

Our Ref: 55/050/0122A
Enquiries To: Mrs Melissa Stephens



**Barwon
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October 6, 2006

Essential Services Commission
Level 2, 35 Spring Street
MELBOURNE VIC 3000

c/o water@esc.vic.gov.au

Dear Sir/Madam,

Re: 2008 WATER PRICE REVIEW – GUIDANCE ON WATER PLANS CONSULTATION

Thank-you for the opportunity to provide comment on the '2008 Water Price Review Guidance on Water Plans' Paper ('Guidance Paper').

Barwon Water notes that a separate consultation process is scheduled to occur on a number of other key issues that will affect the 2008 Water Plan process (section 1.4 of Guidance Paper). Barwon Water looks forward to the opportunity to comment on each of these issues in the near future.

In relation to the "Guidance Paper," Barwon Water's specific comments include:

1. Outcomes for the First Regulatory Period (Section 3)

This section requires each regulated business to outline their performance in delivering the outcomes that they committed to achieve in the first regulatory period.

At the time of consultation on the draft Water Plan (1 May 2007), businesses will have actual data for one year of the previous regulatory period (2005/06) and revised forecasts for 2006/07 and 2007/08.

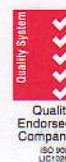
Barwon Water is unclear as to whether businesses are required to revise their original projections as set in the 2005 Water Plan and provide these with appropriate discussion in this section, or whether they are only required to report against their Water Plan projections.

2. Changes in Legislative Obligations (Section 3.4 and Section 7.4.1)

It is noted that sections 3.4 and 7.4.1 both discuss a regulated business' ability to recover material increases in expenditure incurred during the current regulatory period related to changes in legislative obligations. However, Barwon Water notes that whilst section 3.4 outlines a threshold of 'the greater of 2.5% of a business' total revenue over the regulatory period or \$1 million,' section 7.4.1 states that this would only be allowed if 'the impact on costs is greater than 5 per cent of a business' total revenue'.

The latter appears to be a direct replica of what the ESC proposed in its 2005 Draft Decision (page 258 of the Draft Decision), whilst the former is what the ESC approved as part of its Final Decision (page 154 of the Final Decision). Barwon Water seeks confirmation from the ESC that it will be imposing the thresholds confirmed as part of its 2005 Final Decision, and that it will not be reverting back to those proposed in its Draft Decision.

Furthermore, Barwon Water assumes that given the Final Decision refers to the 'net impact on cost' being greater than the prescribed threshold, costs will be aggregated when assessing whether the 2.5% or \$1 million threshold is met for net operating costs and finance costs associated with changed obligations during the first regulatory period.



3. Definition of "business as usual obligations" v "new obligations" (Section 4.2)

New obligations are advised as those obligations that *are reasonably anticipated to "take effect" after 1 July 2008*. Further clarification on "take effect" is required to ensure correct categorisation between new obligations and business as usual.

For example, DSE is currently reviewing the Statement of Obligations. This review is likely to be complete and released prior to 1 July 2008. It is anticipated that any changes will be effective immediately. It is Barwon Water's position that changes in this document should be considered new obligations, regardless of the date of ratification of the revised Statement of Obligations. Obligations do not generally specify when the authority must start to implement the action, but that it is the businesses obligation to do so. Clearly, where the new obligation has arisen post the preparation and compilation of the 2005 Water Plan and costs are to be incurred during the 2008 Water Plan period, these should not be considered "business as usual" costs.

4. Other Obligations (Section 4.2.4)

To provide a clearer nexus between expenditure obligations and cost drivers it would seem appropriate to provide additional separate categories. The current guidance paper provides for these costs within the "other obligations" section. Further categories for consideration include:

- Legislative Obligations – for example changes in Water Act 1989, OH&S Act, Taxation Law, Road Management Act, etc.
- Government Policy Obligations – this section would include costs that are driven by "Our Water Our Future", COAG, National Water Commission, National Competition Policy, etc.
- Economic Obligations – obligations imposed by the Essential Services Commission, eg. Licence fees, shared assets, other outcomes from 2008 consultation process, etc.

5. Minimum Service Standards (Section 4.2)

Barwon Water notes Section 4.2, which states that 'where a business is proposing to deliver an outcome that goes beyond the minimum obligation or target imposed by regulators or the Minister for Water, the Commission expects the business to include evidence that it has consulted with and has the support of customers...in particular, the impact on prices and whether customers have expressed a willingness to pay'.

Barwon Water notes that historically, businesses have delivered service levels greater than 'minimum obligations' in many cases. This is a function of, amongst other things, historical practices, and an individual business' view about managing the risk associated with meeting those minimum service standards.

Barwon Water would suggest that the ESC should draw a clear distinction between service standards that have historically been delivered, and which are above minimum obligations, and those standards where water businesses are explicitly proposing service improvements (eg, above the current average aggregate performance level), with only the latter being subject to aforementioned guidelines around customer willingness to pay etc.

6. Service Standards (Section 4.3.2)

Barwon Water notes that the ESC 'expects performance to be at least consistent with average performance over the previous three years for which actual data is available (2003-04 to 2005-06)'. Whilst at a general level, Barwon Water agrees with this criterion, it notes that the reliance on only 3 data points to determine the long term average level of service may not lead to the most efficient outcomes. This will be particularly so if:

- The data period has been categorised by one or more extreme, asymmetric exogenous events, which in turn have skewed the average one way or the other, such that it no longer reflects the 'long term' expected level of service; or

- There has been a change in the operating practices of the regulated business, such that the historical nexus between cost and service has been broken.

Barwon Water believes that the ESC's Guidance should stipulate that whilst the ESC's primary focus will be on assessing whether proposed levels of service are consistent with the 3 year average, it is still amenable to variations to this average, if regulated businesses provide well reasoned arguments, backed up by valid and verifiable evidence.

7. Box 5.1: Business As Usual Operating Expenditure Categories – Urban Services

The categorisation of Licence fees occurs under each business segment and is further disaggregated by regulator.

It is Barwon Water's preference for licence fees to only be disaggregated by regulator, in order to avoid duplication of costs and commentary within the Water Plan.

8. Updating the Regulatory Asset Base (Section 5.4.1)

Components of this section appear to be contradictory and as such further clarification is required in the Guidance Paper. The Guidance Paper states:

".....include a table which shows the calculation of the value of the RAB across the regulatory period and at 1 July 2008, based on actual outcomes where available, bearing in mind that:

- *At the time the draft Water Plans are prepared businesses will have two years of actual data and two years of forecasts*
- *When the final Water Plans are submitted all businesses will have three years of actual data and one year of forecasts*

For years where actual data is not available, the Water Plans should show the capital expenditure, contributions and proceeds value assumed in the initial pricing determinations..."

To ensure the most indicative revenue requirement is calculated when utilising the building blocks approach, it is imperative that the RAB includes actual data where available and the most up-to-date forecast data for years where this data is not available. This represents the most accurate estimation of likely capital investment and associated RAB value to calculate the return on investment component of the revenue requirement. Furthermore, Barwon Water understands that this has regulatory precedence, with the ACCC adopting a similar approach when regulating GasNet.

Furthermore, section 5.4.1 discusses the need to update the RAB to 'reflect the value of actual efficient and prudent capital expenditure, customer and government contributions and disposals' and 'the value of regulatory depreciation shown should be that contained in the initial pricing determination'.

Whilst Barwon Water understands the sentiment behind these statements, it also believes that the ESC should explicitly state that these parameters need to be updated for actual inflation. This is consistent with the ESC's Final Decision (page 47), which stated that 'the Commission will adjust the components of the regulatory asset base for inflation over time, which implies that financial maintenance is preserved in real terms, and depreciation reflects the return of the real cost of the asset'.

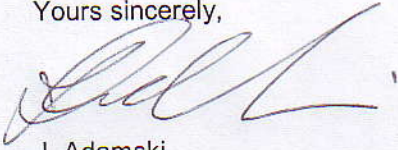
9. Tariff Proposal - Long Run Marginal Cost Analysis (Section 7.1.1 and 7.1.4)

It is stated in section 7.1.1 that long run marginal cost estimates are required where businesses are looking to significantly increase their variable charge on the basis of better signalling of future capital costs. Section 7.1.4 provides that each service section within the tariff proposal should provide the relationship of the proposal to its associated long run marginal cost.

Clear direction regarding the long run marginal cost estimates required from the Commission is required. It is Barwon Water's position long run marginal cost estimates should be provided "where businesses are looking to significantly increase their variable charge" as stated in section 7.1.1. of the Guidance Paper.

Do not hesitate to contact Melissa Stephens (ph: 5226 2368) if you have any questions regarding this submission.

Yours sincerely,

A handwritten signature in dark ink, appearing to read 'J. Adamski', written in a cursive style.

J. Adamski
Acting Chief Executive