



City West Water™

City West Water Corporation

ABN: 70 066 902 467

1 McNab Avenue
Footscray Vic 3011 Australia

Locked Bag 350 Sunshine Vic 3020
DX 30311 Sunshine

citywestwater.com.au

Telephone (03) 9313 8422

Facsimile (03) 9313 8417

2 May 2016

Marcus Crudden
Director, Water
Essential Services Commission
Level 37
2 Lonsdale Street
MELBOURNE VIC 3000

Dear Marcus,

Response submission to the Melbourne Water 2016 Price Review Draft Decision

City West Water is pleased to provide comments on the Commission's *Melbourne Water Price Review 2016 Draft Decision* (2016 Draft Decision). We focus these comments on aspects of the Melbourne Water (MW) pricing proposal that affect bulk water and sewerage services and their associated charges. Our analysis concludes that retail tariffs under the 2016 Draft Decision would have only small savings to end-use customers – in the order of CPI-0.5% or \$5 per annum off the typical residential bill. We believe there is an opportunity for the Commission to provide more substantial bill relief to retail customers – particularly through an appropriate level of capitalisation of desalination security payments.

Aspects of the 2016 Draft Decision we support

We support, in principle, the Commission's review and findings in relation to:

- MW's proposed capital and operating expenditures
- a transition from a point in time estimate to a trailing average cost of debt
- revised MW proposal that addresses the concerns raised by the Commission regarding an appropriate historic debt series.

We are supportive of the Commission's findings on MW's proposed tariff reforms, but seek clarification on the Commission's 2016 Draft Decision on the standalone wholesale variable tariff that is to apply to desalination water order costs. Retail water corporations hold bulk entitlements to the desalination plant and their allocation accounts will be credited water volumes based on these entitlements. We expect retailer payments for desalinated water to align with water allocated under these bulk entitlements, which would imply each retailer would face a fixed share of the desalination water order cost, rather than facing some adjustment to the wholesale variable price. Appropriate volumetric signal to end-use customers would continue to be provided under the retailers' 2013 determinations.

Aspects of the 2016 Draft Decision we believe the Commission should revise – desalination capitalisation

We are disappointed with the 2016 Draft Decision's brief consideration of desalination security payment capitalisation and with the level of capitalisation approved. We were not expecting this outcome for the 2016 Price Review with desalination capitalisation having been the foremost issue in the 2013 Price Review, with the Commission devoting considerable time and effort to it at that time. In its 2013 Final Decision, the Commission took a strong principles-based position on capitalisation including taking the unprecedented step of issuing MW a three-year determination in order to examine the issue more fully in 2016.

We believe that it is beneficial to recap the Commission's prior consideration of capitalisation in order to fully understand the matters we think should be under consideration by the Commission.

The Commission's previous consideration of desalination capitalisation

To review that history, we refer below, in chronological order, to key documents forming part of the 2013 Price Review. Firstly, in its October 2012 submission, MW proposed no capitalisation of desalination security payments on the basis that it had a legal-contractual obligation to make payments in full under the Water Interface Agreement¹. In addition to this argument, MW stated²:

"Melbourne Water does not support spreading of VDP costs over 50 years. While it may result in lower initial prices, it is likely to impact on service levels or will significantly increase borrowings, which is counter to maintaining safe and reliable services and sound financial governance on behalf of the community."

In its 2013 Draft Decision, the Commission rightly decoupled MW's obligation to make desalination security payments from how those funds should be recovered from end-users over the life of the desalination plant. As such, the Commission found that MW's proposal had not sufficiently demonstrated consideration of viable options for the recovery of desalination security payments including consideration of those options against the relevant legislative and regulatory instruments that govern the economic regulation of the water sector. In its 2013 Draft Decision the Commission stated³:

¹ Section 3, 'Supplementary information to 2013 Water Plan Submission', Melbourne Water, 2012

² Section 6.3, '2013 Water Plan', Melbourne Water, 2012

³ Section 6.7.2, '2013 Metropolitan Water Price Review Draft Decision', ESC, 2013

“Based on the evidence before it, the Commission is not satisfied that the proposed prices take into account the interests of customers (including low income and vulnerable customers) or provide appropriate incentives and signals to retailers and end-use customers (or potential customers) about the sustainable use of Victoria’s water.”

Further, the Commission requested that MW submit a capitalisation proposal, stating⁴:

The Commission requires Melbourne Water to resubmit its pricing proposal for the recovery of its desalination security payments demonstrating that it has taken into account the requirements of the WIRO, the Water Industry Act and the Essential Services Commission Act. In doing so, the Commission encourages Melbourne Water to consult with the water retailers, end-use customers and relevant representative bodies.

As part of its 2013 review, the Commission engaged Deloitte to assess MW’s ability to capitalise desalination security payments. Deloitte conducted a comprehensive financial review and stated in its resulting report⁵:

We note that based on the cash flow cover ratio, Melbourne Water could absorb a 15% (the equivalent of capitalising \$95m in FY14) capitalisation and still maintain interest cash cover ratios of greater than 1.5x. Debt and gearing, although high, is relatively stable at these levels, and the FFO ratios show a small but steady improvement over time.

Further, Deloitte noted that even higher levels of capitalisation were possible under certain circumstances. Notably⁶:

Capitalisation of a greater amount, (say, in the range 20% to 40%) could be contemplated in certain circumstances – for example if there was more certainty around the level of government support or if revenue risks were eliminated through the adoption of a revenue cap which placed volume risk on the retailers⁷). However, in the absence of this we would not recommend such a scenario at this time.

In response to the Commission’s 2013 Draft Decision findings, MW undertook end-user consultation and proposed a preferred capitalisation scenario. This scenario proposed capitalisation starting in 2015-16 at \$22.5m and increasing to \$72.5m per year by the end of the period and remaining at that level into the fourth regulatory period as follows⁸.

	2013-14	2014-15	2015-16	2016-17	2017-18	TOTAL*
Capitalisation \$m, 2013	-	-	22.5	45	72.5	140.0

* For the 3rd regulatory period only

⁴ Section 6.8, ‘2013 Metropolitan Water Price Review Draft Decision’, ESC 2013

⁵ Section 4.4, ‘ESC Desalination Plant Capitalisation Scenarios Assessment’, Deloitte, 2013

⁶ Section 4.4, ‘ESC Desalination Plant Capitalisation Scenarios Assessment’, Deloitte, 2013

⁷ CWW notes that MW’s 2016 proposal to move to fixed headworks charges based on retailer entitlements does not remove a significant portion of MW’s revenue risk

⁸ Table 1, ‘Response submission to the ESC’s draft decision’, Melbourne Water, 2013

In summarising the key points of this preferred capitalisation scenario, MW stated that the proposal⁹:

*Responds to the ESC's [2013] draft decision by putting forward a proposal to capitalise a material amount (\$140M) over the last three years of the 2013 Water Plan period. This proposal is consistent with the WIRO requirements, and in terms of the capitalisation approaches **best manages the trade-off between taking into account the interests of customers, providing appropriate pricing signals and providing a sustainable revenue stream for Melbourne Water.** (emphasis added)*

Following MW's response submission, the Commission again engaged Deloitte, this time to review the MW proposal. However, on the basis of the information provided to it by MW, Deloitte found it was unable to definitively establish a firm level of capitalisation. Referring to this finding by Deloitte, the Commission stated in its 2013 Final Decision¹⁰:

Based on the analysis of Melbourne Water's data that has been possible in the time available, the Commission is satisfied that capitalisation will become increasingly sustainable from 2016-17. However, due to the quality of the data submitted, the Commission has not been able to form a view with sufficient confidence about the amount of capitalisation that will be possible from that date.

In relation to MW's consultation with end users and stakeholders, the Commission noted that¹¹:

The Commission considers that Melbourne Water attempted to consult as much as possible in the limited time available since the Commission's [2013] draft decision, when the Commission indicated it was not satisfied with the quality of analysis Melbourne Water had submitted in its Water Plan.

However, the Commission also stated¹²:

The Commission also considers that the capitalisation options presented to customers were limited due to the exclusive priority Melbourne Water placed on satisfying financial conditions such as maintaining a profit in each year of the next regulatory period.

....

For these reasons, the Commission considers the focus group findings, while of interest, cannot be relied upon to represent end-use customer views regarding the merits or otherwise of inter-period smoothing of Melbourne Water's desalination security costs.

As such, given:

- the Commission's broad concerns with MW's proposal, including the limitations of the consultation
- the information made available to Deloitte, and

⁹ Page 21, 'Response submission to the ESC's draft decision', Melbourne Water, 2013

¹⁰ Section 3.4.2, 'Price Review 2013: Greater metropolitan water businesses, Final Decision', ESC, 2013

¹¹ Section 3.2.1, 'Price Review 2013: Greater metropolitan water businesses, Final Decision', ESC, 2013

¹² Section 3.4.1, 'Price Review 2013: Greater metropolitan water businesses, Final Decision', ESC 2013

- the 'conditional' nature of MW's capitalisation proposal,

the Commission rejected MW's proposed approach and approved prices excluding capitalisation for a three year period only. Further, the Commission concluded its coverage of desalination capitalisation in the Final Decision as follows¹³:

"For the avoidance of doubt, the Commission considers that the interests of customers (including low income and vulnerable customers) are best supported by Melbourne Water smoothing the recovery of its desalination security payments over a period that matches the plant's life. This is consistent with the principle that customers contribute to the cost of assets as they receive the benefits of those investments." (emphasis added)

In summary, and as is evidenced by the excerpts above, the Commission took an authoritative, pro-active and principled approach to capitalisation in its 2013 Price Review with the intention of smoothing payments to provide for intergenerational equity – consistent with the legislated objective of the Commission to protect the long term interests of Victorian consumers¹⁴.

The 2016 Price Review

The Commission's previous authoritative, pro-active and principled approach to capitalisation is not evident in the 2016 Price Review Draft Decision. However, given the contentious nature of capitalisation in the 2013 Price Review, the Commission did provide explicit advice to MW in its 2016 Price Submission Guidance that, MW 'must' provide an approach to the recovery of desalination security payments that 'best meets' the objectives of¹⁵:

1. providing price signals that reflect the efficient costs of providing services to current and future customers,
2. aligning the recovery of costs by Melbourne Water with the time period over which the security service will be provided,
3. considering the views of customers, and
4. consistent with the continued financial viability of Melbourne Water.

In its October 2015 Submission, MW proposed \$20m per annum in capitalisation from desalination payments in excess of \$500m per year. In our February 2016 comments to the Commission on MW's Submission, we stated that we were unable to determine how MW had concluded that \$20 million capitalisation satisfied the Commission's guidance¹⁶.

¹³ Section 3.4.2, 'Price Review 2013: Greater metropolitan water businesses, Final Decision', ESC, 2013

¹⁴ Section 8, *Essential Services Commission Act* (Vic.)

¹⁵ Section 4.7.1, 'Melbourne Water 2016 price review guidance paper', ESC, 2015

¹⁶ Page 4, 'Submission to MW's 2016 Price Submission', City West Water 2016

In March 2016, the Commission issued its 2016 Draft Decision approving MW's \$20m capitalisation proposal. However, we believe that many of the Commission's 2013 findings in relation to MW's 2013 Water Plan capitalisation proposal could equally apply to MW's 2016 Price Submission capitalisation proposal – for example, the presentation of limited options for consideration in consultation. Further, the Commission has apparently not sought important information such as that provided by Deloitte in the 2013 Price Review. Given the well document history on this matter from the 2013 Price Review, it is not transparent to us how the Commission has arrived at its 2016 Draft Decision approval.

Having read the Commission's 2016 Price Review Guidance, we expected a thorough review by the Commission of MW's proposal against the principles outlined in the guidance conducted with a similar level of effort and intensity to that applied in the 2013 Price Review. We believe that having a Final Decision that fails to reflect the Commission's formally expressed guidance sets an undesirable precedent for future price reviews. We fully support the Commission's legislated objective to protect the long terms interests of Victorian consumers and we believe the Commission has both the mandate and authority to deliver a better outcome on desalination capitalisation in its June 2016 Final Decision.

If you have any queries on these comments, please do not hesitate to contact me.

Yours sincerely,



SEAN CREEES
Acting Managing Director
City West Water