential Services Commission (Commission) released its 2008 Water Price Review Consultation Guidance on Water Plans (Consultation Paper). Melbourne Water welcomes this paper and the opportunity to respond.

A key issue for Melbourne Water in responding to the Consultation Paper is to ensure that the Commission adequately considers the operating environment over the 2008 Water Plan period. Over the 2008 regulatory period there is uncertainty as to whether the current drought conditions will continue, and this in turn creates further, and unprecedented, uncertainty around demand, obligations and associated expenditures. In addition, water businesses are experiencing higher costs for labour and other resources. This context, which is different from that in which the 2005 Water Plan was prepared, is crucial in forming views on the appropriate regulatory framework going forward.

Melbourne Water's comments on the specific issues identified in the Consultation Paper are set out below.

1. Length of the regulatory period and dealing with uncertainty

The Commission's initial position is that:

- The second regulatory period should be set at five years from 1 July 2008
- Businesses will reprioritise projects and programs in consultation with customers should priorities change over the regulatory period or as need arises to offset the impacts of unforseen events
- There should be limited pass throughs, although there may be scope for reopening of the determination where significant impact on financial viability can be shown
- There may also be merit in having pass throughs for predetermined major projects that were under consideration by Government or other regulators at the time of the determination
- Price controls are not the most appropriate mechanism for dealing with demand uncertainties
- There is merit in introducing a L-factor mechanism to adjust prices to reflect the change in licence fees on an annual basis.

In principle, Melbourne Water supports the Commission's initial position in relation to the length of the regulatory period and the need for appropriate mechanisms for dealing with uncertainty. However, Melbourne Water considers that there are some aspects of the Commission's approach which need further refining.

As identified by the Commission, there are significant benefits to customers and water businesses associated with moving to a longer regulatory period. However, the transition to a longer period should to be cognisant of:

- The significant uncertainties associated with Melbourne Water's current operating environment
- The difficulties associated with forecasting over the longer term
- The principles of optimal risk allocation (see below)
- Creating meaningful and achievable incentives for improved performance.

These factors are discussed below.

Challenges associated with the current operating environment

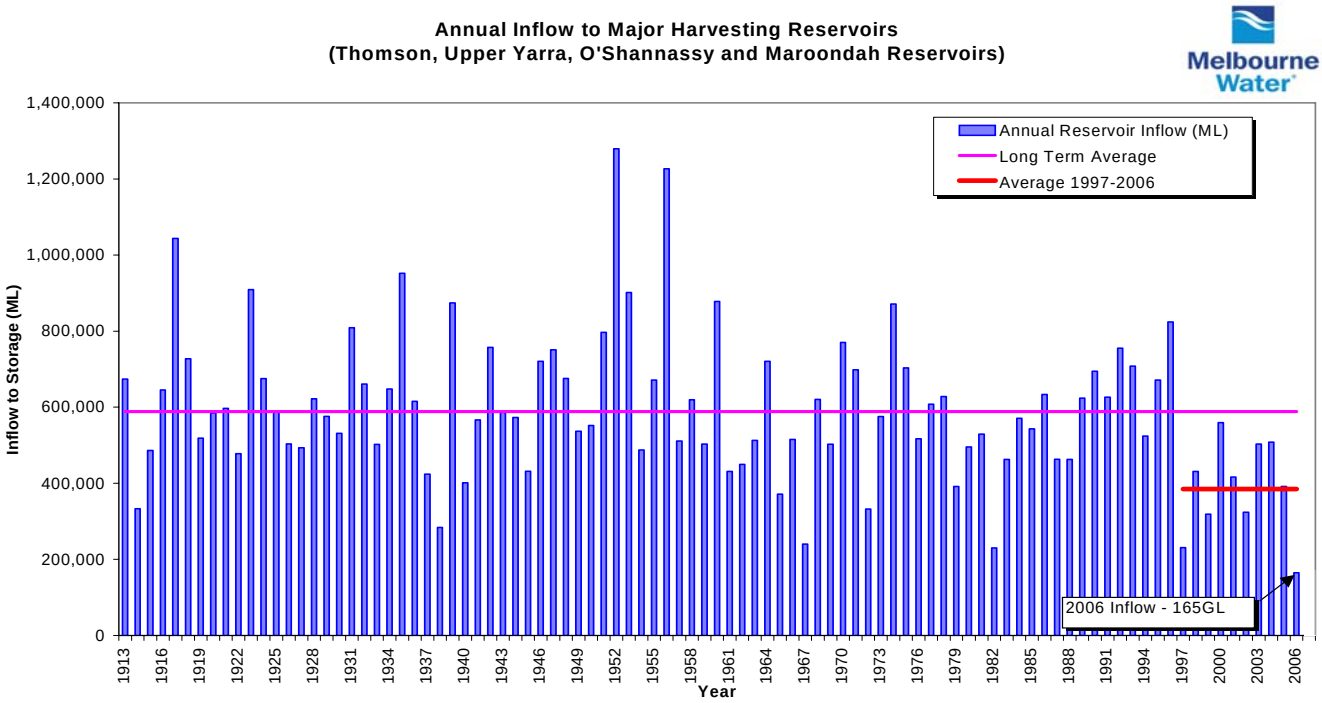
Melbourne Water has experienced considerable unanticipated changes in its operating environment since the Commission last set prices in mid 2005:

- The current drought has reduced revenues through lower demand, increased the threat and incidence of bushfires in the water supply catchments and brought forward capital expenditure requirements to increase supply (e.g. Tarago)
- Ongoing industry reform and new obligations[1] have seen material increases in expenditure over the current period
- Labour and resource costs have increased due in part to labour shortages and significant increases in infrastructure spending across utility industries.

Melbourne Water continues to review and improve its forecasting methodologies as new information becomes available. However, it is realistic to expect that there will be a significant level of uncertainty with respect to demand and costs (particularly infrastructure related) in the 2008 regulatory period.

This is illustrated by the two different planning scenarios included in the Central Region Sustainable Water Strategy, one based on average inflows over the last 50-100 years and another assuming continuation of the low inflow conditions of the last 10 years. The following diagram demonstrates these changing inflows.

[1] For example, the Lower Yarra Stormwater Quality Plan and the Central Region Sustainable Water Strategy.



The above diagram shows that the average inflows to Melbourne's four major harvesting storages for the period 1997-2006 are about 34 per cent less than the long term average. Obviously, this is a significant change to Melbourne Water's operating environment and one which makes it very difficult to assess the likely medium to long-term position.

Approach to managing risks and uncertainties

The Consultation Paper highlights the importance of ensuring the regulatory framework creates incentives for businesses to manage risks appropriately and improve performance. Melbourne Water supports this view but notes that for incentives to drive change they must be meaningful, achievable and consistent with the principles of sound risk allocation.

Melbourne Water notes that if the regulatory period is set at five years, then it will be particularly important to ensure that there are sufficient mechanisms to enable water businesses to deal with any significant risks and uncertainties that may arise over that period. This includes risks and uncertainties around demands, obligations and major capital projects.

In this regard, it is important to distinguish between risks for which a business may be expected to have some understanding of the likelihood of the event occurring and uncertainties, which are essentially unknowns.

The principle of optimal risk allocation suggest that risks should be allocated to those parties who are best able to manage the risk and that where the risk is unmanageable that it is allocated to those parties best able to absorb the risk. The current climatic conditions, and potential for ongoing extreme drought, are outside historical planning

expectations. For example, in 2006 the inflows to Melbourne's four major harvesting storages were 28 per cent less than the previous lowest calendar year on record.

Melbourne Water is seeking to manage these risks by updating its forecasting systems as more data becomes available, and developing contingency positions. However, the optimal allocation of risk suggests that the risk associated with the potential for extreme conditions should be shared with the community and end customers, given current uncertainties around quantifying and mitigating these risks extend beyond the capacity of the businesses to effectively manage them.

Melbourne Water has and will continue to operate its business by reprioritising projects and programs, in consultation with its customers and stakeholders, to manage changing priorities and circumstances. For its large projects, capital cost estimates will also be developed taking into account associated risks and uncertainties. This said, the nature of Melbourne Water's business as a wholesale service provider means that invariably there will be a small number of potentially very large, complex projects that are subject to considerable risk and uncertainty and which can not be fully managed through the normal reprioritisation of projects and estimation approaches.

To address these risks and uncertainties in a manner which optimises risk allocation, Melbourne Water agrees with the Commission that the regulatory framework for the 2008 Water Plan period needs to incorporate the following aspects:

- For certain, pre-determined augmentation projects that are currently being considered by regulatory agencies or Government, a within period process that can be used to assess, and where appropriate incorporate, the costs of those projects into the relevant prices
- A cumulative, end-of-period, pass through mechanism for additional legislative or regulatory obligations that are unforeseen and which arise once the 2008 Water Plan period has commenced. This would be symmetrical in application and have a materiality threshold of 1 per cent of revenues.

In addition, Melbourne Water believes that:

- Price controls should be used to assist in managing demand uncertainties
- Extreme drought conditions should be recognised as a "catastrophic" event given it has the same attributes as the other events identified by the Commission (i.e. low probability, high consequence).

These potential regulatory mechanisms are discussed further below.

Major projects

Melbourne Water believes that the Commission should adopt a mechanism for the pass through of specific costs within the 2008 regulatory period associated with pre-determined projects that are foreseen but uncertain at the time of the Commission's price determination.

Melbourne Water considers that in principle, a small number of very large scale projects, which are currently being considered by the Government, should be separately considered by the Commission within the second regulatory period once they become confirmed. Specifically, augmentation projects which potentially have significant costs and whose scope, including whether they will proceed, are uncertain pending Government decisions or regulatory / customer requirements. This goes beyond the normal uncertainty attached to projects in their early stages of evaluation.

The Commission has discretion to approve prices, or a mechanism for adjusting prices within a regulatory period, provided the prices or mechanisms meet the regulatory principles in the Water Industry Regulatory Order (WIRO). Specifically, the WIRO[2], under the *Water Industry Act 1994*[3], allows the Commission to approve prices, or the manner of calculating prices, provided that customers can readily understand the process or the manner in which they are charged[4]. Any adjustment mechanisms would need to balance competing objectives and interests, e.g. protecting customers, minimising administrative costs of making pricing adjustments, and protecting businesses' financial viability.

In regulating electricity businesses, national and state regulators (the Australian Energy Markets Commission (AMEC)[5] and Independent Pricing and Regulatory Tribunal (IPART) respectively) have adopted within period pass through approaches to manage uncertainties associated with significant uncertain projects and events. This includes and augmentation to transmission capacity in the Newcastle-Sydney-Wollongong corridor driven by load growth and changes in the New South Wales Government's policy on interval / time based metering. In addition, the Commission adopts a "fixed principle"[6] approach in regulating gas distribution businesses to manage uncertainties.

It should be noted that Melbourne Water's business has strong parallels with electricity transmission businesses, as they both have capital intensive and lumpy expenditure profiles, long life cycles for infrastructure assets and integrated networks. This compares to the typically more predictable capital expenditure profile of electricity distribution businesses, although noting that recently some Australian electricity distribution businesses have been experiencing similar lumpy profiles.

The approach for electricity transmission in the National Electricity Rules, and that adopted by IPART, provide that significant uncertain 'contingent' projects are considered separately from the main ex- ante regulatory framework.[7]

In the case of the AMEC approach, specifically identified project costs are assessed shortly before expenditure on that project is about to begin. There are several elements to the approach:

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[2] Clause 8.
[3] Section 4D(2)(c).
[4] WIRO, clause 14(1)(a)(ix).
[5] The AEMC is the rule maker for the National Electricity Market and establishes the regulatory framework administered by the Australian Energy Regulator (AER). The roles undertaken by the AEMC and AER in regard to electricity transmission were formerly undertaken by the ACCC.
[6] As allowed under the National Gas Code.
[7] In the case of the IPART approach, this reflects the unusual lumpiness of expenditure experienced by the electricity distribution businesses.

- The project must be linked to a unique investment driver
- The project must satisfy a materiality threshold
- Where the threshold is not satisfied, it is at the regulator's discretion as to whether these projects will be considered
- Determination of the allowed investment occurs during the regulatory period, once the probability of the project and expected costs become known with greater certainty but before the investment is committed
- Triggers are developed defining when the project can be brought forward for approval. The process then in effect becomes a mini determination, with the project costs reflected through increased prices. At the end of the period, the depreciated value of the actual investment in the contingent project is rolled into the regulatory asset base.

The within period cost pass through mechanism adopted by IPART in electricity applies to certain general events (for changes in certain taxation obligations and regulatory obligations) and specified events. The mechanism for certain specified events recognises that, for some events, it is difficult to assess the reasonableness of any cost estimates due to the uncertainty about whether they will occur, and if they do, exactly what will be the resulting changes and cost implications. For this reason, it is considered more appropriate to deal with these costs as pass throughs, and given they are foreseen at the time of the determination, to not apply a materiality threshold.[8] Businesses are able to apply for cost pass through within 90 working days of the cost pass through event occurring. IPART approves a total amount that can be passed through, as well as a profile of recovery over the remainder of the regulatory period (prices are increased through the annual price approval process).

The fixed principle approach for gas distribution provides the Commission with the capacity to make a legally binding commitment about the treatment of particular matters at future reviews, such as the use of incentive based regulation, the treatment of efficiency carryovers and the methodology to be used to derive the rate of return. By making such commitments, businesses have greater certainty about the approach to be taken at the end of a regulatory period. In the current context, the Commission could apply a modified version of this approach by making a commitment to assess the efficient costs of specific, pre-determined projects, within the regulatory period and to make adjustments to prices accordingly.

Melbourne Water considers that, consistent with established regulatory practice noted above, the regulatory framework for the 2008 regulatory period should include a mechanism that enables pass through of specific costs within the period. These costs would be associated with pre-determined projects that are foreseen but uncertain at the time of the Commission's price determination. Such an approach would address the need created by a longer regulatory period in, what for Melbourne Water, is a highly uncertain operating environment. In this regard, the *Water Industry Act 1994* provides that the Commission's must aim to "ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities".

[8] The general cost pass through must meet a materiality threshold of 1 per cent of the average annual smoothed revenue requirement over the regulatory period.

Specifically, Melbourne Water considers the within period pass through mechanism should be applied to those projects associated with the potential need for a major augmentation of metropolitan Melbourne's water supply system. This includes the major projects identified by the Government's Central Region Sustainable Water Strategy (CRSWS) as requiring further business case and feasibility assessments. Flexibility will be required in the final specification of projects to ensure that the least community cost solution is adopted. Currently, the CRSWS requires further investigation of:

- The Eastern Water Recycling Proposal
- Large scale stormwater treatment and reuse options, in particular those at Dights Falls
- Seawater desalination.

Based on current information it would be inappropriate to include all costs associated with these major augmentations in the 2008 Water Plan as:

- Climate uncertainty means there is uncertainty in relation to future storage levels and security of supply policy and therefore the timing, size, sequencing and cost of the augmentation projects
- There is uncertainty as to which, if any, of the possible augmentation projects will proceed following feasibility studies/business cases and consideration by Government
- Current cost estimates for the projects are very preliminary in nature
- Total costs are material and would have a significant impact on customer bills.

The regulatory assessment of these projects would occur once the probability of a project and its expected costs becomes known with greater certainty but before the investment is committed. The trigger for this assessment process could include a decision by the Government to proceed with an augmentation project following business case and feasibility assessments.[9] Given these projects and their likely magnitude will be foreseen at the time of the Commission's price determination, a materiality threshold should not apply.

A mechanism of the nature outlined above would ensure water prices are set at the right level and that significant uncertain costs incurred by Melbourne Water during the 2008 regulatory period would be recouped. It is noted that unless such a mechanism is put in place the economic profitability of Melbourne Water is likely to be compromised. For example, expenditure of $500 million over the 2005 regulatory period, a conservative estimate of any augmentation project cost, would have equated to approximately 75 per cent of the Commission's allowed return on assets (profit) in the 2005 Water Plan.

Additional obligations over the 2008 regulatory period

[9] It is noted that preliminary business case and feasibility study costs for these projects will be included in the 2008 Water Plan process and to avoid any double counting it would be important to ensure these costs were not also included in the within period assessment process.

Melbourne Water believes that the current end-of-period pass through mechanism for additional legislative or regulatory obligations should remain, with the materiality threshold set at 1 per cent of revenues over the regulatory period, instead of the current 2.5 per cent.

Melbourne Water continues to support an end-of-period pass through mechanism for additional legislative or regulatory obligations which arise once the 2008 regulatory period has commenced. This would continue the approach currently used by the Commission. However, it is proposed that the materiality threshold should be set at 1 per cent of revenues over the regulatory period, instead of the current 2.5 per cent.

Melbourne Water notes that the current 2.5 per cent threshold of revenues over the regulatory period equates to approximately 6 per cent of the Commission's allowed return on assets (profit) in the 2005 Water Plan. Melbourne Water believes that the current threshold places an unacceptable level of risk on it given that it has limited ability to manage the introduction of new obligations.

Melbourne Water notes that currently the new obligations placed on it since the 2005 regulatory period total more than $14 million, but this amounts to only a little over a third of the 2.5 per cent materiality threshold. This represents approximately 2 per cent of Melbourne Water's return on assets allowed by the Commission in the 2005 Water Plan. A significant proportion of this expenditure, over 95 per cent, is operating expenditure. While it may be argued that this additional expenditure does not impact on Melbourne Water's financial viability, given the size of its cash flow, net profit after tax and current gearing ratio, it may imply:

- Reduced returns to the shareholder as a result of events and commitments over which, in many cases, the business has little influence
- Increased borrowings, largely to fund operating expenditure as opposed to capital expenditure.

Price controls

Melbourne Water considers that in the current operating environment either a tariff basket or a revenue cap approach would enable demand risk to be shared appropriately. It notes that any such approach would need to be supported by a well defined tariff strategy, that is consistent with the WIRO.

The Commission has expressed a preference for price caps to be adopted in the 2008 regulatory period and that any concerns related to the impacts of drought and other unforeseen events are better dealt with through a separate adjustment mechanism rather than through the price control.

In general, Melbourne Water supports a more flexible approach as it enables water businesses to adapt to changing conditions and at the same time ensures that price shocks for customers are minimised via appropriate rebalancing constraints. Melbourne Water notes that the Commission has previously indicated it would consider a tariff basket option where a well defined tariff strategy, that is consistent with the WIRO, is proposed, customers are adequately consulted and the impact of

price adjustments is limited by rebalancing constraints. In this regard, it approved both price caps and tariff baskets in its 2005 price determinations.

In relation to the Commission's comments on price controls and managing the risks associated with the drought, in the current environment, with potential extreme drought conditions, there are heightened uncertainties around demand estimates.

Melbourne Water considers, consistent with the principle of risk allocation noted above, that demand risk should be managed by the business to the extent that there is a meaningful relationship between drought related demand changes and costs. The remaining demand risk should be shared with end customers, via the setting of bulk water prices to the retail water businesses. This approach is appropriate because end customers are better able to absorb price changes (water prices are a small proportion of residential expenditures with the annual average bills of the retail water businesses making up less than 1 per cent of national average household income[10]) and is explained further below.

It is noted that a number of infrastructure industries are characterised by high capital intensity, highly specific assets (i.e. cannot be easily be shifted for use elsewhere) and demand risk. These sectors can be divided into those where demand risk can be allocated contractually and those where it is allocated through regulation.

Where it is feasible for contracts to be agreed (e.g. gas transmission, rail) then a common mechanism for allocating demand risk is a take or pay contract. A take or pay contract results in customers paying for all (or most) capacity regardless of actual use. When demand is relatively low then the average unit price to the customer is higher, and vice versa. A take or pay contract structure serves to spread demand risk broadly through all end customers rather then concentrating it with the infrastructure owner. As it is based on capacity, rather than use, it does not create strong signals to conserve water.

Where contracts are not possible (e.g. electricity transmission) then the risk allocation is determined through regulatory processes. In Australia, electricity transmission is regulated by way of revenue caps. Like a take or pay contract, a revenue cap also shifts demand risk to end customers. The reason why this makes sense is that transmission infrastructure needs to be planned for and provided to meet expected peak demand and costs are largely invariant to actual demand. Where demand risk is unmanageable (due for example to extreme weather conditions), the ACCC has determined that customers are able to better absorb the volatility in the unit cost of transmission services than are the transmission companies.

When considering this experience, there seems to be strong parallels between Melbourne Water's position and capital intensive businesses such as electricity transmission and gas pipelines. To a large extent, demand risk related to extreme drought is not able to be managed effectively by any party. For example, Melbourne Water's water supply network is provisioned based on assessment of retail water business peak demands over the longer term. It is unlikely the network would be

[10] *Victorian Water Review – An Accountability Report for the Victorian Water Industry*, Victorian Water Industry Association, 2006.

reprovisioned until there is clear, ongoing, evidence that peak demands have changed. In this regard, extreme drought does not mean that Melbourne Water will immediately alter its capital plan, since its costs are based on meeting peak demand during normal conditions.

Catastrophic events

Melbourne Water believes that the Commission should extend the current definition of catastrophic events to recognise extreme drought conditions.

In its Consultation Paper, the Commission outlined its previous approach for catastrophic events beyond the control of businesses that may have an impact on financial viability. It also noted that the Commission also has some flexibility in deciding how to deal with other events that may not have been defined as catastrophic but nonetheless might have a significant impact on financial viability.

Melbourne Water notes that extreme drought conditions have the same attributes as the other events identified by the Commission as being catastrophic, with low probability of occurring but high potential impact if they eventuate. For example, if the current drought worsens and requires a major augmentation of Melbourne's water supply system this could result in significant expenditure over the 2008 regulatory period. As noted earlier, additional cost of $500 million, which is a conservative estimate of any augmentation project costs, over the regulatory period would have equated to approximately 75 per cent of the Commission's allowed return on assets (profit) in the 2005 Water Plan. In this regard, extreme drought could also be considered as an event for which the Commission could use its discretion to adjust prices within the regulatory period where the businesses' ability to meet its service requirements or its financial viability is compromised.

L-Factor

Melbourne Water supports the use of a L-factor adjustment to the price controls in order to address any licence fee variability.

This said, Melbourne Water notes that while this will be beneficial, the impact of likely variances in licence fees are expected to be small relative to other sources of uncertainty expected over the period.

2. Service standards and General Service Levels

The Commission's initial position is that:

- Targets for the core set of service standards should be consistent with the average performance over the previous three years for which actual data is available (2003/04 to 2005/06)
- Businesses have scope to propose an alternative basis for targets
- In assessing service standard targets the Commission will focus on whether targets:

- Are set in accordance with the definitions outlined in the Commission's performance reporting frameworks
- Are consistent with available historic information on actual performance
- Reflect the impact of proposed expenditure programs
- Reflect customer preferences.

- There is value in all urban businesses implementing a General Service Level (GSL) scheme for the 2008 regulatory period, although it is not proposed to require businesses to adopt GSL schemes.

Melbourne Water considers that the commercially agreed services standards detailed in the various Bulk Supply Agreements (BSAs) should be used as the service targets for the 2008 Water Plan period.

Melbourne Water's service standards are established via commercial negotiations with the retail water businesses and detailed in the various BSAs. Melbourne Water has reviewed the current standards with the retail water businesses in preparing its draft 2008 Water Plan and no major changes have been identified. As Melbourne Water has contractual obligations to meet defined core service standards, and its capital and operating expenditures are based on these standards, it is appropriate that they should be used as the targets for the 2008 Water Plan period. Melbourne Water will provide information on its recent performance to assist the Commission's assessment but notes that the average actual performance over the previous three years may not be appropriate for setting targets given those years do not reflect typical years.

Further, in relation to any outlier events noted by the Commission, these will be managed according to normal commercial processes as detailed in the BSAs.

Going forward, Melbourne Water proposes to refine the definition of some of the targets used in the 2005 regulatory period (which were based on average actual performance over the previous three years). This will ensure that they are better aligned with the detailed service standard definitions contained in the various BSAs, rather than three year averages.

GSL schemes are relevant to businesses that deal directly with end use customers. Given the nature of its business, Melbourne Water does not propose to implement a GSL scheme. Further, it does not consider, given the current high levels of performance against BSA standards, that GSL schemes are necessary to create service level incentives. It is noted that the BSAs already contain financial penalties where particular service targets are not met (e.g. in relation to a failure to chlorinate). If the retailers wish to alter any penalty arrangements in the BSAs then Melbourne Water believes that this can be addressed by them through the relevant BSA provisions.

3. Assessing operating expenditure

The Commission's initial position is that:

- Operating expenditure forecasts will be assessed by examining historical actual expenditure associated with baseline or business as usual levels of services.

Expenditure related to new obligations, functions or service level improvements will be considered separately

- New obligations are defined as those that are reasonably expected to take effect from 1 July 2008
- It is reasonable to expect that businesses will be able to deliver efficiency improvements with respect to business as usual expenditure over the regulatory period.

Definition of new obligations

To provide greater transparency around the factors contributing to price rises in the 2008 regulatory period, Melbourne Water will provide disaggregated information on new obligations which came into effect from 1 July 2005 and which were not included in the 2005 Water Plan.

Melbourne Water notes the Commission's proposed approach to defining new obligations and, consequently, business as usual obligations. In the Consultation Paper, the Commission noted that the intent of distinguishing between the costs associated with business as usual and new obligations is to transparently identify the additional costs associated with regulatory decisions that are expected to take effect over the 2008 regulatory period. Further, that the expenditure assessment process should be largely forward looking, with the focus on the outcomes to be delivered for the 2008 regulatory period and the expenditure needed to deliver these outcomes rather than revisiting the forecasts from the last review.

Melbourne Water considers that it is useful to provide disaggregated information on obligations which came into effect from 1 July 2005 and which were not included in the 2005 Water Plan. Melbourne Water will provide this information in addition to information on the costs of new obligations that are reasonably expected to take effect from 1 July 2008 (as proposed by the Commission).

There have been a significant number of new obligations since the commencement of the 2005 regulatory period, in particular obligations arising from the CRSWS. Providing information on the cost of new obligations since 1 July 2005 has the following advantages:

- It provides stakeholders with greater transparency around the factors contributing to price rises in the 2008 regulatory period
- To the extent that expenditure in relation to these obligations is forecast to increase, it provides transparency around future drivers of expenditure
- It provides a clearer basis to determine whether efficiency improvement assumptions can be reasonably applied (see next section).

In addition to the points identified above, the treatment of expenditures related to obligations put in place subsequent to the 2005 Water Plan as "new obligations" is consistent with the proposed technical review of capital and operating expenditures. As an example: the review of "business as usual" expenditures is typically commenced through a trend analysis of historical expenditures. In the case of obligations that have been imposed since 1 July 2005, little or no historical trend information will be available. The review of expenditures related to post 2005

obligations will have to be undertaken in a similar manner to the way in which post 2008 obligations are reviewed (i.e. prudency and efficiency). Therefore, it would be most appropriate to capture all new obligations, either post 1 July 2005 or 2008, in the same expenditure category.

Assessing forecasts and efficiency improvements

An efficiency factor should be applied to business as usual operating expenditure, but this should be limited to business as usual costs and not costs associated with new obligations or costs which are uncontrollable by the business.

The Commission has proposed that business as usual operating expenditure estimates will be assessed by examining the historical actual expenditure associated with baseline or business as usual levels of services. It also notes that it will consider whether differences between estimates and actuals can be readily explained. Melbourne Water has in place systems and processes for monitoring expenditures relative to Water Plan benchmarks and historical expenditure levels. While past expenditures can help inform the Commission's assessment, this assessment also needs to be cognisant of changes in each businesses' operating environment, performance against existing service levels and input costs.

Seeking efficiency improvements will continue to be an important part of the way in which Melbourne Water operates its business. However, the current operating environment, which holds greater uncertainty about demands, capital and operating expenditures, as well as shortages of skilled labour, increases the challenge associated with achieving ongoing efficiency gains. At this stage, the Commission has not detailed its methodology for assessing efficiency gains, only noting that where efficiency savings are not evident in business as usual expenditure, or are less than thought achievable, it proposes to make adjustments to reflect assumed productivity gains.

In reviewing the 2005 Water Plans, the Commission considered it appropriate for businesses to achieve a minimum of 1 per cent per year productivity improvement on their growth adjusted business as usual expenditure over the regulatory period. Melbourne Water would be concerned if the Commission was to again adopt the approach it used to assess efficiency in the 2005 Water Plan process. This is because:

- The Commission's definition of new obligations implies that business as usual expenditure will incorporate expenditure to meet new obligations that occurred prior to 1 July 2008 and this will contribute to significant growth in business as usual expenditure
- Melbourne Water's business as usual expenditure will also likely include several new and significant expenditure items that are not a part of current business as usual, and these will contribute to growth in business as usual expenditure
- Industry wide increases in costs have occurred that are not a part of current business as usual expenditure
- Assessment of customer growth based on volumes is not a reflective measure for Melbourne Water, particularly in an environment where water conservation is being promoted and restrictions are in place.

Melbourne Water believes that a more appropriate approach would be to continue to apply an efficiency factor, but limiting the application of the factor to business as usual costs, not new obligations or uncontrollable business costs.

The rationale for removing new obligations from the application of an efficiency factor is that the operating expenditure associated with these obligations will, in the majority, be undertaken via contracting and the price will be struck at the most competitive industry rate available. The opportunity to derive efficiencies from these services will only become available if the service/works are ongoing and when the contact comes up for renewal.

A similar argument may exist for the major expenditure items that are not directly controllable by Melbourne Water. Examples may include labour, materials, fees and charges. Melbourne Water is essentially a price taker in a large market place and the application of an efficiency factor to these pass-through costs would be inappropriate and may represent a "double-dip" in effect.

Melbourne Water notes that, more generally, it supports the use of benchmarking studies that are undertaken for business improvement purposes and continues to monitor innovation both within and outside the water industry and participate in benchmarking studies where appropriate. In this regard, since the 2005 Water Plan process Melbourne Water has participated in a number of benchmarking studies. This includes studies with multiple participants and others involving direct one on one comparisons with other water businesses overseas that have been identified as employing best practice. Melbourne Water considers that both forms of benchmarking are relevant and will provide further information on the results of these studies in its draft 2008 Water Plan.

4. Assessing capital expenditure

The Commission's initial position is that:

- Capital expenditure forecasts will be assessed by examining historical actual expenditure associated with baseline or business as usual levels of services. Expenditure related to new obligations, functions or service level improvements will be considered separately
- Any review of the prudence and efficiency of capital expenditure incurred in the first regulatory period will be by exception, particularly where actual costs are significantly higher than forecast and outcomes have not been delivered without sufficient reason
- The drought and efforts to improve security of supply will have led to changed priorities and impacted on the capital expenditure forecasts for a number of businesses. Therefore, in some circumstances the departure of actual expenditure from that forecast may be readily explainable without the need for detailed review.

Definition of new obligations and assessing forecasts

As noted above in the comments in Section 3, Melbourne Water will provide disaggregated information on the expenditures (capital and operating) associated with obligations which came into effect from 1 July 2005 and which were not included in the 2005 Water Plan.

Assessing capital expenditure over the first regulatory period

Over the 2005 regulatory period, Melbourne Water's priority has been to deliver on its targets and maintain its required levels of service. In achieving these outcomes, actual capital costs for some of its projects have been higher than the forecasts detailed in the 2005 Water Plan. There are a variety of reasons for this higher than anticipated level of expenditure, including new obligations, greater information that enables capital cost estimates to be refined, improved cost estimation and process approvals. Melbourne Water welcomes the opportunity to provide greater detail to the Commission on these matters.

On a related issue, the Commission has proposed updating the regulatory asset base using actual capital expenditure, when available, as well as capital forecasts from the 2005 Water Plans. This will mean the 2007/08 capital expenditure forecasts from 2005 Water Plan will be used in updating Melbourne Water's regulatory asset base. Given that more robust forecasts are now available, taking into account information that was not available at the time of the 2005 Water Plan, Melbourne Water considers these updated forecasts are a more appropriate basis for updating the asset base.

5. Efficiency carryover mechanism

The Commission's initial position is that:

- Applying an efficiency carryover mechanism for the first regulatory period may have limited impact for most businesses. Therefore, there is little merit in applying an efficiency carryover mechanism to the first regulatory period
- It is likely that forecasts for the second regulatory period will be more robust and the longer period provides greater incentives for businesses to pursue efficiencies.

Melbourne Water believes it is inappropriate to apply an efficiency carryover mechanism to the 2005 and 2008 regulatory periods given the uncertainty surrounding forecasts.

Melbourne Water agrees with the Commission that there is little merit in applying an efficiency carryover mechanism to the 2005 regulatory period, particularly given the uncertainty surrounding forecasts for the 2005 regulatory period and the changed operating environment and priorities for the industry.

In terms of the 2008 regulatory period, Melbourne Water notes that the operating environment will continue to be unstable with the potential for ongoing drought and possible changes in demands as well as legislative and government obligations. This will mean continuing uncertainty around forecasts and accordingly Melbourne Water

does not consider that an efficiency carryover mechanism should be applied to the 2008 regulatory period.

In the event the Commission decides to implement a carryover mechanism, Melbourne Water considers that:

- Businesses should have certainty at the start of the period as to whether the efficiency carryover will apply or not
- It should only apply to operating expenditure
- Efficiency losses should not be carried over.

The Consultation Paper indicates that the Commission may implement a carryover mechanism. To enable businesses to build these incentives into their operating and capital expenditure planning over the entire regulatory period, Melbourne Water considers there should be clear direction at the start of the period as to whether an efficiency carryover will apply and how it will be applied.

Melbourne Water also considers that it is inappropriate to apply the efficiency carryover mechanism to its capital program given it is characterised by a relatively small number of large projects which are often at the early stages of the planning process when prices are set.[11] Changes in the scope, timing or cost of these projects would have a material impact on Melbourne Water's overall expenditure. The lumpiness of Melbourne Water's capital program can also limit the opportunities to reprioritise or achieve efficiencies in delivering other projects to offset significant cost increases. A more appropriate alternative approach is for the Commission to look for appropriate substantiation of the instances where there are major variances from planned expenditures as part of rolling forward the regulatory asset base at the next price determination.

A further issue if an efficiency carryover is implemented, is the treatment of efficiency losses over regulatory periods. While carrying over net losses should encourage businesses to maintain efficient performance throughout the entire regulatory period, it will also reduce the revenue available to businesses and may cause service quality to be run down over time. This will impact on customers and would be counter productive if the efficiency losses were driven by circumstances external to the business. In this case, a more appropriate approach would be to set to zero any carryover where there are efficiency losses.

6. Service factor incentive mechanism

The Commission's initial position is that:

- A service factor (s-factor) mechanism will not be implemented across the water sector, but may be applicable to some businesses on a case-by-case basis.

Melbourne Water does not consider that a s-factor mechanism should be implemented during the second regulatory period.

[11] For example, current estimates suggest that 7 projects account for approximately 45 per cent of planned capital expenditure over the 2008 regulatory period.

Melbourne Water already achieves a high level of compliance with its service targets, meaning that a s-factor mechanism would not be a significant driver of additional service performance.

7. Tariff structures – bulk water and sewerage

The Commission's initial position is that:

- In assessing proposed prices against the WIRO it is proposing to be guided by three overarching considerations:
  - Proposed prices should be constructed in a way that is consistent with the objectives of demand and supply strategies
  - In meeting demand and supply objectives, proposed prices should aim to provide adequate signals to customers
  - Proposed prices need to have consideration for their impact on customers.

Melbourne Water supports the overarching considerations that the Commission will adopt in assessing proposed prices, in particular that prices should be consistent with the objectives of the Water Supply and Demand Strategy.

This said, it notes that while the objectives of the strategies will remain broadly the same, the detail behind these strategies may change and evolve. Further, there are other Government policies that are relevant to tariff structures, including those that form part of the Government's White Paper, Our Water Our Future, the Bulk Entitlements and the Trade Waste Review.

8. Urban tariffs – bulk water and sewerage

The Commission's initial position is that:

- Inclining block tariffs can play a role in providing signals to residential customers regarding sustainability. The Commission has a number of concerns regarding the application of inclining blocks to non-residential customers. However, the Commission believes there are options for more innovative tariff structures for non-residential customers that should be considered. One such option is to relate tariffs to differing categories of customers.

The Commission has invited comment on its initial position. Melbourne Water notes that this section of the Consultation Paper did not provide any views in relation to the pricing of bulk water and sewerage services. Key pricing issues for these services include ensuring that:

- Variable charges send clear signals in relation to the relative cost drivers
- Melbourne Water's charges recover costs and enable the retail water businesses to make their own assessments as to the mix of price and non-price measures that most effectively change the behaviour of end customers, including the conservation of water
- Charges are based on robust and improved cost allocation modelling

- Charging structures, and particularly the mix of fixed and variable charges, ensure cost recovery in an environment of demand restrictions and therefore revenue uncertainty
- Charging structures provide incentives for the sustainable use of metropolitan Melbourne's water and sewage resources.

9. Recycled water tariffs

The Commission's initial position is that:

- There is merit in establishing a set of standard tariffs for recycled water to apply in typical residential subdivisions. There is also merit in continuing the pricing principles approach currently adopted for non-residential or unique (one-off) customers
- Pricing principles need to be amended to reflect recent policy and legislative developments. Principles should make direct reference to cost. For example, principles may state the prices must not exceed the full efficient cost of providing the service.

Melbourne Water considers it appropriate that its recycled water tariffs are developed consistent with a set of pricing principles, which include cost reflectivity.

Melbourne Water notes that it does not supply a homogenous recycled water service. Its customers have a diverse set of quality and quantity requirements, resulting in different cost based prices. It should also be noted that Melbourne Water's customers are relatively well informed and have a choice as to whether to use recycled water or not.

At this stage, Melbourne Water has agreed with the metropolitan retail water businesses a set of pricing principles for bulk recycled water services. Supplementing the principles employed by the Commission in the 2005 regulatory period, these are that:

- Prices must reflect the total costs of recycling over and above any sewerage treatment and disposal requirements
- Specific costs for projects will be allocated to the relevant retail business and where there are shared assets that service more than one retailer specific project, the costs will be allocated according to recycled water volumes
- For projects that are not specific to a retail business, and where there is a revenue shortfall, the shortfall will be recovered via:
    - Water tariffs for projects that are designed to maintain system demand / supply balance
    - Tariffs for projects that are designed to meet the 20 per cent recycling target or EPA discharge obligations (unless there is a benefit to customers through potable water substitution, in which case a weighting between water and sewerage needs to be determined)
    - Sewerage tariffs for projects whose costs are driven by sewerage treatment and disposal obligations and the benefits are external to the Melbourne system

as the mechanism to enforce beneficiary pays does not exist. These shortfalls should be spread across the whole metropolitan system, not just those retailers serviced by that treatment plant.

Recycled water prices should also be established in the context of water prices from other sources such as potable supply, ground water and river diversions.

10. Miscellaneous service tariffs

The Commission's initial position is that:

- Prices and how they are applied should be clearly defined, including a definition of the service being provided. Prices proposed for miscellaneous services should address the following principles:
  - Prices should be consistent with the broader objectives of the business
  - Prices should be effective in providing adequate signals to customers
  - Proposed prices need to have consideration for their impact on customers
- There may be opportunities to rationalise the number of miscellaneous services being offered, either by offering some miscellaneous services as part of the main water or sewerage service, of combining certain miscellaneous services at the same price. One of the benefits of rationalisation is that it would provide for relatively simpler administration.

Melbourne Water considers that broad pricing principles are appropriate for miscellaneous charges and that where possible there are common and clear definitions of services. There should also be flexibility to introduce new miscellaneous charges within the 2008 Water Plan period.

Where possible, Melbourne Water supports common and clear definitions of miscellaneous services and is prepared to work with other water businesses to achieve this outcome. However, given the nature of Melbourne Water's business, there will be instances where its miscellaneous services are unique and ensuring commonality will not be possible (e.g. drainage services).

In relation to pricing, Melbourne Water considers that broad pricing principles are appropriate for miscellaneous charges and that there should be regulation by exception where customers have concerns. The principles would include cost reflectivity and administrative simplicity, as suggested by the Commission, which would support clear and transparent pricing for customers.

Melbourne Water considers there will be limited opportunities to rationalise its miscellaneous charges. This is because its charges are for unique and quite differentiated services and have been put in place to send clear signals to customers about the costs of those services. Further, Melbourne Water does not support the idea of incorporating some, or all, of the miscellaneous costs into water or sewerage prices. This would mean that clear signals would not be sent to customers about the costs of particular services, that some customers would be paying more than they otherwise would, and it could lead to inappropriate over use of the services.

Finally, Melbourne Water considers there is a need to maintain the flexibility that would enable it to introduce new miscellaneous charges once the 2008 Water Plan period has commenced. This would ensure that businesses can continue to innovate the way in which services are provided and still have the ability to send cost reflective price signals to customers.