



Level 2, 35 Spring St  
Melbourne 3000, Australia  
Telephone +61 3 9651 0222  
              +61 1300 664 969  
Facsimile +61 3 9651 3688

## 2008 WATER PRICE REVIEW

MELBOURNE WATER DRAINAGE AND WATERWAYS  
WATER PLAN 2008-2013 — DRAFT DECISION

MAY 2008

**An appropriate citation for this paper is:**

Essential Services Commission 2008, *2008 Water Price Review, Melbourne Water Drainage and Waterways Water Plan 2008-2013 — Draft Decision*, May.

## PREFACE

On 19 December 2007, Melbourne Water submitted its Water Plan in relation to drainage and waterways services to the Commission for assessment. The Water Plan sets out the prices that Melbourne Water proposes to charge for drainage and waterways services for the five year period commencing 1 July 2008. It also includes information about the strategies and initiatives that are proposed and the revenue needs of Melbourne Water from 2008-09 to 2012-13.

The Commission is required to assess the Water Plan against principles set out in the Water Industry Regulatory Order (WIRO) and to decide whether to approve the prices proposed by Melbourne Water or the manner in which those prices are to be calculated or otherwise determined.

The review of Melbourne Water's prices forms part of the 2008 Water Price Review, in which the Commission is also reviewing the prices proposed by Victoria's regional urban and rural water businesses. This is the third review of water prices undertaken by the Commission since it became the economic regulator of the Victorian water industry in 2004.

This Draft Decision sets out the Commission's views on whether to approve the prices proposed by Melbourne Water in its Water Plan as satisfying the principles set out in the WIRO. The Draft Decision also outlines the Commission's reasons for non approval and suggested amendments or other actions that may result in the proposals being approved.

In response to this Draft Decision, Melbourne Water is required no later than 31 May 2008, to submit a revised schedule of tariffs giving effect to any required amendments set out in this Draft Decision and any other information required by the Commission.

Consultation with stakeholders is an important part of the Commission's decision making process. Customers and other interested parties are invited to comment on the Draft Decision by sending in a written submission. The Commission will accept all submissions received up to 6 June 2008 and will make all submissions available on its website. Details of how to respond are provided on the following page.

Copies of this Draft Decision and Melbourne Water's Water Plan are available on the Commission's website [www.esc.vic.gov.au](http://www.esc.vic.gov.au) or by contacting the Commission on 1300 604 969.

Greg Wilson  
**Chairperson**

## HOW TO RESPOND TO THIS PAPER

We encourage as many stakeholders as possible to provide comment on the Draft Decision. The responses received and information generated through the public consultation process will assist the Commission in making its Final Decision.

Interested parties can provide feedback on the Draft Decision by providing written comments or submissions. Written comments are due by 6 June 2008.

We would prefer to receive them by email at [water@esc.vic.gov.au](mailto:water@esc.vic.gov.au).

You can also send comments by fax (03) 9651 3688 or by mail to  
Essential Services Commission  
Level 2, 35 Spring St  
Melbourne VIC 3000

The Commission's normal practice is to make all submissions publicly available on its website. If you do not have access to the Internet, you can contact Commission staff to make alternative arrangements to view copies of the submissions.

If there is information that you do not wish to be disclosed publicly on the basis that it is confidential or commercially sensitive, you should discuss the matter first with Commission staff.

Further details on consultation with stakeholders can be found on the Commission's website.

# CONTENTS

<b>Peface</b>	<b>III</b>
<b>How To Respond To This Paper</b>	<b>IV</b>
<b>1 Introduction</b>	<b>1</b>
1.1 The 2008 water price review	1
1.2 Legislative framework and role of the commission	3
1.3 The structure of this draft decision	4
<b>2 Key outcomes and service standards</b>	<b>7</b>
2.1 Introduction	7
2.2 Key outcomes for the 2008 – 2013 regulatory period	7
2.3 Service standards	7
<b>3 Demand</b>	<b>11</b>
3.1 Melbourne water’s demand forecasts	11
3.2 Draft decision	11
<b>4 Capital and operating expenditure</b>	<b>15</b>
4.1 Introduction	15
4.2 Overview of the draft decision	15
<b>5 Financing capital investments</b>	<b>17</b>
5.1 Introduction	17
5.2 Regulatory depreciation	17
5.3 Rolled forward regulatory asset base	17
5.4 Rate of return – weighted average cost of capital	19
<b>6 Summary of revenue requirement</b>	<b>21</b>
<b>7 Prices</b>	<b>23</b>
7.1 Introduction	23
7.2 Drainage and waterways prices	23
7.3 Drainage developer charges	32
7.4 Diversion prices	33
7.5 Miscellaneous services	35



## 1.1 The 2008 water price review

On 19 December 2007, Melbourne Water submitted its Water Plan to the Commission on the prices it proposes to charge for the five year period beginning 1 July 2008 for drainage and waterways services.<sup>1</sup> The Water Plan contains information on the key objectives that Melbourne Water intends to deliver over the forthcoming five year regulatory period in relation to drainage and waterways services, the revenue it requires to achieve these objectives and the resultant prices it proposes to charge. This Draft Decision sets out the Commission's analysis and initial views on whether it proposes to approve the prices proposed by Melbourne Water.

The Commission is required to assess Melbourne Water's pricing proposals against certain principles contained in the Water Industry Regulatory Order (the WIRO). On the basis of this assessment, the Commission must decide whether to approve or specify prices or the manner in which prices are to be determined.

The review of Melbourne Water's prices comes within the broader context of the 2008 water price review, in which the Commission is also reviewing prices proposed by 16 of the other 19 Victorian water businesses.<sup>2</sup> The other businesses submitted their Water Plans in October 2007, with the Commission releasing its Draft Decision in March 2008. The Commission will release a Final Decision and issue determinations in June 2008 on prices proposed by all businesses subject to the current price review, including Melbourne Water.

In a number of cases, the Commission has adopted the same assumptions it made in the March 2008 Draft Decision regarding Melbourne Water's pricing proposals. Therefore, in some cases this Draft Decision provides a summary of the analysis that the Commission has used but refers to Volume I of the March 2008 Draft Decision for further details.

It is important to note that this Draft Decision applies only to Melbourne Water's drainage and waterways charges. The review of prices for Melbourne Water's other services, most importantly its bulk water and sewerage charges, was delayed following the Government's announcement on 14 August 2007 that a review into

---

<sup>1</sup> Melbourne Water's Water Plan is available on the Commission's website: <http://www.esc.vic.gov.au/>.

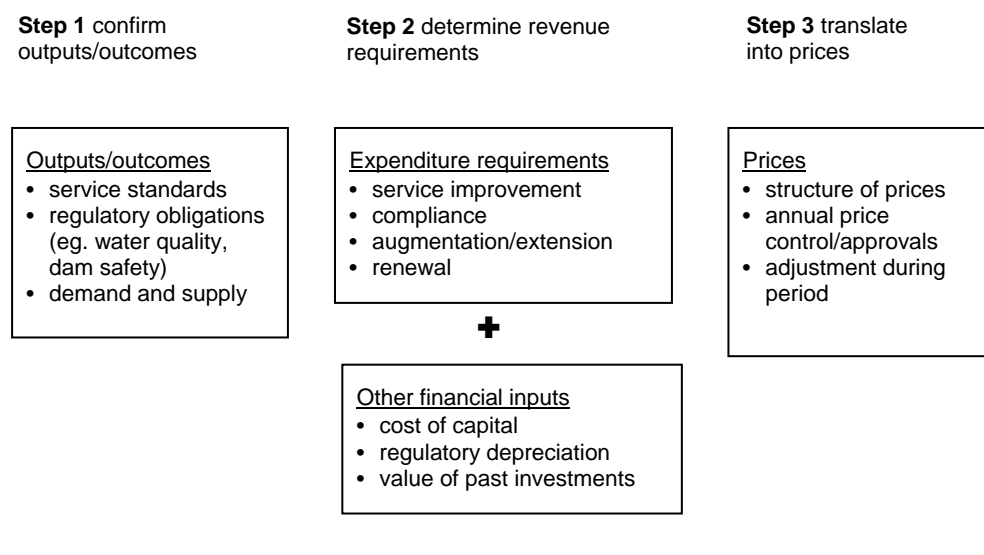
<sup>2</sup> The Commission is currently assessing the Water Plans of Barwon Water, Central Highlands Water, Coliban Water, East Gippsland Water, Gippsland Water, Goulburn Valley Water, North East Water, South Gippsland Water, Wannon Water, Western Water, Westernport Water, GWMWater, Lower Murray Water, First Mildura Irrigation Trust, Goulburn-Murray Water and Southern Rural Water.

the structure of the retail water industry in Melbourne would be undertaken by the Victorian Competition and Efficiency Commission (VCEC).<sup>3</sup>

The Department of Sustainability of Environment (DSE) has indicated that the WIRO will be amended to specify a 14.8 per cent interim price increase in 2008-09 for the three metropolitan retailers and an appropriate interim increase for Melbourne Water following consideration of VCEC’s final report to the Minister.

The Commission’s approach to assessing proposed prices is characterised by three steps (see figure 1.1). The first step involves establishing the service standards and other key objectives that a business proposes to deliver over the regulatory period. These standards and objectives reflect obligations imposed by the Minister for Water through the Statement of Obligations, the Environment Protection Authority (EPA), the Department of Human Services (DHS) and DSE, but also reflect customer preferences for improvements in service quality.

**Figure 1.1 Steps in assessing and approving prices**



Step two involves the Commission assessing the revenue the business requires to achieve the service obligations and expectations referred to in step one. The Commission is required to assess whether the business’s expenditure forecasts and capital works programs reflect efficient costs of supply, are deliverable over the period and reflect a long term planning horizon. The Commission must also ensure that the return that businesses receive on their capital investments reflect efficient costs of capital.

The Commission’s assumptions about efficient expenditure are used only to assess whether prices will result in the business earning sufficient revenue to

<sup>3</sup> The VCEC review also delayed the review of prices proposed by City West Water, South East Water and Yarra Valley Water.



deliver services. They do not represent amounts businesses are required to spend or direct to particular activities or projects. In consultation with customers, businesses are free to determine their own expenditure priorities in light of changing circumstances and to pursue innovation and efficiencies that enable them to outperform the cost assumptions.

The third step in the process involves determining the prices that will apply. The Commission must ensure that prices generate the business's required revenue, taking into consideration forecasts of demand. The Commission must also be satisfied that prices provide appropriate signals about the costs of providing services, provide incentives for sustainable water use and take into account the interests of customers.

## 1.2 Legislative framework and role of the Commission

In carrying out its role, the Commission is primarily guided by the regulatory framework set out in the *Essential Services Commission Act 2001* and the *Water Industry Act 1994*. The more detailed framework is set out in the WIRO made by the Governor in Council under the *Water Industry Act 1994*.<sup>4</sup>

The *Essential Services Commission Act 2001* outlines objectives to which the Commission must have regard in undertaking its functions across all industries. The Commission's primary objective is to protect the long-term interests of Victorian consumers with regard to the price, quality and reliability of essential services. In seeking to achieve this primary objective, the Commission must have regard to:

- facilitating the efficiency, incentives for long term investment and the financial viability of regulated industries
- preventing the misuse of monopoly or transitory market power
- facilitating effective competition and promoting competitive market conduct
- ensuring regulatory decision making has regard to the relevant health, safety, environmental and social legislation applying to the regulated industry
- ensuring users and consumers (including low income or vulnerable customers) benefit from the gains from competition and efficiency and
- promoting consistency in regulation across States and on a national basis.

The *Water Industry Act 1994* contains the following additional objectives that the Commission must meet in regulating the water sector:

- wherever possible, ensure that the costs of regulation do not exceed the benefits
- regulatory decision making and regulatory processes have regard to any differences in the operating environments of regulated entities and
- regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities.

---

<sup>4</sup> The WIRO is available on the Commission's website: <http://www.esc.vic.gov.au/>.

The WIRO requires the Commission to approve or specify the price arrangements to apply to each of the water businesses for the regulatory period. The Commission must approve the price arrangements if it is satisfied that the prices or the manner in which prices are to be calculated or otherwise determined have been developed in accordance with the procedural requirements and comply with the regulatory principles outlined in the WIRO.

Alternatively, the Commission may specify the prices that a business may charge or the manner in which those prices are to be calculated or otherwise determined if it is not satisfied that the arrangements proposed in the Water Plan were developed in accordance with the WIRO. The procedural requirements include the need for businesses to consult with customers and relevant regulatory agencies before submitting the Water Plan to the Commission for assessment.

In deciding whether to approve the proposed prices, the Commission must be satisfied that they provide the business with sufficient revenue over the regulatory period to deliver their regulated services. The revenue must be sufficient to allow the business to recover:

- operational, maintenance and administrative costs
- expenditure on renewing and rehabilitating existing assets
- a rate of return on past investments as at 1 July 2004 that are valued at an amount or in a manner determined by the Minister for Water or the costs associated with any debt incurred to finance recent expenditure in a manner determined by the Minister and
- a rate of return on investments made after 1 July 2004.

The Commission must also ensure that:

- the expenditure forecasts reflect the efficient delivery of the proposed outcomes outlined in the Water Plan and take into account a long term planning horizon
- the businesses have incentives to pursue efficiency improvements and
- customers or potential customers are readily able to understand the prices charged or the manner in which they are to be calculated or determined.

### **1.3 The structure of this draft decision**

This Draft Decision is structured as follows:

- Chapter 2 provides an overview of key outcomes and service levels that underpin Melbourne Water's expenditure forecasts in relation to its drainage and waterways services.
- Chapters 3 sets out the Commission's assessment of Melbourne Water's demand forecasts.
- Chapter 4 sets out the Commission's assessment of Melbourne Water's operating and capital expenditure.
- Chapter 5 provides an overview of the assumptions relating to financing capital investments that have been adopted by the Commission .
- Chapter 6 provides a summary of the revenue to be recovered by Melbourne Water over the regulatory period.

Chapter 7 provides the Commission's assessment on the structure of Melbourne Water's proposed drainage and waterways prices.



## 2 | KEY OUTCOMES AND SERVICE STANDARDS

### 2.1 Introduction

Service standards and other key outcomes are important in determining a water business's expenditure forecasts and the prices that are ultimately charged to customers. This chapter of the Draft Decision provides an overview of the key outcomes underpinning Melbourne Water's expenditure forecasts in relation to its drainage and waterways services. It also sets out the service related targets that Melbourne Water proposes to achieve over the next regulatory period.

### 2.2 Key outcomes for the 2008 – 2013 regulatory period

Melbourne Water undertakes programs to improve the health of rivers and creeks, provide drainage infrastructure to service urban growth and provide sufficient levels of flood protection. Melbourne Water provides drainage and waterways services under a range of legislative and regulatory instruments, which are articulated in its Waterways Operating Charter.<sup>5</sup>

Over the five year period beginning 1 July 2008, Melbourne Water is proposing to spend \$589 million on capital projects and \$453 million in operating expenditure related to drainage and waterways services. In its Water Plan, Melbourne Water identified a number of factors underpinning its proposed expenditure. More specifically, it identified long term objectives and ten year goals in a number of areas, including detailed actions that it intends to take to meet these long and short term objectives.<sup>6</sup> In relation to the regulatory period beginning 1 July 2008 Melbourne Water proposed explicit five year targets for a range of performance indicators. These are discussed in section 2.3.

### 2.3 Service standards

The Commission is responsible for regulating service standards and conditions of supply for the prescribed services provided by Victoria's water businesses, including Melbourne Water's drainage and waterways services. The WIRO provides scope for the Commission to specify standards and conditions in a code,

---

<sup>5</sup> The Waterways Operating Charter is available on Melbourne Water's website: <http://www.melbournewater.com.au/>.

<sup>6</sup> The areas where short and long term objectives were identified are waterways condition, stormwater quality, drainage and flood protection, land development, monitoring, investigations and research and community and stakeholder engagement. See Melbourne Water, 2008 Waterways Water Plan, for details on the outcomes to be delivered over the regulatory period.

but also to approve service standard targets proposed by a water business in a Water Plan.

As part of the 2005 Water Price Review, the Commission consulted on and developed a set of core service standards for water businesses. Melbourne Water was required to comply with service standard targets against a range of performance indicators over the current regulatory to ensure that its performance did not fall below its past performance. However, Melbourne Water's core service standards relate mainly to its bulk water and sewerage services and do not contain any standards that relate solely to drainage and waterways services.

Businesses were also allowed to propose additional service standards that address issues that are specific to their business or of importance to customers. Melbourne Water had a number of additional service standards in place over the current regulatory period relating to waterways and drainage and the Regional River Health Strategy. There are no formal arrangements under the annual performance reporting framework for monitoring performance against these additional service standards. However, they can provide a useful basis for determining whether projects have been delivered on a timely basis or whether a business's proposed expenditure has been effective in achieving its proposed objectives.

Melbourne Water has proposed a range of five year targets that it intends to achieve over the regulatory period in relation to the Regional River Health Strategy, customer service standards under its Customer Charter and the Waterways Water Quality Strategy. These targets are set out tables 2.1 to 2.3.

The Commission proposes that these targets be approved in Melbourne Water's determination as additional services standards. As discussed in chapter 4, the Commission will seek further information on Melbourne Water's proposed expenditure and its ability to deliver on a number of its proposed outcomes. A number of service standards targets may need to be adjusted to reflect the information provided by Melbourne Water..

**Table 2.1 Regional River Health Strategy Targets**

<i>Activity</i>	<i>5 year target</i>
Number of rivers with negotiated environmental flow regimes	12
Number of rivers with improvements made to environmental flow regimes	17
Area of streamside land under management agreements	10km <sup>2</sup>
Length of streamside land revegetated	1 026 km
Number of fish barriers removed	31
Length of riparian land subject to weed management	2 042 km
Number of plans developed for rivers and creeks of high social value	15
Rivers where heritage values are protected or improved	34
Number of plans developed for rivers and creeks of high environmental value	11
Number of investigations to fill data gaps in rivers or creeks	55
Number of sites subject to bed and bank stabilisation	55
Number of Index of River Condition (IRC) reaches with instream habitat reinstated	12

**Table 2.2 Customer Charter Service Targets**

<i>Activity</i>	<i>5 year target</i>
Applications for surface diversion licences determined within 60 days	90%
Permanent transfer of surface diversion licences processed within 30 days	90%
Temporary trade of water entitlement volumes processed within 60 days	90%
Permanent trade of water entitlement volumes processed within 60 days	90%

**Table 2.3 Waterways Water Quality Strategy Targets**

<i>Target area</i>	<i>5 year target</i>
<b>Planning for improved water quality</b>	
Develop a draft Better Bays and Waterways Plan	2008
Percentage of programs implemented from the Better Bays and Waterways Plan assigned to Melbourne Water	100%
New or revised State Government requirements for all industrial, commercial and residential development to meet best practice water quality objectives	2013
<b>Equipping agencies, communities and industry to manage water quality</b>	
Develop and commence implementation of a land management program to manage run-off in rural areas	2009
Number of training modules delivered under the Clearwater program per year with assistance from Melbourne Water	10
Percentage of local governments with improved performance in delivering sustainable urban water management (as measured by the Council Needs Analysis)	70%
Number of guidelines and/or tools prepared to assist in the application of best practice stormwater management	6
Number of rain gardens built in the community with support from Melbourne Water	10 000
<b>Targeted water quality works</b>	
Number of pollution load hotspots addressed	8
Percentage of actions implemented from local governments Stormwater Management Plans assigned to Melbourne Water	30%
Percentage of local governments that have committed to water sensitive urban design implementation targets for pollutant loads, flow and effective imperviousness	50%
Reduction of nitrogen loads in stormwater by 2010	100 tonnes
Annual reduction in nitrogen loads through the establishment of wetlands for the period 2010 to 2013	2 tonnes
<b>Monitoring, investigations and research</b>	
Percentage of health risk assessments completed for major rivers and creeks with a high level of recreational activity	100%
Number of new monitoring programs to fill knowledge gaps for toxicants and pesticides	2
Completion date for delivering faecal investigations program	2013



Melbourne Water's demand forecasts represent a critical element of its Water Plan for the regulatory period. Changes in customer numbers and drainage development lots are important determinants of the capability of the infrastructure to provide services and of the need for expenditure on renewal and augmentation. Thus, the demand forecasts have a direct bearing on the prices that customers will pay during the period.

In assessing the demand forecasts proposed by Melbourne Water, the Commission has given consideration to the business's Water Plan and further information that it has provided in support of the forecasts.

In this chapter, the Commission sets out its initial view on what it considers are reasonable demand forecasts for the purposes of setting prices. It acknowledges that there may be uncertainty over future demand levels and is proposing to deal with this uncertainty through an adjustment mechanism (discussed in chapter 3.2.2).

### 3.1 Melbourne Water's demand forecasts

Melbourne Water noted that demand for waterways and drainage is different to water and sewerage services, as these forecasts are not based on volumes. Forecasts to help determine waterways and drainage tariffs are driven by property development, developer charges and customer charges.

### 3.2 Draft Decision

The Commission has accepted the demand forecasts proposed by Melbourne Water. Tables 3.1 and 3.2. set out the accepted forecasts.

**Table 3.1 Draft decision — annual property forecasts for total extended area**  
thousand properties

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Residential	118.3	123.6	128.7	133.5	138.1
Non residential	5.2	5.4	5.7	5.9	6.1
Rural	54.1	56.6	58.9	61.1	63.2
Total	177.6	185.6	193.3	200.5	207.4

**Table 3.2 Draft decision — annual property forecasts for existing areas**  
thousand properties

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Residential					
Minimum charge	882.1	944.5	1021.3	1071.2	1454.6
Above minimum	486	445.7	391.3	363.4	1.4
Non residential					
Minimum charge	27.1	29.1	31	32.8	34.6
Above minimum	93.2	93.2	93.2	93.2	93.2
Rural	51.2	51.8	52.4	53.1	53.8
Total	1539.7	1564.4	1589.3	1613.7	1637.7

### 3.2.1 Key factors influencing demand

Melbourne Water has relied on customer growth forecasts provided to it by the retail water businesses, which were based on estimates using DSE's Victoria in Future (VIF) 2004 property forecasts. In its Water Plan, Melbourne Water noted that, although there were likely to be minor variations in growth forecasts for water customers and waterways and drainage customers, it did not make any adjustments to its forecasts. These differences arise because drainage and waterways charge apply to rateable properties while water charges apply to metered properties and because multi-unit developments may be separately metered for water use but are not for waterways and drainage.

Growth forecasts for Melbourne Water's extended service areas were based on estimates developed by an independent consultant using the VIF forecasts.

The Commission does not have any major issues with the methodology that Melbourne Water has used with regard to the VIF forecasts and is of the view that the resulting forecasts of connections were reasonable.

### 3.2.2 Uncertainty

Due to the continuing uncertainty around demand and supply levels, the Commission proposes for the second regulatory period, to monitor the level of demand over the period. Where the Commission considers actual demand levels are sufficiently different from those assumed at the time of the price determination, it proposes to conduct a within-period review to assess the impact on Melbourne Water's revenues. Such a review could be initiated by the Commission or requested by the business. Where the Commission finds a material impact on revenue, prices may be adjusted during the period.

Low demand forecasts result in higher prices than those based on higher demand forecasts. If demand forecasts are shown to have been too conservative, prices will have been higher than necessary to meet the business' revenue requirement and

customers will have paid too much. Conversely, if demand forecasts are shown to have been too optimistic, prices will have been set too low to cover the business' revenue requirement. Without an adjustment mechanism to deal with demand uncertainty, the business would have an incentive to forecast conservative demand levels to reduce the risk of not recovering their reasonable costs.

The Commission considers that, in the context of continuing significant uncertainty about the demand forecasts for the second regulatory period, providing for within-period review is the most appropriate means of striking a balance between protecting customers and ensuring the business can recover its reasonable costs. If demand forecasts prove to be significantly too conservative (too optimistic), the Commission will adjust prices downwards (upwards). Thus, the business and its customers will share the risk from uncertainty in the demand forecasts.

Any within-period review would focus solely on the impact of any significant divergences between actual and assumed demand levels. The review would not constitute a full re-opening of the determination.



### 4.1 Introduction

The WIRO requires the Commission to ensure that the prices levied by the businesses provide them with a sustainable revenue stream that does not reflect monopoly profits or inefficient expenditure. The Commission must also be satisfied that the proposed expenditure forecasts are efficient and take into account a planning horizon that extends beyond the five year regulatory period.

Operating and capital expenditure are key elements of the total revenue requirement. Operating expenditure is reflected directly in prices in the year in which it is incurred. Net capital expenditure is recovered by being added to the regulatory asset base (RAB) and is incorporated in prices through a return on the RAB (that is a percentage to reflect financing costs multiplied by the RAB) and a return of the RAB (through depreciation). This reflects the fact that capital expenditure is recovered over the life of the asset.

The Commission has made assumptions about the operating and capital expenditure needed by Melbourne Water to deliver drainage and waterways services over the regulatory period based on information provided by Melbourne Water and a review by independent consultants engaged by the Commission.

The Commission's assumptions are used solely to assess whether prices will result in Melbourne Water earning sufficient revenue to deliver its waterway and drainage services. They do not represent amounts Melbourne Water is required to spend or to direct to particular activities or projects. In consultation with customers, Melbourne Water is free to determine its own expenditure priorities in light of changing circumstances and to pursue innovation and efficiencies that enable it to outperform the cost assumptions.

### 4.2 Overview of the draft decision

The Commission approved the following levels of capital and operating expenditure for Melbourne Water's Waterway and Drainage services across the regulatory period.

**Table 4.1 Draft decision – expenditure**  
\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Capital expenditure	105.7	132.6	118.0	121.4	111.8
Operating expenditure	88.7	88.4	91.3	92.5	92.8

For the Draft Decision the Commission has accepted Melbourne Water's proposed operating and capital expenditure for the Waterway and Drainage services.

Prior to the Final Decision, the Commission will be seeking further information from Melbourne Water on:

- projections on the take up of grants for waterway condition works on private land
- the ability of Melbourne Water to deliver the targeted 10,000 rain gardens during the regulatory period
- development of the definition of intolerable flood risk and its impact on expenditure and
- the potential to smooth capital expenditure across the regulatory period, in particular for the drainage and flood protection program.
- the impact of changes to payroll tax, land tax and Work Cover premiums announced in the recent State Budget.

The Commission's consultant was not required to review expenditure associated with corporate overheads. The Commission has accepted Melbourne Water's proposed expenditure for corporate overheads, comprising capital expenditure of \$33.7 million and operating expenditure of \$123.4 million over the regulatory period. Melbourne Water's corporate expenditure will be reviewed in full as part of the Commission's review of Melbourne Water's bulk water and sewerage services. The Commission will consider the impact of any changes to forecast corporate overhead expenditure on drainage and waterways charges as part of that review.

The Commission may also review other components of the drainage and waterways expenditure during its review of Melbourne Water's bulk water and sewerage charges, including an assessment of progress of planned activities against targets.

## 5 | FINANCING CAPITAL INVESTMENTS

### 5.1 Introduction

The WIRO requires that prices must allow water businesses to earn a return on all existing and new assets.

Typically, the water businesses funds capital investments initially, and recovers financing costs from customers over time through a return on assets and recovers the initial capital costs over time through regulatory depreciation.

This chapter sets out the Commission's Draft Decision on assumptions used by Melbourne Water regarding financing of capital investments, including regulatory depreciation, the initial regulatory asset base attributable to drainage and waterways services and the rate of return on investments.

### 5.2 Regulatory depreciation

Businesses recover the initial outlay on capital investments over the life of an asset through regulatory depreciation. Melbourne Water has proposed to use a straight line approach to calculate regulatory depreciation. It has also identified four asset classes with different asset lives to calculate regulatory depreciation – existing waterways and drainage (61 years), existing corporate (21 years), new waterways and drainage (103 years) and new corporate (7 years).

As indicated in previous guidance, the Commission considers a straight line approach to be most appropriate as it is transparent and is the approach most commonly used. In regards to proposed asset lives, the Commission notes that variations in asset lives affect the timing rather than the size of cash flows. Shorter asset lives result in current customers contributing more to capital assets than future customers, which may also benefit from the same assets, whereas longer asset lives distribute the costs more evenly between current and future customers.

Given the nature of the assets and other water businesses' proposals on regulatory depreciation, the Commission considers that Melbourne Water's proposed asset lives are appropriate. The Commission therefore proposes to adopt Melbourne Water's assumptions on regulatory depreciation in approving its drainage and waterways charges.

### 5.3 Rolled forward regulatory asset base

The Minister for Water determined opening regulatory asset values as at 1 July 2004 for all Victorian water businesses. The Commission will calculate each business's regulatory asset base as of 1 July 2008, which will be used for pricing purposes in the next regulatory period. This is done by updating the initial

regulatory asset value for regulatory depreciation, actual capital expenditure, contributions and disposals between 2004-05 and 2006-07 and updated estimates for 2007-08.

However, this approach is used to determine a rolled forward asset base for each business as a whole. In Melbourne Water's case, the Commission is only required to review its drainage and waterways prices. Melbourne Water has used an implied 'drainage and waterways' regulatory asset base as of 1 July 2008 for the purposes of calculating drainage and waterways prices to apply from this date. The implied regulatory asset base used to determine drainage and waterways prices is \$860.8 million.<sup>7</sup>

The Commission has not been able to undertake a comprehensive review of the allocation methodology used to calculate this value and has not previously required businesses to assign components of their regulatory asset values to particular services. However, for the purposes of calculating Melbourne Water's drainage and waterways prices, the Commission considers the proposed value is not unreasonable and proposes to adopt this value as the basis for approving prices for the next regulatory period.

It is also important to note that the Commission proposes to adopt this value for the purposes of approving drainage and water prices for the next regulatory period only. For any subsequent reviews of proposed prices the Commission will adopt the rolled forward RAB for Melbourne Water as a whole.

The Commission has adopted the following assumptions in relation to Melbourne Water's rolled forward regulatory asset base (relating to drainage and waterways services) over the regulatory period.

---

<sup>7</sup> This information was sourced from financial templates submitted by Melbourne Water with its Water Plan.



**Table 5.1 Rolled forward regulatory asset base (drainage and waterways services)**

\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Opening RAB	860.8	913.7	985.5	1038.3	1089.4
<i>Plus</i> Gross Capital expenditure	105.7	132.6	118.0	121.4	111.8
<i>Less</i> Customer contributions	37.3	43.7	46.5	50.2	51.1
<i>Less</i> Government contributions	-	-	-	-	-
<i>Less</i> Proceeds from disposals	-	-	-	-	-
<i>Less</i> Regulatory depreciation	15.4	17.1	18.6	20.1	21.7
<b>Closing RAB</b>	<b>913.7</b>	<b>985.5</b>	<b>1038.3</b>	<b>1089.4</b>	<b>1128.3</b>

#### 5.4 Rate of return – weighted average cost of capital

In its guidance prior to the submission of Water Plans, the Commission recommended that water businesses adopt a weighted average cost of capital (WACC) of 5.1 per cent, in accordance with the financial market conditions at that time. All businesses, including Melbourne Water adopted this rate in their Water Plans.

The Commission now proposes to adopt a WACC of 6.1 per cent for Melbourne Water to reflect current market conditions, in line with its recent Draft Decision on regional and rural water prices. The difference between the Commission's initial guidance and the revised WACC is due to changes in the risk free rate, debt margin and equity beta. The individual WACC components are discussed in detail in the March 2008 Draft Decision.<sup>8</sup> Table 5.2 outlines the individual components of the of WACC adopted by the Commission.

**Table 5.2 Real post-tax WACC**

<i>Real risk free rate</i>	<i>Equity beta</i>	<i>Market risk premium</i>	<i>Debt margin</i>	<i>Financing structure</i>	<i>Franking credit value</i>	<i>WACC</i>
<i>(per cent)</i>	<i>(β)</i>	<i>(per cent)</i>	<i>(per cent)</i>	<i>(per cent)</i>	<i>(%)</i>	<i>(per cent)</i>
3.41	0.65	6.00	1.95	60	0.5	6.1

<sup>8</sup> Essential Services Commission, 2008, 2008 Water Price Review – regional and urban Draft Decision, Chapter 6, section 6.2, pp.81-89.



## 6 SUMMARY OF REVENUE REQUIREMENT

The revenue requirement represents the revenue that a water business must recover through prices in each year of the regulatory period in order to meet its operating expenditure, capital financing and other related costs.

The Commission has adopted the assumptions set out in table 6.1 in relation to Melbourne Water's revenue requirement in each year of the regulatory period.

**Table 6.1 Breakdown of revenue requirement implied by ESC draft decision**  
\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Operating expenditure	88.7	88.4	91.3	92.5	92.8
Return on existing assets	52.1	51.2	50.3	49.4	48.5
Return on new investments	2.1	6.8	11.5	15.5	19.2
Regulatory depreciation	15.4	17.1	18.6	20.1	21.7
Adjustments from previous regulatory period	4.4	4.4	4.4	4.4	4.4
Benchmark tax liability	3.9	4.3	4.6	4.8	4.9
<b>Total</b>	<b>166.6</b>	<b>172.2</b>	<b>180.7</b>	<b>186.7</b>	<b>191.5</b>

As discussed, the Commission proposes to adopt Melbourne Water's proposed operating expenditure and assumptions on regulatory depreciation and the regulatory asset base.

The Commission also proposes to include an adjustment from the previous regulatory period in Melbourne Water's revenue requirement. As part of the 2005 Water Price Review, the Commission approved drainage and waterways prices that did not account for proposed expenditure in Melbourne Water's extended drainage area. The Commission directed Melbourne Water to separately record any expenditure incurred in the extended area, and to include this amount in calculating prices to apply from 1 July 2008. Melbourne Water incurred \$22 million in expenditure in the previous three years (in net present value terms) and proposes to recover this amount over the next five years. These amounts have also been reviewed as part of the consultants' expenditure review.

Melbourne Water has also indicated that it expects to incur company tax over the regulatory period. The Commission proposes to adopt Melbourne Water's assumptions on benchmark tax liability attributable to waterways and drainage services. The Commission will further review any benchmark tax assumptions in

more detail when it reviews prices for Melbourne Water's bulk water and sewerage services.

The Commission has adjusted the return on existing and new assets components of the revenue requirement to reflect the higher weighted average cost of capital. The adjustments to the revenue requirement resulting from this change are set out in table 6.2.

**Table 6.2 Adjustment to revenue requirement**  
\$ million in January 2007 prices

	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>	<i>2012-13</i>
Total – proposed	157.6	162.6	170.4	176.0	180.3
Adjustments	9.0	9.6	10.3	10.7	11.2
Total – draft decision	166.6	172.2	180.7	186.7	191.5

## 7.1 Introduction

The total revenue that Melbourne Water may recover in the next regulatory period from drainage and waterways services was specified in chapter 6 of this Draft Decision. This chapter sets out the Commission's Draft Decision on whether to approve the tariff structures proposed by Melbourne Water for these services

In assessing proposals regarding tariff structures or individual tariff components, the Commission must be satisfied that the prices are consistent with a number of WIRO principles. These are that prices must:

- provide incentives for the sustainable use of Victoria's water resources by providing appropriate signals to water users about:
  - the costs of providing services, including costs associated with future supplies and periods of peak demands and or restricted supply and
  - choices regarding alternative supplies for different purposes
- take into account the interests of customers of the regulated entity, including low income and vulnerable customers
- provide the regulated entity with incentives to pursue efficiency improvements and to promote the sustainable use of Victoria's water resources and
- enable customers or potential customers of the regulated entity to readily understand the prices charged by the regulated entity for prescribed services, or the manner in which such prices are to be calculated or otherwise determined.

The following chapters discuss Melbourne Water's pricing proposals in respect of its drainage and waterways services and the Commission's assessment of the proposals against the above principles.

## 7.2 Drainage and waterways prices

Melbourne Water currently bases its drainage and waterways charges on customers' property values. The drainage charge payable by any customer is determined by applying a rate to the 1990 Net Annual Value (\$NAV) of that customer's property, subject to a minimum price. Approximately 60 per cent of residential and 14 per cent of non-residential customers currently pay the minimum charge.

This rate and minimum price generally applies uniformly for residential and non-residential customers alike. However, customers in the Baw Baw, South Gippsland and parts of the Bass Coast Shires that receive waterways but no drainage services pay a lower rate. Conversely, customers in the Koo Wee Rup Flood Protection District and Patterson Lakes pay a higher rate to reflect the higher level

of service they receive. Melbourne Water's current drainage prices are set out in table 7.1. Melbourne Water's metropolitan drainage charges are currently regulated through individual price caps. However, drainage rates in all other areas (special drainage areas) are subject to pricing principles, whereby Melbourne Water submits prices to the Commission on an annual basis following consultation with the relevant customer committees.

**Table 7.1 Waterways and drainage charges (2007-08)**  
(\$ 1 January 2007 prices)

	<i>Minimum price (\$)</i>	<i>Rate in \$NAV (cents)</i>
Metropolitan	55.05	0.7728
Shires of Baw Baw, South Gippsland and parts of Bass Coast	31.46	0.3722
Koo Wee Rup Flood Protection District		
- Division A	55.05	3.600
- Division B	55.05	2.000
Extra fees for Patterson Lakes		
- Tidal waterways	0.00	0.4066
- Quiet Lakes	0.00	0.3346

### 7.2.1 Extended drainage and waterways areas

The boundary within which Melbourne is responsible for providing drainage and waterways services was extended in 2005 to include parts of the Westernport, Werribee and Maribyrnong catchments and all of the Mornington Peninsula. Customers located within this extended area will be required to pay Melbourne Water drainage and waterways charges for the first time from 1 July 2008.

The Victorian Government first foreshadowed the extension of Melbourne Water's drainage and waterways boundaries in the 2004 White Paper.<sup>9</sup> The White Paper noted that arrangements for providing drainage, waterways and floodplain management services in these areas were inadequate. While some services were provided locally through a combination of local councils, property owners and community groups, there was no single authority that was responsible for providing services on a catchment-wide basis.

Melbourne Water formally became responsible for the new areas in November 2005 by Order-in-Council. However, Melbourne Water began incurring additional expenditure from 1 July 2005 in preparation for providing services in these areas, and has been incurring additional expenditure ever since. Customers have therefore been receiving drainage and waterways services in these areas for the past three years but have not been required to pay until now.

<sup>9</sup> Victorian Government 2004, *White Paper: Securing our Water Future Together*, June, Action 7.9, p.148.

The Commission notes that similar services, in particular waterways services, are provided in regional areas of Victoria by catchment management authorities, which unlike Melbourne Water, are funded by the Government and not directly from recipients of the services. The difference in funding arrangements was also highlighted as an issue by the Interface Councils in their submission.<sup>10</sup>

However, these arrangements have been determined by the Victorian Government and are outside the scope of the Commission's responsibilities. The Commission is therefore unable to review any such institutional arrangements as part of the current price review. The role of the Commission in this case is to ensure that Melbourne Water levies prices that reflect the costs of providing the services and meet all of the other WIRO principles. If Melbourne Water's pricing proposals are consistent with all of the WIRO requirements, the Commission must approve them, notwithstanding any arrangements that exist in other parts of Victoria.

Melbourne Water's pricing proposals for drainage and waterways services in the extended areas and the Commission's assessment of them are provided in the following sections.

### **7.2.2 Proposed drainage and waterways prices**

In its Water Plan, Melbourne Water highlighted a number of shortcomings with the current approach to calculating drainage and waterways charges, including

- the high cost of maintaining 1990 property values for billing purposes (almost \$1 million per annum)
- the link between a customer's capacity to pay (the original basis for choosing property values) and their current price is questionable, as there have been significant changes in property values since 1990 and 60 per cent of residential customers currently pay the minimum price
- the use of 1990 property values is inconsistent with values used by local governments for rating properties, thereby creating customer confusion and complaints
- the consistency of valuation based prices with Water Industry Regulatory Order principles (e.g. prices reflect cost of service) is questionable
- there are a number of inherited pricing inconsistencies and anomalies within existing arrangements
- appropriate pricing arrangements need to be developed and implemented in Melbourne Water's extended boundary areas.

Over the next regulatory period, Melbourne Water proposes to phase out drainage and waterway charges based on property values for residential customers and introduce two categories of fixed charges for customers in metropolitan areas (residential customers) and rural areas (rural customers). Melbourne Water has argued that these reforms will result in prices that better reflect the extent to which

---

<sup>10</sup> Interface councils, Submission to Water Price Review Issues Paper. The Interface Councils comprise the municipalities of Cardinia, Hume, Melton, Mornington Peninsula, Nillumbik, Whittlesea, Wyndham and Yarra Ranges.

customers impact on or benefit from drainage services, are transparent and easier to understand and are less costly to administer. For residential customers Melbourne Water proposes to stage this reform on a gradual basis by maintaining the rate on \$NAV constant in real terms and slowly increasing the minimum price, thereby increasing the percentage of customers facing the fixed minimum charge. For rural customers, Melbourne Water proposes to introduce the fixed charge from 2008-09.

In the case of non-residential customers, Melbourne Water proposes to maintain the use of property values over the regulatory period and develop further reforms to be implemented in the following period.

In its Water Plan, Melbourne Water indicated that over the regulatory period, the average price for drainage and waterways services is proposed to increase by 1 per cent per annum in real terms. Due to the amendments discussed in the following sections, Melbourne Water revised this annual increase to 0.6 per cent in real terms. Due to the higher weighted average cost of capital, the average annual increase implied by this Draft Decision will be higher than that proposed by Melbourne Water. However, due to the significant change in tariff structures proposed and the introduction of charges in the extended area, the Commission has had difficulty calculating an average annual price increase.

#### *Residential customers*

For residential customers in its existing drainage and waterways areas, Melbourne Water proposes to increase the minimum charge by approximately \$2 per year in real terms over the regulatory period, while maintaining the rate per \$NAV constant. This will result in more customers facing the fixed minimum charge in each year of the regulatory period until 2011-2012. From 2012-13, Melbourne Water proposes to abolish charges based on \$NAV for residential customers and charge every residential customers the fixed charge. Melbourne Water proposes to apply the minimum charge as a fixed charge to all residential customers in its extended area.

Since submitting its Water Plan, Melbourne Water has proposed a different method for applying residential drainage charges on multi-dwelling properties. In order to align with the basis used by two of the three metropolitan retailers that collect drainage and waterways charges on its behalf, Melbourne Water proposes to charge on a per-dwelling rather than per-title basis from 2012-13.

The proposed average prices for residential customers over the regulatory period are specified in table 7.2.



**Table 7.2 Drainage and waterway prices – residential customers**  
(\$ 1 January 2007 prices)

	<i>Current</i>		<i>Proposed</i>			
	<i>07-08</i>	<i>08-09</i>	<i>09-10</i>	<i>10-11</i>	<i>11-12</i>	<i>12-13</i>
Minimum price (\$)	55.05	57.10	59.14	61.25	63.44	65.70
Average price of customers paying above minimum (\$)	88.13	88.13	88.13	88.13	88.13	65.70

*Non-residential customers*

Melbourne Water proposes to increase the minimum charge for non-residential customers by \$20 in 2008-09 in its existing drainage and waterways areas. This is expected to increase the proportion of non-residential customers facing the fixed minimum charge from around 14 per cent to around 23 per cent. For the remainder of the regulatory period, Melbourne Water proposes small annual increases in the minimum charges and the rate per \$NAV.

Melbourne Water has indicated that while non-residential drainage charges will continue to be based on \$NAV and the minimum charge over the regulatory period it will continue to analyse and further develop tariff reforms to be implemented in the following regulatory period from 2013. As is the case for residential customers, all non-residential customers in the extended area will pay the fixed minimum charge.

In its Water Plan, Melbourne Water indicated that it would charge the fixed minimum price for all new non-residential customers in existing areas. However, Melbourne Water proposed an amendment to this after submitting its Water Plan. In order to achieve consistency of approach with its existing areas, Melbourne Water now proposes to base drainage charges for all new non-residential customers in existing areas on \$NAV and the minimum price. The proposed average prices for non-residential customers over the regulatory period are specified in table 7.3.

**Table 7.3 Drainage and waterway prices – non-residential customers**  
(\$ 1 January 2007 prices)

	<i>Current</i>			<i>Proposed</i>		
	<i>07-08</i>	<i>08-09</i>	<i>09-10</i>	<i>10-11</i>	<i>11-12</i>	<i>12-13</i>
Minimum price (\$)	55.05	75.12	75.62	76.13	76.64	77.16
Average price of customers paying above minimum (\$)	455.00	470.79	474.08	477.39	480.74	484.10

*Rural customers*

Melbourne Water proposes to apply a fixed 'rural' charge from 2008-09 to all customers located outside the urban growth boundary. As its drainage assets are located predominantly within the urban growth boundary, those customers outside the boundary only receive waterways services. Therefore it is proposed that these customers pay a lower price compared to customers receiving both drainage and waterways services. It is proposed that the rural charge will apply to customers in both existing and extended areas from 2008-09. In introducing the rural charge, it is expected that around 47,000 properties located inside Melbourne Water's existing drainage and waterways area but outside the urban growth boundary will experience reduced charges. The proposed average prices for rural customers over the regulatory period are specified in table 7.4.

**Table 7.4 Drainage and waterway prices – rural customers**  
(\$ 1 January 2007 prices)

	<i>Current</i>			<i>Proposed</i>		
	<i>07-08</i>	<i>08-09</i>	<i>09-10</i>	<i>10-11</i>	<i>11-12</i>	<i>12-13</i>
Minimum price (\$)	55.05 <sup>a</sup>	35.89	36.13	36.38	36.62	36.87
Average price of customers paying above minimum (\$)	112.44	35.89	36.13	36.38	36.62	36.87

<sup>a</sup> Customers Shires of Baw Baw, South Gippsland and parts of Bass Coast face currently face a minimum charge of \$31.46.

*Special drainage area customers*

The prices that apply to Baw Baw, South Gippsland and parts of Bass Coast shires are currently set and approved by the Commission on annual basis after consultation with the relevant customer committees. As these customers receive similar service levels to customers in other areas, Melbourne Water proposes that customers in these areas face the standard drainage and waterways tariff structure as described in the above chapters. However, Melbourne Water proposes to

continue the current annual consultation and approval process for special drainage charges in the Koo Wee Rup Flood Protection District and Patterson Lakes.

The prices to apply in these areas in 2008-09 will be approved by the Commission as part of its Final Decision.

### **7.2.3 Assessment of drainage and waterways prices**

The Commission recognises the difficulties in designing an appropriate tariff structure for drainage and waterways services. First, it is not practical to measure the volume of stormwater that is removed from each property. As such, it is difficult to determine the extent to which individual customers contribute to the costs of or benefit from drainage and waterways infrastructure. It is also important to recognise that people also benefit from drainage and waterway services not only to the extent that it benefits their own properties, but more generally (for example, in providing flood protection to roads, places of employment and recreation, etc). Further, and due to the nature of the service, it is difficult and in many cases not possible for customers to change their behaviour in response to changes in prices.

In regards to its specific pricing proposals, the Commission agrees with Melbourne Water on the shortcomings of using 1990 property values to calculate drainage and waterways charges. It agrees, in principle, with Melbourne Water's proposal to transition away from property values and to introduce fixed charges for residential and rural customers. It also agrees that any change in the basis for charging should be implemented gradually if it is likely to result in large and adverse customer impacts. However, the Commission also considers that customers receiving the same level of service should pay the same price or incur charges that are calculated in the same manner.

#### *Residential customers*

In relation to residential customers, the Commission considers that fixed charges are appropriate as residents receive a broad range of benefits that can be considered uniform between customers. It also notes that introducing the minimum price for residential customers in the extended drainage areas and continuing the use of property values in the existing areas may lead to cases where two similar properties face different charges.

The Commission acknowledges the importance of minimising adverse customer impacts, which can be achieved through gradual price increases as proposed by Melbourne Water. However, gradually implementing the change means that the period where inconsistencies in approach exist between existing and extended areas is longer.

Melbourne Water proposes to complete its reforms of residential prices within the regulatory period, so any inconsistencies will be temporary. However, to minimise the period that the inconsistency exists, the Commission would like to better understand the impacts of moving residential customers onto fixed charges at a faster rate. In response to this Draft Decision, Melbourne Water will be required to provide further information on the pricing impacts of introducing fixed charges for residential customers within a shorter timeframe.

### *Rural and special drainage area customers*

In relation to rural customers, the Commission also considers that fixed charges are appropriate and should be set lower than the standard drainage and waterways price to reflect the lower level of service being provided. The Commission therefore proposes to approve Melbourne Water's pricing proposals relating to rural customers.

In relation to the Koo Wee Rup Flood Protection District and Patterson Lakes, the Commission notes that the additional services provided in these areas are very specific and mainly benefit customers in these areas. As such, it considers that the full cost of providing the services should be recovered from the benefiting customers through higher charges. In regards to the approach for approving charges in the special areas, it should be noted that individual price caps provide customers with certainty on prices that will apply over the regulatory period and provided the business with incentives to pursue efficiency improvements.

However, the approach currently used, whereby Melbourne Water submits its prices for approval by the Commission on an annual basis after consulting with relevant customer committees, has been in place for the past three years and appears to be operating effectively. Further, customers in these areas are actively involved in the current arrangements and have not indicated any preference to change from this approach. The Commission therefore proposes to retain the current approach for prices in the special drainage areas.

### *Non-residential customers*

The Commission has a number of concerns relating to Melbourne Water's proposals for non-residential customers. First, it is noted that Melbourne Water proposes to continue basing non-residential drainage and waterway charges on property values over the entire regulatory period. While the increase in the minimum charge in 2008-09 will increase the percentage of non-residential customers paying the minimum price (and hence paying fixed charges), from 14 to 23 per cent, the increases in the minimum price over the following four years do not appear to increase this percentage materially.<sup>11</sup>

The Commission understands that Melbourne Water proposes to move away from property values for all customer types in the longer term, including non-residential customers. While acknowledging the need to be mindful of customer impacts, the Commission is concerned that the non-residential prices proposed for the next regulatory period may not be consistent with the longer term objective of discontinuing the use of property values. Further, Melbourne Water has noted that further analysis is required to develop specific reforms for non-residential pricing, but has not indicated what its broader long term strategy for these reforms are and how the proposed prices for the next regulatory period are consistent with this strategy.

---

<sup>11</sup> This information was sourced from financial templates submitted by Melbourne Water with its Water Plan.

Second, introducing the minimum price for non-residential customers as a fixed charge in the extended drainage areas and continuing the use of property values in the existing areas is likely to create situations where two similar properties face significantly different charges. These inconsistencies are likely to be greater for non-residential customers compared to residential customers due to the greater range in property values. This issue was also highlighted in a joint submission provided by the Interface Councils, which supported a consistent application of fixed charges for non-residential customers in both existing and extended areas.<sup>12</sup> Further, as Melbourne Water has not proposed a timeframe for discontinuing the use of property values, these inconsistencies would currently be expected to continue indefinitely.

The Commission considers that customers receiving similar services should pay similar prices and that the inconsistencies that are likely to occur under Melbourne Water's proposed non-residential prices is an important issue. In order to address this matter the Commission considers that a number of options may be explored. These include:

- Increasing the minimum charge for non-residential customers at a faster rate over the regulatory period and moving all customers to fixed charges from 2012-13, in line with the reforms for residential customers.
- Using property values to calculate drainage charges on a consistent basis in both existing and extended areas while further reforms are undertaken.

In response to this Draft Decision, the Commission invites Melbourne Water to provide further information on its broader long term strategies for reforming non-residential drainage and waterways charges, including how its current pricing proposals fit this strategy. It also seeks Melbourne Water's input into the feasibility of the above options (in regards to costs, benefits and customer impacts) for addressing the inconsistency of approach between the existing and extended areas. The Commission would also welcome Melbourne Water's comments on any other alternatives that it may have considered to address the issue.

It is acknowledged that there is not likely to be sufficient time before the start of the regulatory period to consult on and develop a new set of non-residential prices to apply over the whole period. However, the Commission will work closely with Melbourne Water on the prices that will apply from 1 July 2008 and arrangements for consulting on and introducing further reforms during the regulatory period.

---

<sup>12</sup> Interface councils, *Op cit.*

### **Draft decision**

The Commission seeks further information from Melbourne Water on the impacts of introducing fixed charges for residential customers within a shorter timeframe.

The Commission proposes to approve Melbourne Water's proposed drainage and waterways prices for rural customers.

The Commission proposes to continue the current annual consultation and approval process for special drainage charges in the Koo Wee Rup Flood Protection District and Patterson Lakes.

The Commission seeks further information from Melbourne Water on its longer term strategies for reforming non-residential drainage and waterways charges. The Commission will work closely with Melbourne Water on options for addressing inconsistencies in approach for non-residential customers between its existing and extended drainage areas.

### **7.3 Drainage developer charges**

Melbourne Water currently calculates developer charges in development service schemes in accordance with pricing principles approved by the Commission during the 2005 Water Price Review. Melbourne Water calculates developer charges by:

- identifying future capital expenditure for each year of the expected life of the development service scheme
- identifying forecast developable hectares for each year using an estimate of development density
- applying a pre-tax real discount rate (consistent with the weighted average cost of capital adopted by the Commission) to convert future cash flows into present value terms
- setting the developer charge such that the present value of future income equals the present value of future costs. Future income is equal to the developable hectares in each year multiplied by the developer charge
- reviewing the financial assumptions relating to each scheme on an annual basis and reviewing engineering specifications every five years.

Melbourne Water has generally proposed to continue with the current methodology for calculating drainage developer charges.

In its Water Plan, Melbourne Water provided further information on the current approach that addressed a number of matters raised by the Commission in the 2005 Water Price Review Final Decision.<sup>13</sup> After considering this response and given that drainage developer charges has not been identified as a significant

---

<sup>13</sup> Melbourne Water, 2008 Waterways Water Plan pp.106-107.

issue by developers over the previous three years, the Commission proposes to continue with the current approach.

Melbourne Water has indicated that a number of reforms are being considered to improve the pricing for development services schemes. In response to the Draft Decision, Melbourne Water must confirm whether the current pricing principles for calculating developer charges should remain in place or whether any amendments are required to implement its reforms. Any change in principles will be reviewed by the Commission before approval in the Final Decision.

#### **Draft decision**

The Commission proposes to approve Melbourne Water's proposed methodology for calculating drainage developer charges.

Melbourne Water is required to confirm whether the current pricing principles for calculating drainage developer charges should remain in place in the next regulatory period.

### **7.4 Diversion prices**

Melbourne Water administers about 1,900 diversion licences accounting for about 45,000 ML of entitlements to surface water from a number of waterways in the Yarra and Maribyrnong catchments. Melbourne Water currently charges an annual service charge to each licence holder and a volume charge for each ML of entitlement (as opposed to actual usage). A number of administration charges also apply for various 'one-off' services such as licence applications, transfers and re-issues.

Melbourne Water proposes to maintain the current tariff structure for its diversion services. However, it has identified a number of changes in water resource management requirements and initiatives to improve customer service that will increase prices over the regulatory period. These include:

- contributing to the creation of a state-wide register for water entitlements and collection of an environmental reserve contribution from customers
- additional resources being required to enforce compliance with licence conditions and manage additional licensing requirements under the Central Region Sustainable Water Strategy
- implementing Stream Flow Management Plan requirements in regards to monitoring water flows

Melbourne Water has proposed annual price increases over the regulatory period of 4 per cent and 16 per cent respectively for annual service charges and volume charges respectively. The proposed diversion prices for 2008-09 are set out in table 7.5.

Table 7.5 **Diversions prices (2008-09)**  
(\$ 1 January 2007 prices)

	<i>Annual service charge (\$ per annum)</i>	<i>Volume price (\$ per ML of entitlement)</i>
<b>Unregulated waterways</b>		
All months	182.75	13.65
Off-stream winter-fill	182.75	6.88
On-stream winter-fill	182.75	6.88
Licensed farm dam	182.75	6.88
Dam operating licence	62.44	N/A
Non-consumptive	182.75	1.25
Power generation	182.75	N/A
Stormwater diversion	182.75	13.65
<b>Regulated waterways</b>		
All months	182.75	41.17
Off-stream winter-fill	182.75	6.88

The Commission notes that the proposed price increases for diversion services are higher relative to the price increases for drainage and waterways services in general. However, it also recognises that obligations regarding water resource management have been increasing, and that the proposed price increases are consistent with similar price increases for diversion services in other parts of Victoria. Further, Melbourne Water's diversion prices have also been the subject of customer consultation.

The Commission considers that it is likely that the proposed price increases for diversion services are cost reflective. However, the Commission requires further information to be satisfied that the proposed prices are consistent with the WIRO.

In response to the Draft Decision, Melbourne Water is required to provide further information on the costs that it expects to incur in providing diversion services and the revenue it expects to receive under the proposed prices over the regulatory period. If, after receiving this information, it is satisfied that the price increases are reflective of changes in cost, the Commission will approve the proposed diversion prices.



### **Draft decision**

Melbourne Water is required to provide further information on the costs that it expects to incur in providing diversion services and the revenue it expects to receive under the proposed prices over the regulatory period.

The Commission proposes to approve Melbourne Water's proposed diversion prices, subject to receiving information confirming the price increases are cost reflective.

## **7.5 Miscellaneous services**

In its March 2007 Guidance Paper, the Commission proposed an alternative method for pricing and regulating miscellaneous services. Under the alternative approach, businesses would be required to nominate a core set of miscellaneous services. The core set would comprise of the business's major miscellaneous services and would be responsible for generating a significant proportion of miscellaneous revenue. Each core miscellaneous service would have a scheduled price and would be subject to individual price caps and the annual tariff approval process. Core miscellaneous services would also include a brief definition, which describes the nature of the services provided and how the price will be applied.<sup>14</sup>

Melbourne Water has identified a core set of six miscellaneous services related to drainage and waterways, including definitions and proposed prices for 2008-09.<sup>15</sup> The Commission has reviewed the proposals and considers them to be consistent with its preferred approach. The Commission therefore proposes to approve Melbourne Water's proposals regarding miscellaneous services.

### **Draft decision**

The Commission proposes to approve Melbourne Water's proposals regarding miscellaneous services.

---

<sup>14</sup> See Essential Services Commission 2008, *Water Price Review, Regional and Rural Businesses Water Plans 2008-13 — Draft Decision*, March, chapter 14 for more information on the new approach.

<sup>15</sup> See Melbourne Water, 2008 Waterways Water Plan, pp. 108-109 and Appendix 4 for details on proposed miscellaneous charges.