

### **The Essential Services Commission**

The Commission is the independent economic regulator of the Victorian water industry. We periodically assesses prices put forward by water businesses in a three to five year Water Plan.

### **Commission review of Water Plans**

Last year, all metropolitan water businesses submitted their Water Plans to the Commission for the third regulatory period (2013-18). Their Water Plans set out the costs they will be facing and the prices they proposed to charge customers over the next regulatory period to recover those costs. In approving prices for the water businesses, we assessed whether the proposed operating and capital expenditure forecasts were prudent and efficient, and assessed the required revenue to operate the businesses and to meet obligations from the Minister for Water and other regulatory bodies. The Commission engaged PwC to assist with the assessment of metropolitan businesses' proposed expenditure.

### **Operating expenditure – final decision**

Total operating expenditure is a significant component of the water businesses' total revenue requirements, ranging from 50 per cent to 80 per cent for metropolitan water businesses for the next regulatory period.

The operating expenditure we adopted is not a representation of the amount that the businesses must spend or allocate to particular operational, maintenance and administrative activities. Rather, it is a benchmark that represents assumptions about the overall level of expenditure to be recovered through prices, and that we consider sufficient to operate the business and to maintain services over the regulatory period.

If a business operates inefficiently or incurs additional expenditure on the activities and its actual operating expenditure during the regulatory period exceeds the benchmarks used to set prices, the business will bear those additional costs (rather than customers via higher prices). The converse is true if the business makes an efficiency gain during the regulatory period.

The metropolitan water businesses identified the key drivers of proposed increases to operating expenditure as:

- higher labour, energy and (for some businesses) chemical costs
- defined benefits superannuation payments due to a shortfall in the funds
- increase in the environmental contribution from 2013-14 and
- additional expenditure associated with new facilities such as treatment plants.

We considered the businesses' responses to our draft decision and have adjusted the relevant benchmarks for each business only where:

- errors have been identified in the assumptions or forecasts adopted by the Commission in our draft decision
- businesses have provided further information or arguments to support their original forecasts
- additional obligations have been imposed by other regulators that were not known or could not have reasonably been known at the time the Water Plans were submitted or
- material adjustments have been proposed.

We considered the benchmarks provide a sufficient level of expenditure for the businesses to operate and deliver their proposed services. Key areas of adjustment made by the Commission include: lower financing costs; operating expenditure reductions; for example, labour, energy, revisions to regulatory and other costs; and productivity improvements.

In our final decision, we have adopted \$3.0 billion of operating expenditure for Melbourne Water's 3 year regulatory period. With its regulatory period reduced to three years, the benchmark expenditure for 2016-17 and 2017-18 is indicative only, based on a five year assessment. When this expenditure is reassessed for the fourth regulatory period, any material changes to forecasts for these years must be clearly reconciled by Melbourne Water.

For the other four metropolitan water businesses (City West, South East Water, Yarra Valley Water and Western Water), we have adopted \$9.1 billion over the same period. This is \$567.1 million (or 5.8 per cent) lower than that proposed by the businesses.

### **Capital expenditure – final decision**

Capital expenditure is another key component of the water businesses' revenue requirements. It increased significantly in the metropolitan water businesses, reflecting the significant one-off investment projects aimed at augmenting water supply in response to the drought. South East Water, City West Water and Western Water forecast increases due largely to customer growth.

The metropolitan water businesses identified the key drivers of proposed capital expenditure as:

- projects to meet forecast increases in demand
- compliance with government standards and
- renewal of infrastructure to maintain or improve service.

In our final decision, we have adopted \$1.5 billion of capital expenditure for Melbourne Water over the 3 year regulatory period. With Melbourne Water's regulatory period reduced to three years, the benchmark expenditure for 2016-17 and 2017-18 is indicative only, based on a five year assessment. When this expenditure is reassessed for the fourth regulatory period, any material changes to forecasts for these years must be clearly reconciled by Melbourne Water.

For the other four water businesses, we have adopted \$3.2 billion of capital expenditure. This is \$135 million (or 4.1 per cent) lower than that proposed by the water businesses. The adopted capital expenditure reflects changes to the timing of the delivery of certain projects and the removal of some projects. The Commission's revised capital expenditure allowance reflects its proposed changes to the timing of delivery of projects and the removal of some projects.

Examples of the water businesses' key projects and programs are highlighted on the next page. For most businesses, a small group of projects account for a significant proportion of their total capital expenditure. We will monitor the delivery of key projects through the next regulatory period, via our annual water performance reporting. The annual performance report will provide an opportunity for businesses to explain any changes in the timing or scope of their major capital projects, and the implications for any outcomes to which they committed in their Water Plans.

### Renewals/replacements/refurbishments

The Commission's final decision provides for water businesses' proposed renewals, replacements and refurbishments of capital projects and programs. These are undertaken to improve or maintain existing levels of service, to reduce corporate operating costs and to address operational and safety concerns. Examples of key projects or programs for which expenditure has been allowed:

- Melbourne Water: Eastern Treatment Plant (mechanical and electrical renewals program), Preston water mains renewals.
- City West Water: network renewals program.
- South East Water: water and sewer mains renewals program.
- Yarra Valley Water: water, sewer and house connections branch renewals programs.

### Compliance

The Commission's final decision provides for capital expenditure to meet the obligations imposed by the Victorian Government, including technical regulations such as Department of Health and the Environmental Protection Authority. Examples of key capital projects:

- Melbourne Water: flood mitigation program.
- South East Water: Dromana-Portsea sewer backlog.
- Yarra Valley Water: sewer hydraulic improvement program.
- Western Water: Melton stormwater harvesting and sewer spills prevention strategy.

### Efficiency

- City West Water: Program Arrow business efficiency initiative.
- South East Water: construction and fit out of new office.
- Western Water: IT systems improvement.

### Growth

The Commission's final decision allows for capital expenditure to meet forecast customer growth and increases in demand for some of the water business service areas. Examples of key projects for which expenditure has been allowed are:

- Melbourne Water: Western Treatment Plant (treatment capacity augmentation stage 2), St. Albans to Werribee pipeline (stage 2).
- City West Water: integrated water and 3<sup>rd</sup> pipe (recycles water), sewerage system upgrades.
- South East Water: three sewage treatment plant upgrades and Cranbourne recycled water tank.
- Yarra Valley Water: sewer expansion projects.
- Western Water: Sunbury recycled water plant capacity upgrade, recycled water facility and Surbiton recycled water plant upgrades.

Apart from the timing of Western Water's Sunbury additional water storage – Bald Hill tank project, our final decision on capital expenditure remains unchanged from our draft decision. The Commission adopted the capital expenditure benchmarks. We consider benchmarks provide sufficient expenditure for the businesses to deliver their proposed services and meet known regulatory obligations.

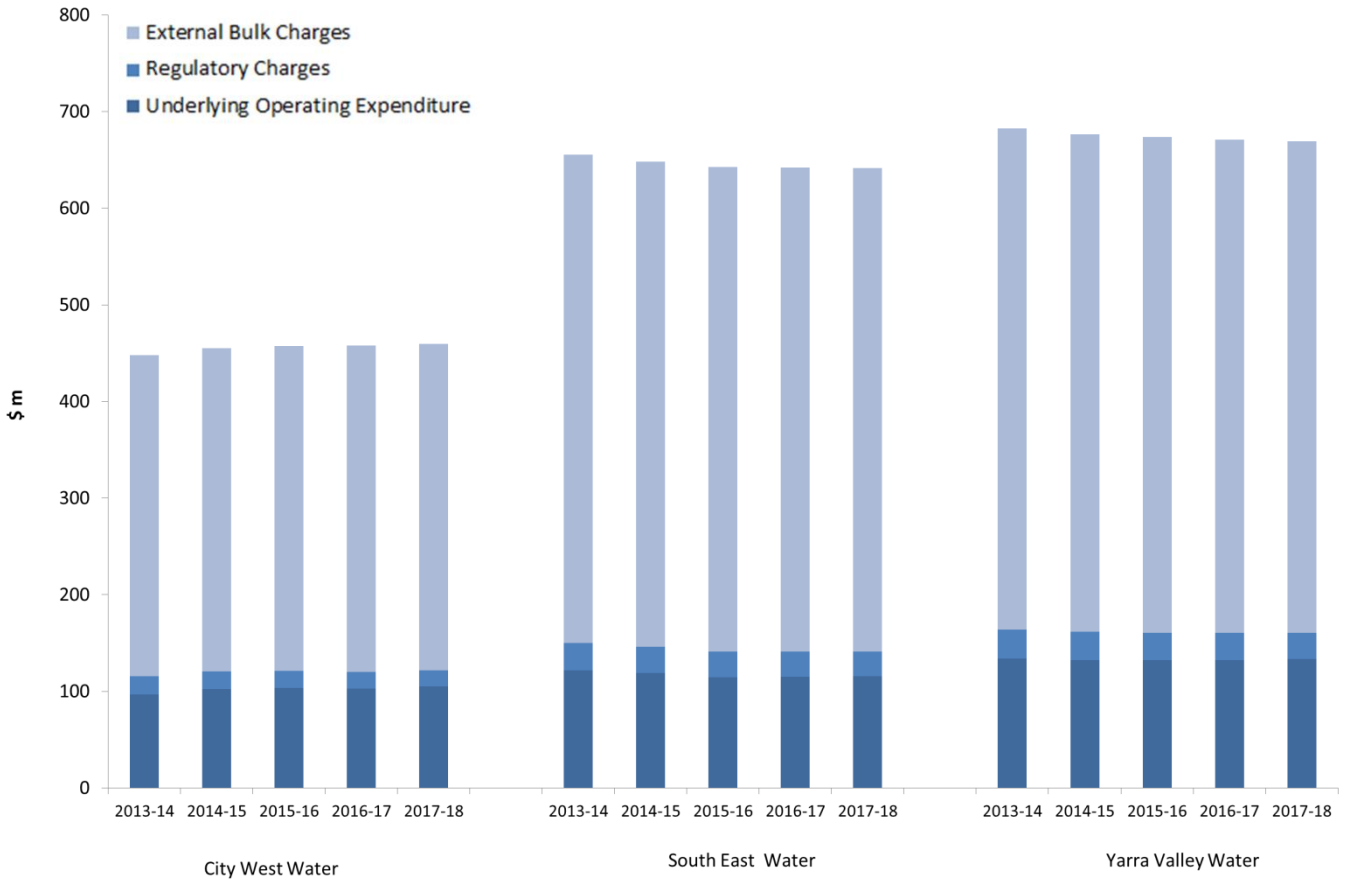
### **Where to get details of the Commission's expenditure assessment**

We publicly released our final decision for the greater metropolitan water businesses on 25 June 2013. This final decision also contains our findings and final decision on forecast expenditure. Further details are also contained in PwC's expenditure review reports that are available on our website.

### **For more information**

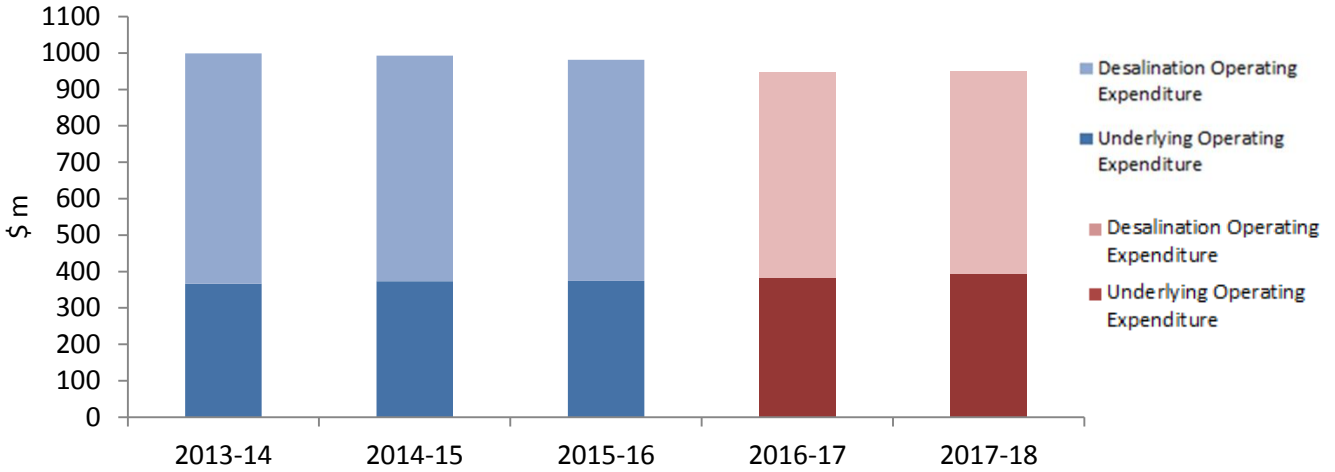
More information, including material from past price reviews can be found on the website [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

**Figure 1. Water Businesses' Operating Expenditure 2013 to 2018 (\$m 2012-13)**

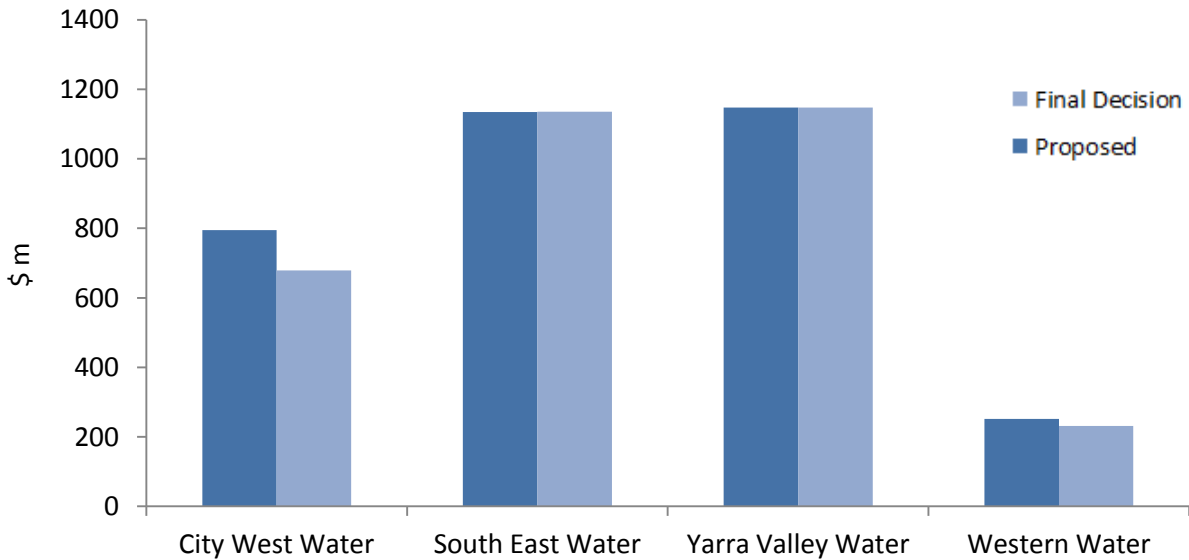


**Note:** Desalination is not a key cost for Western Water.

**Figure 2. Melbourne Water’s Operating Expenditure 2013 to 2018 (\$m 2012-13)**



**Figure 3. Water Businesses’ Total Capital Expenditure 2008 to 2018 (\$m 2012-13)**



**Figure 4. Melbourne Water’s Total Capital Expenditure 2013 to 2018 (\$m 2012-13)**

