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MELBOURNE WATER SPECIAL DRAINAGE AREAS

2012-13 PRICE REVIEW

JUNE 2012

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2012-13 Price Review, June

We have approved 2012-13 maximum prices for Melbourne Water's Special Drainage Areas. The approved price changes are:

1. Koo Wee Rup – Longwarry Flood Protection district

No price increase (including the consumer price index (CPI)) – the approved price is consistent with Melbourne Water's application.

2. Patterson Lakes – Quiet Lakes

A price rise of 11.1 per cent (plus CPI) – this approved increase to maximum prices is lower than the 14.4 per cent (plus CPI) increase sought by Melbourne Water.

3. Patterson Lakes – Tidal Waterways

A price rise of 12.8 per cent (plus CPI) – the approved increase to the maximum prices is lower than the 16.1 per cent (plus CPI) increase sought by Melbourne Water.

We have provided approved prices at Appendix 1.

This paper provides an outline of our process and decision.

2.1 Background

Melbourne Water applies special drainage prices to properties in the Patterson Lakes (including the Quiet Lakes and Tidal Waterways areas) and the Koo Wee Rup – Longwarry Flood Protection District. Part 13 Division 5 Section 259 of the *Water Act 1989* gives Melbourne Water the power to charge these prices. Melbourne Water uses revenue collect through these prices to recover cost associated with efficient levels of expenditure they undertake.

On 5 April 2012, Melbourne Water submitted its 2012-13 price proposal for the special drainage areas to us.

We are required to assess Melbourne Water’s proposal in accordance with criteria established in Schedule 4.4 “Special Drainage Area pricing Principles” of our *2008 Melbourne Water Determination*. These criteria include that Melbourne Water:

- Consult with respective customer committees in each special drainage area on the prices to apply in each year of the regulatory period.
- Not propose prices that seek to recover more than the efficient level of expenditure.
- Submit the proposed prices, detailed expenditure forecasts and proposed activities to the Commission for approval at least 30 business days prior to the commencement of the regulatory year (1 July).

We published Melbourne Water’s pricing submission on our website on 5 April 2012 and invited submissions on the proposal. We considered all submissions, comments and information received during the consultation process in reaching our decision.

2.2 Proposed Prices: Special Drainage Areas – 2012-13

Melbourne Water's 2012-13 price proposal comprised increases of:

- 14.4 per cent (plus CPI) for the Quiet Lakes
- 16.1 per cent (plus CPI) for the Tidal Waterways.

No price increases were proposed for the Koo Wee Rup – Longwarry Flood Protection District.¹

Quiet Lakes proposal

To achieve full cost recovery by 2022-23 (end of the 2018-19 to 2022-23 regulatory period), Melbourne Water proposed a price path which limits the annual increase to 14.4 per cent plus CPI in 2012-13. This price path includes an amount to recover CPI not approved in prices for 2011-12 (see section 3.3.1 for more detail).

Tidal Waterways proposal

To achieve full cost recovery by 2022-23 (end of the 2018-19 to 2022-23 regulatory period), Melbourne Water proposed a revised price path which limits the annual increase to 16.1 per cent plus CPI for Tidal Waterways in 2012-13, which also includes an amount for CPI recovery (see section 3.3.1 for more detail).

The cost base for the 2012-13 proposal comprises Tidal Waterways operating costs and costs associated with capital expenditure encompassing jetty replacement, dredging and foreshore works.

Koo Wee Rup – Longwarry Flood Protection District proposal

Melbourne Water proposed no price increase for Koo Wee Rup – Longwarry Flood Protection District for 2012-13. Revenue is expected to cover costs in the coming year.

¹ Melbourne Water (2011) *2012-13 Price Review – Melbourne Water's Special Drainage Areas* available at the Commission's website at www.esc.vic.gov.au.

Melbourne Water's submission notes the over-recovery of revenue that has occurred, dating back to 1999. Its submission states that rather than address the over collection through future price reductions, the Koo Wee Rup – Longwarry Flood Protection District Advisory Committee preferred to resolve the over collection by having Melbourne Water increase its expenditure for Koo Wee Rup without increasing its prices.

Melbourne Water is exploring projects for investment in the Water Plan 3 period (2013-18).

2.3 Public Submissions – Key Issues

We received 24 submissions in response to Melbourne Water's pricing proposal for Patterson Lakes (Quiet Lakes and Tidal Waterways). Three key issues emerged:

- **Capital expenditure** – some submitters questioned the appropriateness and efficiency of capital expenditure projects in the Patterson Lakes areas.
- **Operational expenses** – many submitters had concerns that operational expenses such as maintenance were not spent efficiently in the Patterson Lakes areas.
- **Recovery of CPI** – many submitters were opposed to an adjustment for the omission of CPI (2.9 per cent) in Melbourne Water's 2011-12 price proposal.

We considered all matters raised during our review process.

Submissions are available at the Commission's website at www.esc.vic.gov.au.

We have summarised other issues beyond our scope in Section 2.4.

We thank all interested parties who submitted their views for our consideration.

2.4 Other Issues Outside of Our Scope

We also received submissions that raised matters outside of the scope of this review. Three key themes emerged:

- **Legislative** – the legislative basis for the special drainage area charges were raised in some submissions. The charges are pursuant to Part 13 Division 5 Section 259 of the *Water Act 1989*, which the Department of Sustainability and Environment administers.
- **Alternative funding sources** – several submissions suggested that alternative funding arrangements for the charges including payment by local council. Matters regarding funding decisions are not within the scope of this review.
- **Water Quality** – several submissions outlined concerns that water quality does not permit swimming at all times. Section 189 of the *Water Act 1989* does not require Melbourne Water to provide water quality of a standard suitable for primary contact recreation. Melbourne Water's *Statement of Obligations* under the *Water Industry Act 1994* requires Melbourne Water to report on the impact of Blue-Green Algal Blooms on water quality to the Department of Human Services and the Department of Sustainability and Environment. The administration of the *Water Act 1989* is beyond the scope of this review.

3.1 Assessment of Melbourne Water's Application

We assessed Melbourne Water's application for consistency with Schedule 4.4 of our *2008 Melbourne Water Determination*, to ensure that they met administrative, pricing and consultation criteria when establishing prices for 2012-13.

3.2 Customer Committee Consultations

We are satisfied that Melbourne Water has provided following information criteria to customer committees through their consultation process:

- the proposed activities for the forthcoming year
- information on expenditure related to those activities
- proposed price and estimated revenue
- expected prices in subsequent regulatory years.

3.3 Cost Recovery of Efficient Level of Expenditure

We must be satisfied that prices do not recover more than the efficient level of expenditure and that customers are not paying for services or assets not yet in place – consistent with Schedule 4.4 of our *2008 Melbourne Water Determination*.

To assist us with our assessment of the price proposal for each special drainage area, we engaged an independent consulting firm Strategic Economic Consulting Group (SECG). We asked SECG to advise us on whether Melbourne Water's actual and proposed expenditure is appropriate and efficient. The review covered a

high-level assessment of capital and operating expenditure in each of the Special Drainage Areas. The SECG report is available separately on our website.

Koo Wee Rup

SECG considered Melbourne Water’s proposed prices and planned operating expenditure for Koo Wee Rup areas to be appropriate and reasonable.

Patterson Lakes

We note Melbourne Water’s strategy to achieve cost recovery for Patterson Lakes by 2022-23 and absorbing any shortfalls in revenue. However, SECG identified areas of operating and capital expenditure that may require adjustment.

SECG made a number of recommendations for the Patterson Lakes areas in their final report, these include²:

Tidal Waterways

The proposed 2012-13 capital expenditure for the Dredging program has been deferred to 2013-14.

The expenditure for the Jetty Replacement program should be adjusted to reflect the delays in the project resulting from planning approval processes as the original program and expenditure profiling did not accurately reflect the actual timeframes required.

Table 1: SECG’s recommended capital expenditure for jetty replacement

Jetty Replacement	2011-12	2012-13	2013-14	2014-15
Proposed by Melbourne Water	2,585,268	3,717,525	1,680,148	-
Recommended by SECG	2,585,268	3,360,297	2,037,376	-
Difference	-	-357,228	357,228	-

² Strategic Economics Consulting Group (2012) *Melbourne Water Special Drainage Areas 2012-13 Price Review – Final Report*

Table 2: SECG's recommended capital expenditure for dredging

Dredging	2011-12	2012-13	2013-14	2014-15
Proposed by Melbourne Water	250,000	2,750,000	1,899,730	-
Recommended by SECG	250,000	500,000	2,250,000	1,899,730
Difference		-2,250,000	350,270	1,899,730

Three downward adjustments to particular operating cost items shown in Table 2. This includes ongoing reductions to 'Newsletter' and 'Jetty Maintenance' related costs.

Table 3: SECG's recommended operating expenditure adjustments

Program	2012-13 Proposed	2012-13 Recommended	Variance
General maintenance related costs	240,000	220,000	20,000
Newsletter related costs	17,526	8,500	9,026
Jetty maintenance related costs	25,000	20,000	5,000

Quiet Lakes

That the proposed operating expenditure for Silt Removal be reduced to \$26,000 (from \$41,000) to reflect the expectation, based on 2011-12 expenditure, that silt disposal costs will be lower than expected.

No other recommendations were made by SECG.

Assessment

We agreed with and have decided to adopt all recommendations made by SECG. With commensurate adjustments for these recommendations, we are satisfied that prices do not recover more than the efficient level of expenditure.

Recent project delays and underspends in Patterson Lakes cast some doubt as to whether the long-term price path, and the proposal to absorb any revenue shortfalls, remains consistent with future expenditure required for the region.

Melbourne Water must review its long-term price path as part of the Water Plan 3 process. We have provided further details on this process in Chapter 5.

3.3.1 Adjustments: CPI and WACC

In 2010-11, Melbourne Water provided us with supporting modelling for their prices. This modelling did not include a CPI adjustment for 2010-11. This was an omission on Melbourne Water's part that we decided not to rectify within 2011-12 prices. Melbourne Water has included an adjustment of 2.9 per cent for 2010-11 CPI as part of its recent price application³.

Submissions outlined objections to the recovery (or catch-up) for CPI. Submitters drew attention to the fact that while we did not approve increases for CPI in the last review, Melbourne Water's actual expenditure is significantly under that budgeted for the 2011-12 period.

Melbourne Water has adopted the WACC of 5.8 per cent for the second regulatory and third regulatory period. Our guidance to water businesses on WACC indicates that Melbourne Water should use a 5.1 per cent WACC for the third regulatory period. This is a better approximate of the current cost of capital for water businesses.

Assessment

We have decided not to revisit our past decision regarding the recovery of CPI. This reflects typical regulatory practice.

We have also adjusted Melbourne Water's modelling to adopt a 5.1 per cent WACC for the third regulatory period, which is in line with our guidance to water businesses on WACC.

³ Based on the ABS data for all groups Australia, 2.89 per cent would be the appropriate CPI 2009-10 adjustment rather than the 2.88 per cent proposed.

4.1 Final Decision

We have approved 2012-13 maximum prices for Melbourne Water's Special Drainage Areas. The approved price changes are:

1. Koo Wee Rup – Longwarry Flood Protection district

No price increase (including the consumer price index (CPI)) – the approved price is consistent with Melbourne Water's application.

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5 | WATER PLAN PROCESS

In 2008 we asked Melbourne Water to develop a strategy to move away from property based charges in its special drainage areas to an approach that better reflects the costs of services provided.

As part of its recently released draft Water Plan, Melbourne Water outlined a proposal for a new approach to how prices are calculated. Melbourne Water has summarised their new proposed approach on their website:

- for Patterson Lakes:

http://www.melbournewater.com.au/content/library/about_us/customers_and_prices/wp_draft_2013/wp3_fact_sheet_plakes.pdf

- for the Koo Wee Rup – Longwarry Flood Protection District:

http://www.melbournewater.com.au/content/library/about_us/customers_and_prices/wp_draft_2013/wp3_fact_sheet_kwr.pdf

We encourage customers to provide feedback to Melbourne Water on their proposals. We expect Melbourne Water to take customer feedback into account prior to submitting a final proposal to us in September 2012 in their final Water Plan.

Interested parties can provide feedback to Melbourne Water via:

Online – via an online feedback form at melbournewater.com.au/2013waterplan

Email - to 2013waterplan@melbournewater.com.au

Post - 2013 Water Plan, Melbourne Water, PO Box 4342, Melbourne VIC 3001

Melbourne Water has requested feedback from stakeholders by 20 July 2012.

Given delays to major projects in the Patterson Lakes, we expect Melbourne Water to review and provide updated information on proposed future expenditure and prices in the area, and also allow for a reasonable rate of productivity improvement in proposed prices, as part of their final Water Plan.

We will also look for information that shows Melbourne Water has in place a robust strategy to provide customers with confidence that prices are set only to recover efficient levels of expenditure.

APPENDIX 1

Melbourne Water's Special Drainage Areas Approved Prices

We have set out the approved prices for Melbourne Water's Special Drainage Areas below:

Table: Special Drainage Areas Approved Prices

Approved 2012-13 Prices	
Koo Wee Rup – Longwarry Flood Protection District	Rate in \$ NAV*
Division A (higher flood impact exposure)	(3.6494¢) \$56.40
Division B (lower flood impact exposure)	(2.0274¢) \$56.40
Patterson Lakes	Rate in \$ SV**
Tidal Waterways	\$0.8083 (including CPI)
Quiet Lakes	\$0.6310 (including CPI)
*NAV – Net Annual Value as at 1990	
**SV – Site Value	

