



6 October 2006

Sean Crees
Acting Director, Water Regulation
Essential Services Commission
Level 1, 35 Spring Street
Melbourne Vic 3000

Dear Sean,

City West Water response to Essential Services Commission Guidance on Water Plans

City West Water (CWW) appreciates the opportunity to comment on the Essential Services Commission (ESC) 2008 Water Price Review Guidance on Water Plans.

CWW is supportive of the overall content outlined in the Commission's guidance paper on Water Plans and will endeavour to structure its Water Plan submission as outlined by the Commission. Specifically, CWW is seeking further clarification associated to the following issues raised in the guidance paper:

- Benchmarking;
- Changes in legislative obligations;
- Prudent and efficient capital expenditure;
- Individual demand forecasts;
- Service Standards.

Additionally, CWW would like to take this opportunity to introduce two issues not referred to in the guidance paper, fixed principles associated with recycled water and the application of the L (licence fee) factor to the pricing formula.

Benchmarking:

The Commission has indicated throughout the guidance paper that the Water Plan should make reference to 'benchmarking'. The Commission has not explicitly consulted on a framework for benchmarking efficient expenditure levels nor signalled the appropriate emphasis that should be placed on benchmarking. CWW seeks

clarification from the Commission as to how much emphasis should be placed on benchmarking and the appropriate framework that should be adopted.

Changes in legislative obligations:

The Commission has outlined that new obligations are being considered post 1 July 2008. CWW recognises the importance of delineating between business as usual and new obligation expenditure in terms of the assessment of efficiency. However, the definition as it currently stands may exclude new obligations that arise during the regulatory period, such as the Central Region Sustainable Water Strategy and other new obligations through the Statement of Obligations. It is CWW's position that new obligations be defined as being post 1 July 2005 and not part of the 2005-2008 ESC price determination. This will ensure business as usual and new obligations expenditure reflects the intended split.

Prudent and efficient capital expenditure:

The Commission has indicated at the last review that it intends to rely on the incentive properties of the regulatory regime with regard to updating the RAB for actual capital expenditure. The Commission also noted that it would adopt this approach rather than undertake an extensive ex-post audit of the businesses actual capital expenditures.

CWW seeks confirmation that the information requirements outlined in section 5.3.3 relate to forward looking capital expenditure proposals and not actual capital expenditure incurred during the first regulatory period.

Individual demand forecasts:

The Commission recognises the importance of estimating elasticity of demand in terms of ability of tariffs to change behaviour and the impact on the businesses demand forecasts.

Does the Commission expect elasticity of demand estimates for existing tariffs or only where material changes to the structure and level of tariffs are proposed?

Service Standards:

On page 17 of the Guidance Paper, the Commission makes it clear that service standard levels should be consistent with the three year average. CWW intends to propose a range for many of its targets which will encompass that average, similarly to our current target of "0-250 customers on > 5 unplanned water interruptions". We believe that a range works very well for our customers. Their required level of service is met efficiently. The range allows for fluctuations in conditions such as brought about by weather, and means that we can forecast efficient, consistent spend without the necessity of budgeting for bad years. If performance rises above or falls below the range, it triggers a review of management processes for that KPI.

Fixed Principles:

CWW is contemplating the concept of fixed principles (such as those used in gas access arrangements) to address the lack of certainty around recycled water projects. Recycled water is a relatively new product and government targets and policy are still evolving. Identification and development of appropriate projects is a cautious process. To ensure the right opportunities are not missed, CWW is considering the proposal of a fixed principle that provides the right incentives to efficiently meet government obligations associated to recycled water.

A fixed principle would provide the Commission with the capacity to make a legally binding commitment on particular matters at future reviews as well as provide regulated businesses with greater certainty about the approach to be taken in future reviews.

CWW is considering proposing a fixed principle expressed as follows:

The value of the Capital Base at the start of the third regulatory period will be adjusted to take account of the present value of recycled water capital costs incurred during the second regulatory period.

In considering those recycled projects to be included in the Capital Base the regulated entity will ensure the capital costs does not exceed the amount that would be invested by a prudent service provider acting efficiently, in accordance with Government policies and strategies.

Any operations and maintenance costs due to the implementation of recycled water projects and not recovered as prices, fees or charges during the second regulatory period are to be reflected in prescribed tariffs for the third regulatory period.

CWW would like the Commission to consider the possibility of incorporating the concept of fixed principles for recycled water projects into the regulatory framework for the next regulatory period.

L Factor:

The costs associated with licence fees are generally recovered through tariffs on a forward-looking basis. As the actual licence fee for a particular period reflects the Commission's actual costs, it is possible that the applicable licence fees may change significantly from year to year.

One way to address the issue of licence fee cost variability is to incorporate the recovery of actual licence fees into the price control formula. This would result in the recovery of licence fees moving from a forward looking allowance in the calculation of X factors to a backward- looking recovery of actual fees paid. That is, the prescribed tariffs for a given calendar year would recover the fees paid for the preceding financial year. This approach is referred to as the L Factor. CWW would like to the Commission to consider the application of the L Factor into the regulatory framework for the second regulatory period.

Please contact Andre Kersting directly on 9313 8791 if you wish to discuss this response further.

Regards,

David Heeps
General Manager External Affairs