

6 October 2006

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 Guidance on Water Plans September 2006'.

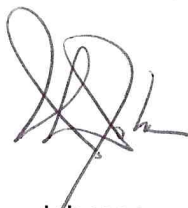
South East Water welcomes the opportunity to participate in the process of setting the framework for the 2008 Water Price Review process.

Given the requirement to deliver a Draft Water Plan by May 2007, South East Water recommends that the Commission and Water Businesses focus their efforts on the high priority items for consultation and consideration of the impacts of new obligations.

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

Guidance on Water Plans

October 2006

South East Water (SEW) welcomes the opportunity to provide feedback to the Essential Services Commission (Commission) on its approach to the 2008 Water Price Review. While South East Water has commenced the internal processes required to be able to deliver a Draft Water Plan by May 2007, our views on many issues are still subject to refinement. We would like to provide the following preliminary comments and look forward to further developing these views through the ongoing consultation process foreshadowed by the Commission.

General Comments

There are a number of high level issues that we would like to discuss in addition to the issues related to specific sections of the Guidance Paper.

Timetable

SEW is currently reviewing its resource levels and work program. The preparation of the Water Plan is particularly resource intensive and requires significant input from most areas of the organisation. In order for SEW to prepare a Water Plan that adequately addresses the issues of importance to all stakeholders, the work program needs to be fully understood in the short term.

An approximate timetable, in particular the issues for consultation, would be a valuable addition to the Commission's guidance document. While recognising that there may be changes as the project moves forward, it is important for businesses to understand and be able to plan to meet the Commission's expectations.

It would also be beneficial for businesses to have an understanding of the Commission's proposed strategy for consultation once the Draft Water Plans have been delivered.

Departures from historical trends rather than first principles

Given the very recent reviews of both urban and rural water businesses, SEW considers that there is little to be gained from another detailed investigation of past costs. Businesses have had their costs set at efficient levels by the Commission and have subsequently been operating under an incentive based regulatory regime. SEW considers that, given the limited time available and the critical supply issues facing the water industry, there is more to be gained from focussing the review on the implications of new obligations and individual water businesses responses to water shortages.

Appendices

There are a number of pieces of work (eg supporting documents for demand forecasts) that the Commission suggests it would like to receive as appendices to the Water Plan. Some of these documents/models are extremely large and as a result may detract from the Water Plan document, in particular for the purpose of public consultation. While we support the need for appendices to enhance the Plan's consideration, other documentation need not be included but rather made available to the Commission and its auditors as required.

Order of discussion

It is expected that substantial changes to demand forecasts are likely to be the driver of a large proportion of the new obligations and the associated costs to be included in the 2008-2013 Water Plan. Therefore, SEW would prefer to include the Demand section early in the Water Plan document.

While it is appreciated that having separate sections on service outcomes, operating costs and capital costs make for better reading, it does not allow for considered discussion on the tradeoffs between service, operating and capital. We would suggest these be discussed together with summaries of outcomes and costs being made.

Comments Specifically Related to the Guidance Document

1.4 Consultation

In total there are 10 topics for consultation listed under point 1.4. Given the limited time available before the Draft Water Plans are to be lodged it is difficult to envisage there being sufficient time available to consult on all of them. It is recommended that where possible, topics are combined in order to facilitate concurrent consultation processes.

For example, it would be easier to deal with the scope for better alignment of service standards across the state, guaranteed service levels and incentive mechanisms with a single consultation process. Although it is difficult to see how alignment of service standards across the state would be beneficial.

If it is the case that topics for consultation need to be prioritised, SEW considers that new customer contributions, unforeseen events and incentive mechanisms need to be dealt with as priorities. SEW also considers that the topics of sustainability and productivity changes will need to be addressed as part of the Price Review process and would benefit from early consideration.

3.3 Actual capital expenditure associated with the delivery of outcomes

Given that the 2005-2008 Water Plan represented a point in time, it is certain that there will be differences between it and the actual expenditure that has occurred over the past three years. Significant effort would be involved if businesses were to justify all past capital expenditure. The Commission should seek justification for large unexpected capital projects or projects that have gone substantially over budget. However, where capital expenditure is within a reasonable range of the budget set at the last Water Plan and the business concerned has delivered an appropriate standard of service to customers, the Commission should not question the prudence of this expenditure.

3.4 Changes in legislative obligations

Under this section the Commission should take into account all unforeseen changes, including changes to licence fees, environmental levies and errors made in the initial determination as well as changes to legislative obligations. This should include changes that may have been introduced immediately prior to the commencement of

the current regulatory period, but after the 2005 – 2008 Water Plans had been finalised.

4.1.1 Overview of customer consultation

SEW assumes that the last paragraph is meant to refer to customer groups that have been consulted rather than individual customers. SEW sees this as entirely unnecessary and would be unable to release the details of individual customers due to privacy issues.

4.2 Regulatory and government obligations

As previously noted, it appears that the Commission expects the Water Plans to be structured around the delivery of obligations. This would require businesses to set out the obligation and the work program that will ensure that this obligation is delivered.

Unfortunately, there is not a one to one relationship between work programs and obligations. In most cases a single program of works will be designed to deliver several obligations. In order to avoid repetition, the more preferred structure would be to set out the various programs of work and then identify the corresponding obligations that they contribute to.

We also believe that identifying the obligations, outcome, expenditure and consultation for all obligations under the Statement of Obligations to be unnecessary.

4.3 Service Standards

The Commission's paper indicates that it expects businesses to have consulted on their performance relative to other businesses, among other indicators. This is one area of consultation that businesses would find very difficult to undertake as few customers are likely to have experienced the services of multiple water businesses. Also businesses are focussed on developing their own performance standards based on customer consultation and willingness to pay research, rather than closely monitoring the performance of other industry participants.

4.3.2 Core Service Standards

SEW makes the following comments in regards to some of the KPI's:

- **Planned Works KPI's**

SEW would like the Commission to give further consideration to the relevance of planned works service standards. The relevance of setting KPI's in this area is questioned because:

- The number of planned outages is strongly linked to the size of the overall works program as opposed to the businesses skill in managing the network;
- In some cases an increase in planned outages demonstrates a businesses foresight in undertaking preventative maintenance before an unplanned outage occurs;
- Customers are significantly less impacted by planned outages;
- There is a trade off between planned and unplanned outages; and
- It is better to extend the duration of planned outages and complete the work than have multiple outages (a negative KPI in its own right).

SEW considers that in the above circumstances, planned outages should be seen as positive outcomes. This matter was raised during the previous price determination and we seek further consideration.

- **Restrictions**

SEW is strongly opposed to setting targets for the number of customers subject to restrictions. SEW has an effective program for managing customers who fail to pay their accounts and providing assistance to those who are in hardship. However, the number of customers who fail to pay their accounts and ultimately go through the debt management process is beyond SEW's control. These numbers are mostly driven by general economic circumstances.

SEW has no objection to reporting to the Commission the number of customers subject to restrictions and will continue to strive to find alternative payment schemes for customers who do not pay their account. However, if customers consistently fail to pay their account the only options available to SEW are to apply restrictions or to increase prices to customers generally to cover the debt write off.

- **Time to attend vs time to rectify**

SEW considers that the focus of emergency response measures should be the time taken to rectify a problem. There is little value to customers in attending an incident quickly but taking an extended period of time to rectify the problem. It is more effective and cost efficient to make one visit to the site and rectify low impact issues on the spot, than attending quickly but delaying final resolution of the problem.

5.2.4 Productivity Improvements

SEW considers that more consultation is required in relation to the productivity assumptions regarding costs and actions that are managed by the business in order to determine future costs. Productivity improvements are generally derived through ongoing small increments and are therefore very difficult to predict with a high degree of accuracy. In addition, given the lower water volumes and intended future reductions the industry generally may find that productivity improvements per unit of output are harder to achieve.

5.4.1 Updating the regulatory asset base

In this section, (and across the whole Water Plan) where actual data is not available the best available forecast should be used – not figures from the last Water Plan. There have been significant one off changes to the water industry as well as normal strategic changes since the time that the last plan was finalised, which make figures from the last plan invalid.

It would also be beneficial if this section commented on the use of the CPI to escalate the initial 1 July 2004 RAB.

5.4.3 Weighted average cost of capital

The Commission has indicated that it will release indicative WACC figures in early 2007 to assist those businesses that do not have the resources to undertake their own WACC research. It would be beneficial for the Commission to undertake this work earlier in the program so that businesses can make a choice about conducting their own WACC research once they have seen the Commission's outputs.

In practice, businesses will need to have their Water Plans largely finalised by February/March 2007 in order to allow internal approval and Board processes to be completed by 1 May. Given that WACC expertise is a specialised field, businesses cannot wait until after the Commission's work is complete to make their decision about whether to engage consultants, resulting in potentially duplicated costs.

6.4 Demand Forecasts

A discussion of recycled water forecasts need to be added to this section.

7.1 Tariff structures

While it is reasonable to expect justification of any proposed changes to tariff structures, the Commission appears to be indicating that businesses need to provide justification for continuation of current tariff structures.

In making a decision about which tariffs to change and which to retain, businesses need to be cognisant of the impacts this has on customers. That is, customers find wholesale changes to tariff structures confusing. In many instances businesses will have no option other than to maintain their existing tariff structures (except for a small number of well considered changes) for the purpose of continuity.

The Commission should focus on the benefits of the new tariff structures that are proposed rather than justifying those that already exist.

7.1.4 Tariff proposals

Box 7.1 is missing from the Guidance Paper.

7.2 Miscellaneous charges

SEW has a large number of miscellaneous charges (that represent a very small proportion of total revenue), some of which are only applied in rare circumstances. In these cases there is little to be gained from undertaking detailed forecasting and justification exercises.

SEW considers that the Commission should request volume forecasts, the reasons for the change and the impact on customers only when charges are to increase by more than CPI or be restructured. Where charges are to increase by CPI or less in the first instance, further justification should not be warranted.

This issue could be considered in the consultation paper for miscellaneous charges, including consideration of them being priced by principle rather than by price cap.

7.4.1 Changes in legislative obligations

The purpose of this section is unclear given the comments already made under section **3.4 Changes in legislative obligations**. SEW suggests that it would be more logical to combine these sections and include them in the earlier discussion of costs.

The Commission appears to have concluded that where a legislative obligation has changed and a business is currently meeting the higher standard, there would be no ability to recover the cost of meeting the higher standard on an ongoing basis.

The Commission needs to take into account the fact that there may be factors outside the businesses control that are allowing the business to meet the higher standard in the short term but which may change in the long term eg weather.

In order for a business to meet a higher target a program of actions needs to be put in place that ensures the target is met in all circumstances not only in favourable ones.

This section also advises that business are able to recover costs resulting from changed obligations where they exceed 5% of total revenue. The previous price determination set this level at 2.5% of total revenue or \$1m.

8.1 Classification of service as non-prescribed

SEW understands the need for the Commission to see a full breakdown of prescribed services and understand the process of cost allocation between prescribed and non-prescribed services. However, as noted by the Commission in the Guidance Paper, non-prescribed services, “are often provided in a competitive market”. For this reason SEW would not expect the Commission to require the inclusion of a breakdown of non-prescribed services provided, the costs of providing these services or the revenue earned from provision of these services in a public document.

The regulatory accounts audit report in conjunction with the information provided on cost allocation methodologies should be sufficient for the Commission to ensure that the costings provided for prescribed services are accurate.

Summary

SEW considers this an important opportunity to participate in the development of well thought out positions on issues of importance to the water industry. However, given the obligation to have a Draft Water Plan submitted by May 2007, the full intent of the Guidance Paper will be difficult to achieve.

SEW suggests that in addition to giving consideration to the above issues, the Commission and water businesses need to urgently reconsider the activities to be undertaken prior to delivery of the Draft Water Plans in the context of the remaining time available.

One practical way of achieving this deadline would be to look to the experience of the last Electricity Distribution Price Review. This review focussed the efforts of both the Commission and businesses on justification of departures from historical trends rather than a detailed review of past expenditure.

SEW looks forward to working with the Commission to achieve delivery of the Draft Water Plans.