Yarra Valley Water | a fresh approach

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Mr Greg Wilson
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Level 2, 35 Spring Street
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Dear Greg

Yarra Valley Water response to ESC Guidance on Water Plans

Yarra Valley Water welcomes the publication of the Commission's Consultation Paper on the proposed framework and approach to be applied in the 2008 Water Price Review. Broadly, Yarra Valley Water sees considerable merit in the Commission providing a clear and comprehensive description of the framework and approach that it proposes to adopt in the forthcoming water price review. It is important, however, that in the process of providing this clarification, the Commission keeps an open mind on key issues including, in particular, the regulatory arrangements that would best facilitate the efficient management of risks that are beyond the reasonable control of the water companies.

This letter sets out Yarra Valley Water's comments in response to the Consultation Paper. The Company's comments relate mainly to its concerns regarding the approach taken within the regulatory framework to manage the considerable uncertainty now facing the water sector. Other matters are also addressed. Our comments are set in further detail under separate headings below.

1. Dealing with uncertainty

In its submission to the Commission's September 2006 Guidance, Yarra Valley Water noted that uncertainty relating to the potential impacts of an extended drought and water restrictions has a significant bearing on a number of important matters including:

- the length of the regulatory period;
- the form of the price control;
- demand forecasts; and
- regulatory arrangements for dealing with unforeseen events.

Yarra Valley Water expressed a keen interest in exploring how the prospect of continuing drought might affect the efficient management of revenue risk and cost risk over the forthcoming regulatory period and beyond. The Company noted therefore, that as part of the forthcoming water review, it will be important for the Commission to consider the regulatory mechanisms that can mitigate the revenue and cost impacts of events (such as drought) that are clearly beyond the Company's control. Yarra Valley Water continues to hold these views.

In relation to these matters, the Consultation Paper makes the following points (on pages 12 and 14):

- The Commission considers that it is appropriate to move to a five year regulatory period on the basis that the benefits from moving to a longer period, in particular the reduction in the administrative burden and costs on the businesses and the Commission, are likely to outweigh any costs.

- The Commission acknowledges that the proposed move to a five year regulatory period and the current drought conditions may raise concerns about the ability of businesses to manage the additional costs associated with uncertainty going forward.

- The Commission considers that there is sufficient scope within the regulatory framework to deal with issues related to uncertainty or unforeseen events or other challenges that might be identified by stakeholders.

In describing the arrangements within the regulatory framework that would enable these issues to be addressed and managed, the Consultation Paper (on page 17) points to the arrangements put in place in the 2005-2008 Water Price Determination, as follows:

> "Rather than propose a specific mechanism for dealing with catastrophic events, the Determination for each water business provides for the Commission to amend the Determination or adjust prices where it is necessary or desirable to avoid an unintended consequence of the Determination. If a catastrophic event occurred which significantly threatened a business's financial viability, the Commission would consider this to be an unintended consequence of the Determination. Accordingly, it would use its discretion under this clause to decide whether to amend the Determination or adjust prices during the regulatory period.
>
> This provision also provides the Commission with 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."

The Consultation Paper (on page 19) then sums up the Commission's initial position on the length of the regulatory period and related risk management matters as follows:

> "The second regulatory period should be set at five years from 1 July 2008 until 30 June 2013.
>
> The Commission expects that businesses will reprioritise projects and programs in consultation with customers should priorities change over the regulatory period or as the 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.
>
> The Commission considers that there is merit in introducing an 'L factor' mechanism to adjust prices to reflect the change in licence fees on an annual basis.
>
> 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."

Yarra Valley Water welcomes the Commission's recognition of the water companies' legitimate concerns about uncertainty in the context of the present unprecedented drought. The Company also welcomes the Commission's recognition of the need for the regulatory framework to deal with uncertainty.

In addition, Yarra Valley Water strongly agrees that there would be merit in having cost pass-through arrangements for major projects. Consideration should be given to ensuring that such pass-through arrangements permit the recovery of costs of any unforeseen major projects that arise within a regulatory period as well as the costs of those that were under consideration by Government or other regulators at the time of the determination.

However, Yarra Valley Water does not consider that the issues relating to uncertainty and the mitigation of risk (through the adoption of a shorter - say, three year - regulatory period) have been assessed in sufficient detail at this time to warrant the adoption of a five year period by the Commission. In addition:

- Yarra Valley Water notes that the suggested reprioritisation of projects and programs is unlikely to be sufficient to offset the potentially significant financial impacts of events such as prolonged drought.
- Yarra Valley Water does not consider that risk mitigation mechanisms that rely heavily on the application of regulatory discretion are necessarily the most effective, as the outcomes delivered by such arrangements are themselves difficult to predict.

In this context, the Company considers that there are a number of different approaches that are worthy of the Commission's further careful examination. These include, but are not necessarily limited to:

- adoption of a three year regulatory term for the period commencing in July 2008;
- adoption of a five year period, but with a scheduled mid-term review (conducted, say, at year three) to assess the impact of a pre-defined set of factors that may include:
    - variations between actual and forecast expenditure where these exceed a defined material threshold (with adjustments then made to expenditure benchmarks for the remaining years of the regulatory period to reflect those variations); and
    - variations between actual and forecast demand and / or revenue (with adjustments then made to demand forecasts and allowed prices for the remaining years of the regulatory period to reflect those variations);
- adoption of objective "off-ramps" or "triggers" for a re-opening of a price determination at any time. An example of a possible trigger is:
    - positive or negative variations (greater than a defined threshold) between forecast and actual demand or forecast and actual revenue.

We discuss demand forecasting in section 2 below where we present the sensitivity of profit to demand-driven changes in revenue. We would welcome a further discussion with the Commission on what level the threshold should be set.

On the question of the form of the price control, the Consultation Paper stated (on page 14):

> "A number of urban businesses have also suggested that the impact on demand and hence revenue of the current drought has implications for the form of price control adopted. In the 2005 urban price review the

> Commission expressed the view that individual price caps are administratively simple, less costly and best meet the requirements of the WIRO. The Commission's preference is for individual price caps to be adopted in the second regulatory period for urban businesses. 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."

Yarra Valley Water does not consider that the question of the form of the price control has been given sufficient consideration at this time to warrant the continuation of individual price caps into the next regulatory period.

In this regard it is noted that Yarra Valley Water made the following points in its response to the Commission's September 2006 Guidance:

- There is heightened uncertainty surrounding demand forecasting at a time of extended drought and climate change[1]. The Commission's comment (on page 31 of the Guidance) that "rigorous demand forecasts are somewhat less important in the case of a revenue cap" had been read by the Company as suggesting the possibility of a revenue cap as a way of addressing demand forecasting uncertainty.

- The Company is interested in exploring further the suitability of revenue capping.

- The Company urges the Commission to keep an open mind on the issue of the form of the price control, notwithstanding the position it adopted on this matter in the 2005-08 Urban Water Price Review.

Yarra Valley Water remains strongly of the view that in the present circumstances, a revenue cap form of control has considerable merit. The Commission will also be well aware of the merits of the tariff basket form of control, having applied that form to both the gas and electricity sectors in Victoria following extensive consultation and analysis. Both of these forms of control encompass arrangements that may facilitate efficient management of demand-related revenue risk by the water companies. It is important that the water companies be given every reasonable opportunity to manage that risk (through a range of measures, including suitable price control arrangements) particularly in light of the following views expressed on page 15 of the Consultation Paper:

> "The Commission has previously outlined a preference for not adjusting prices to reflect demand related events (including the loss of major customers and the impact of drought)."

Yarra Valley Water considers that it is premature for the Commission to express a preference for individual price caps. The merits of alternative forms of price control, particularly in the context of on-going uncertainty regarding the drought and climate change should be carefully examined during the forthcoming water price review.

2. Demand forecasting

The Consultation Paper states that expenditure and demand forecasts "should be based on best estimates for the period given the known obligations".

As noted above, in the present context of prolonged drought and climate change, there is unprecedented uncertainty associated with forecasting future demand. This uncertainty is exacerbated by the potential

[1] Issues relating to demand forecasting are discussed separately below.

impact on demand of price rises that are likely to be required to fund planned supply side and network infrastructure works over the forthcoming regulatory period.

The critical uncertainties when forecasting demand for the coming price period are around:

- The uptake by customers of initiatives such as the showerhead exchange program;
- Customers reaction and adherence to restrictions;
- Price elasticity of demand and the impact of a significant price increase; and
- Customer response to tariff changes.

Each of these items on its own can provide a range of outcomes for demand. It is difficult to determine a best estimate for them individually. The showerhead exchange program and possible longer term restrictions are entering new territory. Studies examining price elasticity of demand for water show a wide range of response by customers.

It is also hard to predict the degree to which these elements will interact. Practical demand management actions, such as restrictions and the showerhead exchange program, will to a greater or lesser extent tighten the scope for price signals to affect demand. Conversely, higher prices may encourage greater than expected uptake of showerheads as customers seek ways to lower their bills.

The importance of forecasts that take account of uncertainty, and measures to mitigate its impact, is shown by Figure 1 below. The chart below illustrates the clear relationship between demand and revenue and profit. As expected, revenue and profit are sensitive to the amount of water sold. The effect is becoming more pronounced. It is obvious that overestimating future demand will create a shortfall in revenue and profit.

Figure 1

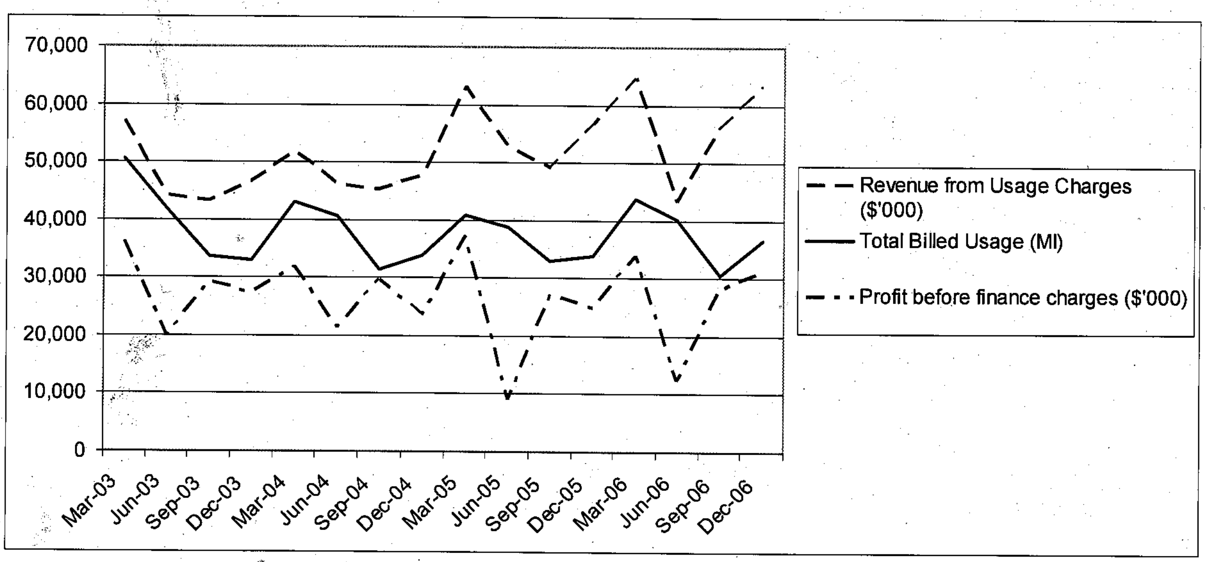
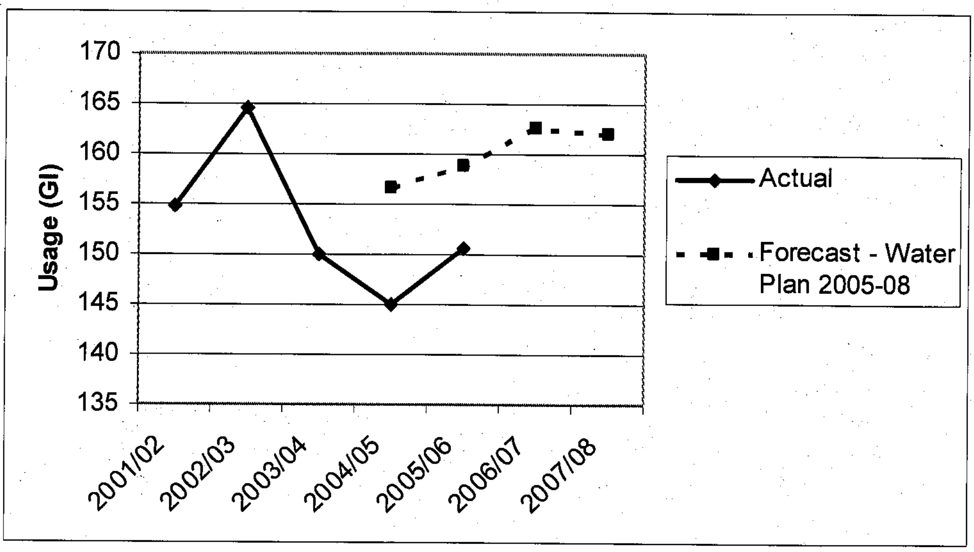


Figure 2 shows that, despite best estimates in the Water Plan for 2005/06 to 2007/08, the forecast annual demand is overestimated compared to actual usage for the past two years. The pattern is likely to be repeated in 2006/07.

Figure 2



Yarra Valley Water will use the end use model (EUM) approach to demand forecasting for residential customers, breaking it down into the components of indoor and outdoor use. The company will also look at trends in demand, including comparison of actual 05/06 to 06/07 demand with the first water plan forecasts. Forecasts for non-residential customers are based on the characteristics of defined classes and the programs in place to help them reduce demand.

The Company will examine these forecasts and determine the uncertainties surrounding them. It proposes to undertake a Monte Carlo simulation exercise to model the expected demand outcome. This will provide a prudent view of an allowance for uncertainty.

Yarra Valley Water is confident that its approach will satisfy the Commission's requirement that demand forecasts should be based on best estimates, in light of the unprecedented ongoing uncertainty associated with the drought and climate change.

3. New Customer Connection (NCC) charges

The Commission proposes that the present cap on customer contributions be increased up to $1000 per lot for water and $1000 per lot for sewerage. It is noted that this cap is a nominal amount, and does not necessarily reflect the incremental costs attributable to new developments in different locations across Yarra Valley Water's service territory.

Page 88 of the Consultation Paper states:

> "The Commission considers that customer contributions should provide appropriate signals about the costs associated with connecting to the existing network at one location relative to another."

Yarra Valley Water concurs. There are three major development corridors in Yarra Valley Water's territory, and the approximate incremental (that is, avoidable) costs of servicing new development averaged across these corridors can be reasonably estimated from information presently available. Further, infill development can cause spare capacity created by reduction in demand from existing customers to be fully and/or over utilised resulting in the need for augmentation of the network.

In addition to water and sewer NCCs, Yarra Valley Water proposes to introduce recycled water NCCs. The installation of third pipe infrastructure to service new development increases the marketability of an estate and "drought proofs" its residents. As the combined cost of providing water, sewer and recycled infrastructure is greater than the cost of providing sewer and water infrastructure to a like development and the with the price of recycled water being set at block 1 potable water price, the developers should pay the cost of providing the additional infrastructure.

The table below provides an indication of the New Customer Connection (NCC) charges that would apply to development under a more cost-reflective charging approach.

Development corridor	Indicative NCC charge ($ per lot)		
	Water	Sewerage	Recycled Water
Infill development	$100	$5,000	Not applicable
Greenfields	$5,000	$11,000	To be calculated

The following key principles underpin the indicative prices shown above:

- Infill Development - The existing customer base is reducing their demand for water and sewerage services and thus the augmentation of the systems are required to service growth. This is particularly relevant for principle and major activity centres where redevelopment will cause overloading of the existing systems

- Greenfield Development - Consumption decisions of existing customers cannot influence the location of or need for expansion of the network for new customers and thus such expansion is only required to service growth

- Developers of lots created over the five year regulatory period pay the average capital cost of providing infrastructure to service growth

- Sunk assets, headworks and tailworks are not included in the calculations

Yarra Valley Water would be pleased to provide the Commission with further information regarding this matter, at the Commission's request.

The Company notes that the Victorian Water Industry Association (VicWater) had discussions with Greg Wilson and Sean Crees on 9th February 2007 and has proposed that an industry submission on this topic be prepared. In an effort to reach a satisfactory outcome on NCCs, Yarra Valley Water is generally supportive of an industry approach.

4. Efficiency carry-over

Page 54 of the Consultation Paper states:

"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."

Yarra Valley Water favours the application of an efficiency carry-over mechanism for the regulatory period commencing in 2008. However, the Company recognises that any mechanism should be robust. In particular, the rules governing the application of the mechanism should be clearly specified before it comes into effect.

The Company is concerned about its position on capex at the end of the 2005/06 to 2007-08 period and how this will impact on the next period. Forecast actual capex in 2007-08 is likely to be significantly in excess of the forecast in the price determination. The Commission has said that it will base its view for the next period using the price determination forecast rather the latest information. This would have a negative impact on the Company as it would carry the difference for five years, through the next period, before it could start to earn a return that part of the capex. Yarra Valley Water would like to discuss tis issue further with the Commission and believes it would be useful in establishing the principles for a carry-over mechanism.

5. S-factor mechanism

Yarra Valley Water notes and accepts the Commission's proposal to not implement an S-factor mechanism across the water sector. The Company considers that the effort and resources involved in designing and implementing an effective S-factor mechanism at this time would be more gainfully allocated to addressing the many other more pressing challenges facing the sector in the forthcoming regulatory period.

6. Expenditure forecasting

The Consultation Paper states (on page 41) that:

"The Commission's preferred approach is to assess proposed capital expenditure forecasts by using trends in historical expenditure to consider the business as usual level of service, and to consider separately the costs associated with any additional obligations, functions or service levels. The purpose of distinguishing between expenditure on new obligations and business as usual expenditure is to identify clearly the extent to which price increases are the result of additional requirements imposed through regulatory obligations and/or customer driven service improvements."

This approach appears to differ somewhat from that foreshadowed in the September 2005 Guidance, which said that businesses would be required to substantiate their capital expenditure forecasts in terms of the key drivers of expenditure. The Commission will be well aware that investment in water infrastructure typically occurs in large, infrequent increments. The recent past level of capital expenditure does not necessarily provide any meaningful guide as to the immediate future requirements. In addition, the asset renewal and replacement capital expenditure requirements will reflect the age, condition and risk of key assets; again these cost drivers may vary substantially from one regulatory period to the next.

In view of these considerations, Yarra Valley Water is concerned that the approach to assessing capital expenditure forecasts foreshadowed in the Consultation Paper may place inappropriate weight on recent historical levels or trends in capital expenditure. For the reasons noted above, such an approach would be inappropriate.

The Commission proposes to assess operating expenditure with reference to "business as usual" expenditure requirements, and additional expenditure requirements associated with new obligations. In principle, Yarra Valley Water accepts that this is a reasonable approach, however it will be very important for the Commission to ensure that its assessment of "business as usual" expenditure requirements for the future takes appropriate account of increasing expenditure requirements driven by compliance obligations under standards that exist today. For example, implementation of the Central Region Sustainable Water Strategy will be classed as a "business as usual" obligation. However, implementation of the Strategy involves a ramping up of expenditures over a number of years in the future. Indeed, as shown in the table below, the Strategy sets out input-based obligations on Yarra Valley Water that involve an increasing volume of work and expenditure in future years.

Action	**Potential Expenditure to 2015**
Shower head replacement	$32Ml
Washing machine rebates	$27M
Single flush toilets	$59M

Clearly, the concept of "business as usual" in terms of obligations does not necessarily entail static operating cost levels. This important consideration should be properly taken into account in the Commission's assessment of "businesses as usual" expenditure requirements.

Yarra Valley Water looks forward to working constructively with the Commission and all other stakeholders over the course of the forthcoming water price review.

Should you have any further queries in relation to the matters raised in this response, please contact Brett Mathieson (Manager, Regulation and Planning) on 9872 2441.

Yours sincerely

Tony Kelly
MANAGING DIRECTOR