

12 February 2007

Essential Services Commission
Level 2
35 Spring Street
MELBOURNE VIC 3000

Please find enclosed South East Water's comments in relation to '2008 Water Price Review Consultation Paper, Framework and Approach, December 2006'.

South East Water welcomes the opportunity to participate in this consultation process as part of the 2008 Water Price Review and greatly appreciated the opportunity to discuss, in person, the issues posed by the Consultation Paper on Friday, 2 February 2007.

As discussed at this meeting, South East Water has already put considerable effort into preparing its Draft Water Plan in order to facilitate the internal approvals process before the 1 May deadline. As a result, South East Water would appreciate any actions the Commission could take to issue early guidance on matters critical to the Draft Water Plan.

South East Water considers the following issues need to be given priority for resolution in order to facilitate development of the Draft Water Plan:

- The application of an efficiency carryover for the first period;
- The continuation of the tariff basket form of price control;
- The use of pricing principles for most/all miscellaneous service pricing; and
- The new customer contributions methodology.

In addition, the mechanisms to deal with issues of uncertainty need to be confirmed before a commitment is made to the longer regulatory period.

South East Water looks forward to working with the Essential Services Commission throughout the process of developing the 2008-2013 Water Plan.

If you wish to discuss any of the issues raised, please feel free to contact me on 9552 3725 or ian.johnson@sewl.com.au.

Yours sincerely



Ian Johnson
General Manager, Regulation

South East Water Response to:

2008 Water Price Review

Consultation Paper: Framework and Approach

January 2007

South East Water welcomes the opportunity to provide feedback to the Essential Services Commission (Commission) on its 2008 Water Price Review Consultation Paper. South East Water would like to provide the following comments and looks forward to further developing these views through ongoing consultation.

Timetable

Due to South East Water's internal requirements for quality control and Board approvals, preparation of the Draft Water Plan is already at a relatively advanced stage. The consultation paper indicates that the Commission will be providing its Final Guidance Paper in early March, by which date substantial components of the Draft Water Plan will already have been presented to Board. This timing means that there will be little or no opportunity to analyse the Commission's comments and make changes before submission of the Draft Water Plan. Any actions on the Commission's behalf to issue its final guidance early would be appreciated.

South East Water would also see benefit in the development of a full 2008 Price Review timetable and in particular, the Commission's proposed strategy for consultation once the Draft Water Plans have been delivered.

Chapter 2 - Length of Regulatory Period/Uncertainty

South East Water recognises the need to move to a five year regulatory period in order to:

- Reduce the cost of regulation for water businesses, the Commission and other interested parties; and
- To provide the Commission and businesses with sufficient time between price determinations to review the operation of the regulatory model and implement changes as required.

However, in the current uncertain environment it is particularly important for businesses to be able to make the transition to a five year regulatory model with sufficient clarity around the triggers for any adjustment mechanisms or reopening of a determination.

Reopening

South East Water accepts that the costs involved in reopening a determination are substantial and these events should be limited to events of major consequence that may potentially impact on financial viability.

South East Water is also of the view that if the Price Determination for Melbourne Water is reopened then the determinations for all other businesses that are impacted by Melbourne Water's charges should be automatically reopened.

Adjustment Mechanism

South East Water considers that businesses are best placed to deal with uncertainties in the course of normal operations. However, an end of regulatory period adjustment mechanism is required when a business:

- could not reasonably have forecast the given outcome; and/or
- has not been given the opportunity to respond to the changed circumstances at the discretion of its management.

For example, water businesses have in the past, forecast customer demand on the basis of long term average rainfall. Should the rainfall for the regulatory period be below the long term average, an adjustment mechanism should not be triggered because there is an equal likelihood of higher than average rainfall in a subsequent period and the business can use its management skills to offset the short term impacts. However, if there is confirmation of climate change and the long term average rainfall

permanently reduces then there are several important factors that indicate that an adjustment mechanism should be initiated:

- The business could not reasonably have been expected to forecast permanent climate change;
- The nature of climate change is such that there is no likelihood of a compensating variance in a subsequent price period; and
- If the businesses response to the adverse impact of climate change is prescribed by a central authority, the business has been denied an opportunity to manage the situation to the best of its ability (ie centrally imposed, consistent water restrictions across Melbourne).

Licence Fees

South East Water would prefer to go into the next regulatory period with a relatively firm understanding of the licence fees that are expected to be imposed by the Commission. However, if this is not possible and it is determined that changes to licence fees will flow through to businesses during the period, then South East Water would support the introduction of an L factor to allow this to occur on an annual basis as part of the annual tariff approval.

Materiality Threshold

The materiality threshold should be set to ensure that no applications are made for amounts that are less than the administrative costs of conducting and reviewing the application. Given the adoption of specific principles, as suggested above, to define which events will trigger an adjustment mechanism the costs involved are expected to consist of labour costs for both the Commission and the business concerned, the cost of a consultant to verify the validity/costing of the application and the administrative costs of implementing the resulting tariff changes.

Pass Through for Predetermined Major Projects Under Government Consideration

South East Water is not opposed to the concept of cost pass through for a very small number of likely/uncertain predetermined major projects, should they proceed, to the extent that the costs associated with these projects have not been included as part of the Water Plan.

However, given the lengthy period required between the initial assessment of options and the commissioning of a major project, it is unlikely that significant costs will be incurred before the end of the five year regulatory period. It may be more cost effective for these adjustments to be made at the start of the next regulatory period.

South East Water would prefer to go into the next regulatory period with a more certain understanding of the likely nature and total cost of projects that are expected to commence during the period. If projects are to be added at a later date, stakeholders would need to ensure that they retain the opportunity to argue that other projects (included at the time of the Water Plan) should be delayed or removed from the works program in order to accommodate these additions.

Price Caps

The Commission's conclusions to Chapter 2 don't make any reference to the comment in section 2.2.1 regarding its preference for individual price caps for the second regulatory period.

South East Water implemented a tariff basket approach at the last review and intends to propose a similar form of price control at this review. At the last review, the tariff basket form of price control was assessed by the Commission as being compliant with the WIRO, therefore South East Water expects a similar conclusion to be reached as part of the 2008 review, subject to justification of any additions to the basket.

The tariff basket approach provides a business with the ability to:

- Better manage the increased uncertainty resulting from the lengthening of the regulatory period;
- Adapt to the impact of climate change on volumes;
- Gradually reposition tariffs if required, rather than forcing all repositioning to be accomplished in year 1 of the regulatory period or trying to guess the required transition path;
- Use price as a mechanism to ensure that Central Region Sustainable Water Strategy targets are met – given the degree of uncertainty around the take up rate assumptions for some of the demand side initiatives to be implemented eg shower heads; and
- Provide customers with some certainty in relation to potential impacts through a rebalancing constraint.

South East Water will also be recommending the addition of other products to the tariff basket, for the 2008 regulatory period such as trade waste and residential recycled water.

Chapter 3 - Service Standards & GSLs

South East Water believes there needs to be clear understanding of the meaning of the terms target and standards. Standards infer that performance criteria must be met under all circumstances, this is not South East Water's understanding of the current regulatory arrangement.

Approach to Regulating Service Standards

In section 3.2.1 one of the stated aims of the Commission's annual comparative report is to facilitate competition by comparison. However each business is responding, through its own Water Plan, to the individual service needs (and preparedness to pay) of its customers, based on consultation and market research undertaken.

The main focus should be on delivering customer needs within the constraints of each individual business and its Water Plan rather than competing to be 'best in class'. Accordingly, reporting of the supporting indicators should be "pass/fail" against the targets set in each individual Water Plan, rather than a ranking from best to worst. How much each business exceeds its performance targets by is not relevant to the overarching KPIs, and could impose additional costs on customers.

Factors the Commission should consider in assessing proposed service standard targets

One of the factors that the Commission needs to be mindful of in assessing service targets is climate. Unusually dry or wet conditions can significantly impact on a number of indicators including burst rates, sewer blockages and sewer spills. For example, the dry conditions currently being experienced across the state have resulted in work practice changes to respond to the need to conserve water. The average duration time for an unplanned water supply interruption will increase if water is turned off as soon as a work crew arrives on site rather than undertaking preliminary work prior to turning off the supply to minimise inconvenience to the affected customers. Also, additional resources and attention have been allocated to reducing the time to respond to reported bursts and leaks, rather than having water wasted. This change to response times has come at significant cost and may be reviewed when storages return to normal levels.

Rather than considering these issues when assessing proposed service targets, South East Water believes that the Commission could either:

- take such matters into consideration at the end of the regulatory period when assessing the performance of each business against the Water Plan; or
- set service targets as a range that reflects the variability of the indicator with respect to climate and other variables.

Core set of indicators/targets

While South East Water always strives to minimise the impact of any supply interruptions on customers, it is considered that the following core service standards

create perverse incentives for water businesses to reduce the standard of service provided to customers:

- Planned interruptions – Setting targets for planned interruptions can discourage businesses from implementing a program of works designed to improve long term system performance and increase the number of outages (two shorter outages vs one longer outage);
- Time to attend vs time to rectify – For low priority incidents, South East Water would rather rectify the issue in the shortest possible time than use up resources attending quickly but taking longer to resolve the issue (by sending a second crew); and
- Restrictions - South East Water's preference is to use hardship programs to manage customer's payment issues rather than restrict customers supply for non-payment. A target level of restrictions does not encourage water businesses to strive to not restrict customers for non-payment or find the most effective tool for each individual customer.

Harmonising service standard targets across the businesses

South East Water considers that on balance, the disadvantages associated with common core service standards/targets outweigh the advantages as:

- All water businesses are subject to different soil, geographic distances, climate and asset conditions that make any technical comparisons invalid;
- Businesses have tailored their service targets to the needs of their customers which may vary significantly;
- Innovation and cost efficiencies resulting in better than average performance should be encouraged; and
- Public reporting of individual business' achievement (or not) of their performance standards has been an effective method of encouraging performance improvements in the past.

South East Water would therefore not support the Commission's proposition.

Monitoring the delivery of the Water Plan

Rather than imposing new reporting requirements on businesses, it is recommended that the Commission use the Comparative Performance Report data collection process to obtain sufficient information for monitoring the delivery of the Water Plan targets.

Core set of GSLs

It is noted that the Commission does not intend to require businesses to adopt a GSL scheme at this time. South East Water introduced a range of GSL's at the time of the last price determination. South East Water intends to continue these GSL's for the 2008 regulatory period in order to provide consistency to customers.

South East Water would only support the implementation of GSL's across the state in a way that:

- reflects the issues of importance to the customers concerned;
- appropriately incentivises the water business concerned;
- minimises implementation costs; and
- at a time when the individual businesses believe that GSL's are able to add to their customer value proposition.

Application of GSLs to non-residential customers

South East Water has previously extended its GSL scheme to non-residential customers based on the following:

- there are a number of property types that are difficult to allocate to either residential or non-residential (e.g. milk bars with a residence; residential properties that have been converted to other uses such as medical suites);
- non-residential properties suffer similar inconvenience if there is a service interruption; and
- most larger non-residential businesses are minimally impacted as the majority have a dual supply.

South East Water would not support a different GSL amount for non-residential customers as the GSL is not intended as compensation, but as a gesture to acknowledge a poor service event.

Chapter 4 – Assessing Expenditure

OPEX

Defining new obligations

The ESC has concluded that opex associated with new obligations or increased services levels is to be separately identified and explained for only those items which take effect from 1 July 2008. Those new obligations or increased/new service levels which take effect before 1 July 2008 are to be considered business as usual.

It should be noted that new obligations including programs associated with water conservation, obligations on Melbourne Water to provide new supply sources to

overcome climate impacted shortages and sustainability programs incurred during the current regulatory period, have resulted in significant increases in opex. Opex in relation to these programs will continue to rise sharply through the next regulatory period. However, as a result of the definition of new obligations, this expenditure will be classified as business as usual.

South East Water is not convinced that this is the best outcome. One of the major roles of the Water Plan document is to explain what these changes are, why they have occurred and how they affect prices. While South East Water intends to provide this explanation of changes, it will be difficult to reconcile this explanation with the financial templates.

For this reason, South East Water recommends that the costs associated with new obligations that took effect within the 2005-2008 regulatory period also be separately identified in the Commission's template.

Benchmarking

South East Water suggests that the Commission should be cautious about relying on benchmarking studies in order to assess businesses forecasts or opex.

Benchmarking studies often fail to take into account the specific circumstances of a business that can significantly affect the unit cost for providing a particular service, eg. size of area, soil type or customer requirements. Also benchmarking studies do not take into account the trade offs that exist between one measure and another. It is unlikely that a business with limited resources can achieve the highest ranking in all measures. This type of analysis can in some cases lead to an expectation that all business should be capable of meeting the highest standard for all measures.

Productivity improvements

The ESC requires businesses to verify that efficiency savings have been built into the forecasts of 'business as usual' operating expenditure. Given the significant and continuing increases in 'business as usual' expenditure during the current and next regulatory period, (largely due to new obligations, including programs associated with water conservation and sustainability), it will be difficult to separately identify the extent to which productivity improvements have been incorporated.

South East Water has concentrated on delivering efficiency improvements during the current regulatory period and intends to maintain the same focus for the 2008 regulatory period. As a result South East Water expects to be able to deliver efficiency savings in relation to core business activities (excluding new obligations), taking into account the impacts of growth in customer numbers.

CAPEX

General

South East Water supports the Commission's proposal to review first regulatory period capital expenditure by exception. However, in doing so, South East Water expects that the Commission will carefully examine the reasons behind non-delivery of any projects. In some cases projects are delayed because innovative alternatives to the previously identified capex have been discovered or circumstances have changed. In these cases capex has been underspent efficiently rather than as a result of insufficient resources or mismanagement.

New Obligations

As previously noted, the Commission's definition of a new obligation will result in many of the recent changes to capex requirements being disguised in "business as usual" in the templates. South East Water intends to discuss these requirements separately in its Water Plan document.

Chapter 5 - Incentive Mechanisms

Efficiency Carryover

South East Water considers that while there have been several unexpected occurrences that may impact on the implementation of an efficiency carryover mechanism for the first regulatory period, the Commission should implement a mechanism as foreshadowed at the last review.

This mechanism should be based on the following principles:

- allow businesses to retain efficiency gains for at least five years;
- include both capex and opex;
- be based on businesses forecast of expenditure for the final year of the regulatory period; and
- provide for negative efficiencies to offset positive efficiencies but not carry forward a net negative amount.

South East Water also supports the introduction of a carryover mechanism for the second regulatory period. However, in order for this mechanism to effectively encourage innovation and efficiency, it must be fully documented before the commencement of the second regulatory period (to take effect during the third period).

South East Water believes that the efficiency carryover mechanism to be introduced should:

- Apply to OPEX and CAPEX – South East Water sees value for customers in the pursuit of efficiencies in the delivery of capital projects and construction methodologies, in addition to OPEX reductions;
- Should recognise that in some cases the deferral of a capital project may be efficient. For example new techniques in operations and maintenance may extend the life of an asset that would otherwise have to be replaced sooner (ie allowing offsets between opex and capex);
- Retain efficiencies for at least five years in order to provide businesses with sufficient incentives;
- Recognise that the impact of service level reporting and GSL's ensures that businesses will strive to achieve true efficiency improvements; and
- Recognise that events outside the business' control (eg climate change) occasionally occur and should not prevent the business from receiving a full 5 years value from any innovations or efficiency improvements that may have been implemented.

S Factor

South East Water supports the Commission's conclusion that an S Factor mechanism should not be implemented in the water industry at this time, as:

- The combination of GSL's and the existing public performance reporting requirements provide sufficient incentives for businesses to maintain service standards;
- There is not sufficient history for most of the performance measures to ensure that S Factor standards can be set without exposing businesses to adverse or unintended outcomes; and
- The development and implementation of a process for businesses to apply for exemptions in exceptional circumstances would be particularly resource intensive.

Chapter 6 - Tariff Structures

Pricing Principles

South East Water accepts the Commission's overarching principles for assessing proposed prices.

Given the severity of the current supply imbalance, water businesses and the Commission need to give appropriate emphasis to the achievement of the consumption targets in the CRSWS. While price elasticity will be a contributor to the

attainment of these targets, they will ultimately be achieved by a combination of price, restrictions and targeted programs. Rather than having a cumulative effect, these measures will work together to ensure that these targets are achieved.

Any assessment that the Commission makes regarding the effectiveness of a tariff to drive customer behaviour needs to consider the tariff as part of a package of measures designed to achieve an outcome.

Residential

The Effect of Inclining Blocks

While there has been a significant reduction in both the total volume of water consumed and the amount that was/would have been consumed in Block 3 since 2001, it is not possible to conclude that the introduction of an inclining block tariff is completely responsible. While the higher third block price has contributed price elasticity to the reduction, public education campaigns, technological advancement and restrictions have all had some effect. Over time the average price across all tariffs will need to rise to deliver enhanced conservation signals.

In the future, it is possible to see that the inclining block tariff structure may be further extended to both encourage customers to use water sustainably, and reflect the cost of future supply augmentation at the top tier. This would ensure that those customers who use excessive amounts of water and don't respond to price signals bear the full cost of the supply augmentation that will be required to meet their levels of demand.

South East Water considers that such a tariff structure would generally comply with the WIRO because:

- While it is likely to be priced above average cost, it will reflect the more likely long run marginal cost including externalities;
- It sends a clear message to customers and will provide a financial incentive to look at overall usage level or alternative supplies; and
- The inclining block is understood and the impacts for large families can be managed.

Large Families

South East Water has a hardship scheme in place which can be accessed by large families. This scheme has had very few applications over the past regulatory period. The level of complaints/enquiries has also been low.

While South East Water intends to retain this scheme, it is expected that the provision of assistance in the form of subsidised water efficient shower heads, washing

machines and water tanks plumbed to toilets will also make a major contribution to assisting low income large families to avoid paying the higher tariffs associated with higher usage.

Non-Residential

The Commission refers to the alternative approaches to non-residential prices used in electricity as a potential example for the water industry. Electricity distribution prices reduce as customer usage levels increase, to recognise that the marginal cost of supplying these large customers is less. This highlights a conflict in the water industry between recognising the reducing cost to serve large customers and the potential to reduce customer's consumption through price elasticity. Inclining block tariffs for lower marginal cost non-residential customers also exposes water businesses to an increased risk of third party access and potential "cherry picking".

The heterogeneous nature of the non-residential sector makes it very difficult to universally implement inclining block tariffs without creating barriers to entry, impacting on competitiveness and discouraging mergers and expansions.

Inclining block tariffs may have greater applicability to specific industry sectors where individual non-residential customers have relatively consistent water consumption patterns. South East Water may support such tariffs for individual sectors, subject to the necessary research being completed to identify these market segments and define the customers that will be affected.

ACIL Tasman were engaged (through the Smart Water Fund) to investigate pricing options and elasticity functions for the non-residential sector. They have concluded that:

- Businesses would prefer to retain the current pricing structure;
- The next best alternatives may involve either a transition to a targeted "excess" tariff arrangement or scarcity pricing in order to better reflect marginal cost; and
- There is a demonstrable elasticity of demand.

Recycled Water Tariffs

South East Water supports the Commission's proposal that a prescribed set of tariffs be set for residential recycled water customers in mandated third pipe areas and pricing principles continue to apply for all other supply situations.

For residential subdivision third pipe customers, South East Water would expect to see a tariff that consists of a fixed component and a single variable charge, with prices approved annually by the Commission under a tariff basket. Given the expected large increase in customer numbers it is considered necessary to provide customers with greater clarity and certainty about what and how they will be charged for recycled

water. That said, it is considered appropriate to include these tariffs in the tariff basket in order to:

- Allow price to be used to encourage the take up of recycled water should the take up rates be less than forecast;
- Provide customers with some certainty around potential price changes, subject to the rebalancing constraint; and
- Adapt to customer feedback when the use of residential recycled water becomes more widespread during the regulatory period.

South East Water has however, already entered into a number of contractual arrangements with residential developers. These contracts will need to be “grandfathered” for the appropriate time.

South East Water has been supplying recycled water to non-residential customers for some time. The prices that have been negotiated with these customers have been driven by a number of factors including:

- Recovery of the efficient costs of providing the service;
- Achievement of the 20% recycling by 2010 and 10GL by 2030 targets;
- The customer’s willingness to pay;
- South East Water’s obligation to encourage customers to minimise potable consumption for the purpose of supply security;
- The distance of the customer from the source of recycled water;
- The prevailing weather conditions; and
- Whether recycling is an integral part of the sewage treatment process.

South East Water proposes to continue to negotiate directly with non-residential customers. This gives South East Water the ability to negotiate an agreement that accurately reflects the circumstances of the particular customer and takes into account the above factors.

In addition, the CRSWS only supports recycling proposals where the total cost is comparable with the cost of other long term water augmentation options. This effectively provides a maximum cost per ML at which recycling projects can proceed, and as a result a maximum price which recycled water customers could be expected to pay.

Miscellaneous charges

Background

Charging for “miscellaneous services” is based on the principle (endorsed by the Commission) that users of a service should pay the full cost of providing that service, and that there should not be cross subsidies between services provided by South East Water.

Water businesses have different mechanisms for delivering services to customers which may impact on their fee structure. Also, it is the decisions about what services are to be provided at what charges, that differentiate companies and over time drive innovation.

Avoiding cross subsidies

South East Water views the issue of not having cross subsidies between services as particularly important.

It must be recognised that by not charging a price for a miscellaneous service that recoups the cost of providing that service, the cost is born by the customer base as a whole, many of whom are not in a financial position to subsidise the services provided largely to property developers and individuals who are selling properties.

South East Water believes that its customers would be best served by a system where the decisions as to what “Miscellaneous services” will be provided, and policies regarding charging for these services are left with the water businesses. However should a water company choose to charge for a service, then the charge should be determined on the basis of principles laid down by the Commission.

Miscellaneous service definitions

South East Water recognises a trade off between the amount of information provided on its schedule of miscellaneous charges and the simplicity required for customers to be able to read the schedule and locate the service they require.

South East Water is prepared to provide additional information to the customer on request or through additional documentation but believes it would be difficult to get consensus across the State on the definition of miscellaneous charges other than for the most commonly provided.

Pricing Principles

Given the relatively small amount of revenue collected from miscellaneous service charges, South East Water believes that miscellaneous service pricing should be left to water businesses and not subject to individual regulatory approval for each service.

It is expected that businesses would be obligated to set prices in accordance with principles established by the Commission and the total estimate of miscellaneous charges revenue made at the time of the price determination.

Businesses would only expect to deviate from the revenue estimates made at the time of the price determination where an additional service is introduced or removed or there is a substantial change (up or down) in the actual cost of providing an existing service.

It is expected that the pricing of these services would be based on:

- the direct costs of service provision by contractors; plus
- South East Water's direct costs; plus
- a 25% contribution to overheads.

This is consistent with the "actual cost" principles adopted by the Commission for the 2005 Water Plan.

The application of this pricing methodology is expected to be subject to the Commission's audit process.

In order to allow the merits of this approach to be assessed, a transition process may be able to be implemented where the Commission would continue to approve the individual prices for a small selection of charges (high volume, high revenue or fundamental services) and allow businesses to set the remainder by pricing principles. If this were to occur, South East Water would recommend that the following charges may be best approved by the Commission:

- 20mm meter fees
- Removal and testing of meters
- Restoration of supply
- Information Statements (rate encumbrance certificates)
- Application fees for single house connections
- Build over easement application fees
- Sewer location plan fees (house connection plans)
- Trade waste application fees

Businesses would expect to use their websites to provide full disclosure of the services offered and prices charged for all services as a substitute for the Commission's published tariff schedule.

Do we need to introduce new services between Water Plans?

South East Water is committed to innovation and continuous improvement. Work practices are continuously evolving, as is legislation, regulations and customer expectations. Any of these factors can drive the introduction of a new service or cause the cost of an existing service to change sufficiently to warrant a price adjustment.

It would be unreasonable to delay the introduction of a new services or innovation because a fee could not be introduced between Water Plans or adopt a zero charge, and cross subsidise, until the price is approved.

It is therefore South East Water's view that new services and or alterations to existing fees to reflect cost changes should be able to be introduced between regulatory reviews. This can be achieved via the pricing principles process, already outlined.

Chapter 7 – Customer Contributions

Background

In its 2005 Determination, the Commission initiated a significant change in the approach under which the infrastructure costs associated with urban growth were to be recovered.

Rather than utilising upfront charges levied against developers, the Commission essentially chose to spread those costs across the entire South East Water customer base.

While, from a financial perspective, there were no implications for South East Water, the Commission's decision had significant impacts on equity between customers and developers, and between developers.

The new process capped upfront charges at \$500 per lot and allowed applications to be considered for prices above that based on the bring forward cost of shared assets.

While the administration processes have bedded down, concerns remain about the equity elements of the decision.

The opportunity to redress this appears not to have been taken by the Commission in the draft guidelines leading up to the 2008 Water Plan.

What costs are fair and reasonable to be recovered from developers?

South East Water has recently experience growth in customer numbers of around 10,000 lots per annum. Each lot requires water, sewerage and now in some areas reticulated recycled water infrastructure to be installed, with the local reticulation (smaller sized assets) funded by the developer and larger distribution assets funded by the existing "mums and dads" customers of South East Water.

For the 2008 Water Plan, it is estimated that some \$39m of distribution type infrastructure will be installed for urban growth per annum.

This can be further disaggregated into:

- approximately \$22.5 mill in greenfield areas (6628 lots); and
- approximately \$1.1 mill in existing areas (2633 lots)

With respect to the latter the Commission is predisposed in its Consultation Paper to say that there is no certainty that the brownfield lots do not directly cause the \$1.1m of expenditure. Its view is that the existing customer base could also cause growth in demand, hence growth in infrastructure.

This is problematic from two perspectives:

1. per capita demand for existing customers is declining; and
2. the majority of infrastructure can specifically be related to new growth in demand – even though existing customers may use the asset – eg. A new sewer lift pump.

The Commission, in its Consultation Paper, leads the reader to the view that upfront charges in existing areas could be zero – ie no incremental expenditure, therefore no charge. From this, one could only assume that if there was incremental cost, it would be appropriate from both an efficiency and equity point of view to recover these costs.

This view has been supported by industry for some time and is consistent with the Commission’s own principles – the user of a service should pay.

In regard greenfield development, there is a very clear nexus between the investment in infrastructure and new lots. \$22.5M of infrastructure would not be invested if it were not for 6600 lots.

On p95 of the Consultation Paper, it appears as if the Commission supports direct recovery via upfront charges:

“the overarching principle may be that customer contributions are calculated as the per lot cost of shared infrastructure related to the development, with a maximum per lot charge of \$1000”, and

“such an approach is relatively simple to understand, ensures that contributions are cost reflective and the information needed to generate per lot costs is readily available”.

South East Water would fully support such an approach other than the artificial cap of \$1000 per lot, being proposed. Using the data provided above, this simple approach would lead to a price in excess of approximately \$3,400 per lot for all services.

Reticulated Assets

The Commission’s 2005 Determination also overturned the established industry practice of sharing local reticulated infrastructure equitably across all developers. The Commission determined that the first developer should pay.

In practice, some discretion has been applied, with the water company sometimes funding external works to a subdivision where these are of basic size.

However, the majority of cases require the pioneer developer to pay the cost of infrastructure. While he may get the market jump on his competitors, these subsequent competitors eventually get a free ride.

Next steps

The Consultation paper has not necessarily clarified the many issues surrounding the new NCC regime. Also, the proposed increase from \$500 to \$1000 seems one sided, based on the suggestion that some areas have a zero charge (being cost reflective), while others are capped.

South East Water understands that a joint industry paper is being developed to further explore alternatives to the calculation of new customer contributions. South East Water intends to use its Draft Water Plan, to test both the Commission's principles and alternatives.

SUMMARY

Given the limited time remaining before the submission of the Draft Water Plan, South East Water considers that the Commission needs to focus on providing advice on the key issues as soon as possible.

South East Water considers that the following issues need to be given priority for resolution in order to facilitate further development of the Draft Water Plan:

- The application of an efficiency carryover for the first period
- The continuation of the tariff basket form of price control
- The use of pricing principles for most/all miscellaneous service pricing
- The new customer contributions methodology

In addition, the mechanisms to deal with issues of uncertainty need to be confirmed before a commitment is made to the longer regulatory period.