

Lower Murray Water
2018 Water Price Review

Response to ESC Draft Decision – Urban Submission

May 2018

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1. Introduction

The 2018 Water Price Review is the first regulation period where a key change in approach has been introduced, being the new ESC PREMO framework.

LMW identified the need to have a deeper level of engagement with customers. Adopting the International Association of Public Participation (IAP2) principles for customer engagement, LMW created a new Customer Engagement Strategy as part of the preparation for the Price Submission preparation. The 'deeper' level of engagement took LMW from an 'inform' level of consultation to 'involve', which provided LMW with a strong link from customer wants to the outcomes proposed in LMW's urban price submission.

Lower Murray Water has reviewed the Essential Services Commission's (ESC) Urban Draft Decisions for Lower Murray Water (LMW), dated 28 March 2018, and is pleased with the ESC's conclusions that LMW's price submission presented clear and comprehensive information that supported its proposals gained from the 'deeper' customer engagement and that LMW has taken this feedback into account.

The submission information and the re-submitted financial templates reflect the ESC provided new cost of debt being 4.5283% and LMW acknowledges the ESC will update the CPI figure with the March 2018 1.9% in the final determination.

In this submission, LMW provides a reconciliation of expenditure not included in the draft decision and outlines any adjustment sought to the operating expenditure. The additional operating expenditure has resulted from the latest electricity information available since both the LMW submission in September 2017 and from ESC's engagement of Deloitte Access Economics who conducted an expenditure review of Lower Murray Water.

This submission also reviews other recommendations made by the ESC and discusses their acceptance or non-acceptance by LMW.

LMW's response provides comment on the draft decision on the following areas for urban services:

- Key Outcomes and Service Levels
- Revenue Requirement
- Regulatory Asset Base
- Cost of Debt
- Operating Expenditure
- Capital Expenditure
- Demand Forecasts

- Water and Sewerage Tariffs
- Average Residential Customer Bill
- Price Adjustment Mechanisms
- New Customer Contributions
- PREMO rating

2. Key Outcomes and Service Standards

2.1 Urban Key Outcomes and Service Standards

The extensive customer engagement has informed LMW on the outcomes desired by our customers and key stakeholders.

- Keep my costs to a minimum
- Be easy to contact and quick to respond
- Provide me with consistent, safe drinking water
- Provide me with reliable sewerage service
- Be present and active in the community
- Be mindful of our environment
- Comply with other government obligations

To track LMW's performance against these key outcomes, service standards targets have been set and a public reporting methodology has been developed.

The ESC approved each of the urban service standards proposed in LMW's Pricing submission due to the service standards supporting the objectives in the pricing framework relating to efficiency and being in the interest of consumers.

LMW accepts the ESC's decision and proposes no changes in this submission to the draft decision.

3. Revenue Requirement

3.1 Urban Revenue Requirement

LMW proposed a revenue requirement of \$188.7 million over the 2018-23 regulatory period and note the ESC's proposed slight reduction of \$0.8 million (0.4% of the total revenue requirement) due to minor corrections to estimates in LMW original price submission. Table 1 sets out the ESC proposed revenue requirement.

Table 1

ESC Proposed Revenue Requirement - Urban (\$m 1/1/18)	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	24.2	23.1	22.5	22.7	22.7	115.2
Return on assets	6.5	6.8	6.9	7.1	7.1	34.4
Regulatory depreciation	8.1	8.5	8.6	8.7	9.0	42.9
Non-prescribed revenue offset of revenue requirement	-0.09	-0.9	-0.09	-0.9	-1.0	-4.6
Adjustments from last period	-	-	-	-	-	-
Taxation allowance	-	-	-	-	-	-
Draft - Total revenue requirement	38.0	37.4	37.1	37.6	37.9	187.9

It is acknowledged that Deloitte have recommended no adjustments to LMW's controllable operating expenditure and that the ESC accept Deloitte's recommendation however on the understanding that LMW would update the electricity costs with the latest information available in response to the draft decision.

In response to the draft decision's controllable costs, LMW does propose amendments to the electricity costs. Further commentary on the additional electricity costs are contained in section 4.1.2.

In addition, a reduction has been made to in response to the Victorian State Government's budget released in April 2018. Further commentary contained in section 4.1.2.

The ESC has made the minor adjustment to our original pricing submission estimates for non-controllable costs by \$0.7 million as set out in table 2.4 (page 16) of the draft decision. LMW accepts the ESC's decision for the non-controllable costs and proposes no changes in this submission to the draft decision.

The LMW updated proposed revenue requirement is set out in Table 2 below.

Table 2

LMW Updated Proposed Revenue Requirement - Urban (\$m 1/1/18)	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	24.23	23.12	22.55	22.73	22.66	115.30
Return on assets	6.43	6.72	6.88	7.02	7.10	34.14
Regulatory depreciation	8.14	8.45	8.56	8.74	8.98	42.89
Non-prescribed revenue offset of revenue requirement	-0.87	-0.89	-0.91	-0.93	-0.95	-4.55
Adjustments from last period	-	-	-	-	-	-
Benchmark tax liability	-	-	-	-	-	-
Proposed - Total revenue requirement	37.93	37.41	37.08	37.56	37.79	187.78

3.2 Urban Regulatory Asset Base

A reconciliation of the regulatory asset base submitted in the pricing submission to the regulatory accounting statement identified the requirement of a minor increase of \$0.3 million. LMW accepts the draft decision updated regulatory asset base to 30 June 2017 of \$155.0 million for the urban business which was amended in January 2018 as part of the reconciliation of the pricing submission and the regulatory accounting statement from 2012-13 to 2016-17.

Table 3

Updated Regulatory Asset Base June 2017 - Urban

(\$m 1/1/18)	2012-13	2013-14	2014-15	2015-16	2016-17
Opening asset base	147.3	148.0	152.9	153.8	157.4
plus Gross capex	6.6	1.0	9.4	11.5	6.4
less Government contributions	0.0	0.0	0.0	0.0	0.0
less Customer contributions	0.7	1.6	1.5	0.9	1.7
less Proceeds from disposals	0.3	0.7	0.6	0.2	0.1
less Regulatory depreciation	4.9	5.8	6.4	6.8	7.1
Closing asset base	148.0	152.9	153.8	157.4	155.0

LMW acknowledges that the pricing submission included uncertain capital projects which were moved into the following pricing period 2023-28. Should the need to complete any of these uncertain capital projects in this 2018-23 pricing period arise then LMW will need to demonstrate the prudence and efficiency of the cost to include them into the regulatory asset base.

LMW confirms and accepts the forecast regulatory asset base benchmark in the ESC draft decision as set out in Table 4.

Table 4

Rolled Forward Regulatory Asset Base - Urban

(\$m 1/1/18)	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening asset base	154.96	156.10	167.96	170.67	175.81	177.67
plus Gross capex	9.81	21.18	12.34	14.88	11.78	12.26
less Government contributions	0.0	0.0	0.0	0.0	0.0	0.0
less Customer contributions	0.81	0.76	0.76	0.76	0.76	0.76
less Proceeds from disposals	0.42	0.42	0.42	0.42	0.42	0.42
less Regulatory depreciation	7.45	8.14	8.45	8.56	8.74	8.98
Closing asset base	156.10	167.96	170.67	175.81	177.67	179.77

3.3 10 Year Averaged Cost of Debt

LMW has updated the revenue requirement and prices to reflect the ESC provided (April 2018) cost of debt.

LMW adopts the estimated ESC's cost of debt of 4.5283 per cent which for the urban pricing submission. The urban draft decision (page 9) states that;

“Lower Murray Water must update its revenue requirement and prices to reflect our April 2018 updates to estimates for the cost of debt and inflation.”

The ESC has requested, via email dated Friday 27 April 2018, that LMW are NOT required to update the 2018 financial model with the March Quarter 2018 CPI of 1.9% and the 2018-19 inflation is to continue to reflect a forecast inflation rate of 2.3%.

LMW has complied with this request.

4. Operating Expenditure

4.1 Urban Operating Expenditure

Lower Murray Water acknowledges that the ESC has proposed no adjustments to the LMW controllable costs but has requested that LMW update our electricity forecast based on the latest available information.

Lower Murray Water has proposed no changes to the controllable operating expenditure in the draft decision other than an updated electricity cost and payroll tax adjustment due to the April 2018 State Government Budget.

Lower Murray Water had included \$10.349 million of electricity costs in the pricing submission submitted 30 September 2017 and have now included an additional \$620K. Section 4.1.2 contains further detail on the electricity expenditure LMW have proposed in this submission to the draft decision.

Lower Murray Water also acknowledges that the ESC has proposed adjustments to the non-controllable expenditure. Refer to section 4.1.1 for further detail.

Table 7 sets out LMW's amended proposed operating expenditure for this submission to the draft decision.

Table 7

(\$m 1/1/18)	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating Expenditure Summary						
LMW proposed operating expenditure	24.3	23.2	22.6	22.9	22.9	115.9
ESC Adjustments (LMW Accept)						
Bulk Water Charges	0.0	0.0	0.0	0.0	0.0	0.0
Licence Fees	-0.003	-0.003	-0.003	-0.003	-0.008	-0.005
Environmental Contribution	-0.059	-0.098	-0.135	-0.172	-0.208	-0.671
LMW Adjustments						
Increase in Energy	0.09	0.14	0.17	0.13	0.09	0.62
Decrease in Payroll Tax	-0.12	-0.12	-0.11	-0.11	-0.11	-0.57
Revised operating expenditure	24.23	23.12	22.55	22.73	22.66	115.30

4.1.1 ESC Adjustments

Bulk Water Charges

LMW acknowledges that the ESC's has not made any adjustments in the draft decision for bulk water charges. In the draft decision the ESC has indicated that the bulk water charge forecast estimate will be verified against the current price determination for Goulburn-Murray Water prior to making the final decision.

Licence Fees

The ESC adjusted licence fees for the Department of Health and Human Services, Environment Protection Agency Victoria, and the ESC themselves. The adjustments were based on recent advice from those agencies.

LMW accepts the ESC's adjustments to the licence fees.

Environmental Contribution

The ESC in their adjustment have used the 2018-19 value of \$1.765 million for the environmental contribution as provided by the Department of Environment, Land, Water and Planning. Whilst LMW have used the correct 2018-19 value, LMW had assumed the value would be indexed by inflation. The amount will be held in constant nominal terms (decline in real terms) during the 2018-23 regulatory period.

LMW accepts the ESC's adjustments to the environmental contribution. LMW however note that the current environmental contribution value ends in FY 2019/20 and a new environmental contribution value will be calculated by DELWP. The current environmental value of \$1.765 million increased \$0.556 million from \$1.209 million 2017-18. Should the same increase occur at the end of the new contribution value period, it would mean additional cost of approximately \$1.6 million over the FY's 2020-23. LMW consider this an uncertain event and as such have not included this in the pricing submission.

4.1.2 LMW Adjustments

Electricity Costs

Lower Murray Water has been active in the electricity market to procure its energy requirements into the future and has considered varied methods of procurement. LMW has negotiated a new energy contract, via a broker, with ERM Business Energy for our large contestable sites over a two-year period starting on 1 July 2018 and concluding on the 30 June 2020.

The agreement has been entered with other Victorian businesses and share the brokering adviser Procurement Australia.

LMW has entered into a Retail Electricity Agreement (STEP REA) where the energy and environmental rates payable are not fixed for the term of the agreement but purchased on the ERM Business Energy website via STEP Online in a strategic manner supported by SaavyPlus consulting.

LMW does not know what the actual purchased energy price is currently due to using the progressively purchasing strategy however the energy forecast price has been updated based on advice from SavvyPlus Consulting.

The energy price forecast has used the latest Victorian market information which includes the future market analysis using a Black Scholes model. The Black Scholes technique is a standard modelling technique to measure the value of a call option in financial markets and is extensively used in the electricity market.

The SavvyPlus Consulting electricity price forecast report is available to the ESC on request.

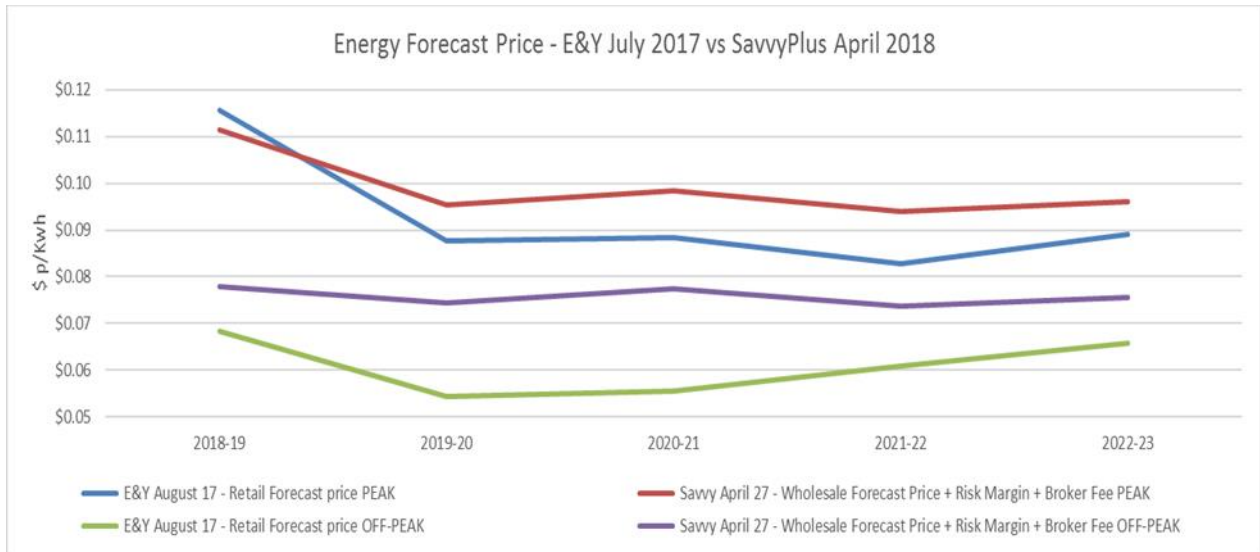
For the small sites, network and other electricity costs, LMW has worked with Ernst & Young, energy price forecasting specialist, to ascertain if the underlying assumptions had changed from our original price forecast report. Ernst & Young had used LMW's actual energy usage and time of use profile data to ensure that the forecast is applicable to LMW's operating environment. It has been concluded that the forecast prices contained in the pricing submission for the small sites, network and other costs are robust and remain relevant for the regulation period FY's 2019-2023.

Lower Murray Water is seeking an increase of \$0.62 million to the \$10.349 million of operating electricity expenditure in the urban pricing submission submitted to the Essential Services Commission. In Lower Murray Water's submission, it was highlighted that electricity expenditure was to be reviewed and any changes incorporated into our response to the ESC's draft decision due to unknown impacts to our electricity pricing path as a result coming out of contract June 2018 and the volatility in the energy markets at the time of our submission.

Comparison of the Ernst & Young August 2017 electricity price forecast to a new issued April 2018 forecast prices via our broker, SavvyPlus Consulting, shows that prices are expected to be higher than LMW initially included in the submitted pricing submission.

Figure 1

Energy Price Comparison of September 2017 submission to LMW response to Draft Decision Submission (not including transmission losses)



Lower Murray Water is seeking an additional electricity expense over the five-year regulatory period of \$620K.

(\$m 1/1/18)

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
LMW proposed electricity adjustment expenditure	0.09	0.14	0.17	0.13	0.09	0.62

On request, LMW will provide the currently negotiated contract for energy throughout FY's 2018-2020 which show the step factors and negotiated brokering fees however not the cost of energy as it is unknown.

Payroll Tax

The Victorian State Government released its 2018-19 budget in April 2018. The budget contained a payroll tax rate cut from the currently 3.65% to 2.425% for Victorian regional businesses with the commencement date of 1 July 2018.

LMW meet the criteria for the regional business test and have applied the savings in payroll tax to the operating expenditure in this response to the ESC draft decision.

LMW's submitted urban price submission contained payroll tax expenditure of \$1.7M, due to the payroll tax rate cut a decrease of \$0.57M has been applied over the five-year regulatory period.

(\$m 1/1/18)

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
LMW proposed payroll tax adjustment expenditure	-0.12	-0.12	-0.11	-0.11	-0.11	0.57

5. Capital Expenditure

5.1 Urban Capital Expenditure

Lower Murray Water acknowledges the ESC's draft decision to accept the total gross capital expenditure as submitted in the pricing submission 30 September 2017.

No requirement for new capital work projects has emerged since the submission of the pricing submission on 30 September 2017.

As a result, LMW is not proposing to amend the capital expenditure total gross capital expenditure of \$72.4 million from its original pricing submission in 30 September 2017 in this submission to the draft decision.

Lower Murray Water confirms the capital expenditure for the pricing submission as set out in Table 10.

Table 10

(\$m 1/1/18)

Capital Expenditure Summary

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
LMW proposed capital expenditure	21.2	12.3	14.9	11.8	12.3	72.4
ESC Adjustments – draft decision	0.0	0.0	0.0	0.0	0.0	0.0
LMW Adjustments – submission on draft submission	0.0	0.0	0.0	0.0	0.0	0.0
Total Adjustments	0.0	0.0	0.0	0.0	0.0	0.0
Revised capital expenditure	21.2	12.3	14.9	11.8	12.3	72.4

5.1.1 ESC Adjustments

The ESC made no adjustments to LMW's urban capital expenditure proposed.

5.1.2 LMW Adjustments

LMW have not made any additional adjustments to capital expenditure in this submission to the draft decision.

6. Demand Forecasts

6.1 Urban Demand Forecasts

LMW acknowledges that the ESC has approved the demand forecasts submitted in our pricing submission in the draft decision.

LMW is not proposing any adjustments to the pricing submission demand forecast in this submission to the draft decision.

7. Form of Price Control and Urban Tariffs

7.1 Urban Form of Price Control

LMW proposed no change to the form of price control for the regulatory period 2018-23. LMW acknowledges that the ESC accepts LMW's form of price control being a price cap via a tariff basket with a maximum tariff adjustment of 10%.

LMW propose no change to the form of price control in this submission to the draft decision.

7.2 Urban Tariff Structure

In its draft decision, the ESC proposes to approve LMW's proposed tariff structure.

LMW accepts the ESC's draft decision and proposed no changes in this submission to the draft decision.

7.3 Urban Tariff Price

LMW acknowledges that the ESC has not approved the maximum individual tariff prices in the draft decision. That the ESC requires LMW to submit updated tariff prices that reflect the changes made to the revenue requirement due to ESC adjustments, LMW adjustments and the updating of the cost of debt.

LMW has submitted updated tariff prices with this submission to the draft decision in the financial model templates.

7.4 Urban Price Levels

The outcome of the ESC's draft decision, LMW's adjustment to electricity cost, payroll tax and the update of the cost of debt has tariffs decreasing by 0.3% (real) per annum. An average residential customer bill (usage of 477 kL) is show in Table 14 below.

Table 14

(\$m 1/1/18)

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
LMW proposed residential average bill						
Water Service Charge	203.20	202.57	201.93	201.30	200.67	200.04
Sewerage Service Charge	479.68	478.18	476.69	475.20	473.71	472.23
Volumetric Charge	274.60	273.75	272.89	272.04	271.19	270.34
Total average residential customer bill	957.48	954.49	951.51	948.54	945.57	942.62
Percentage movement		-0.3%	-0.3%	-0.3%	-0.3%	-0.3%

7.5 Urban Price Adjustment Mechanisms

7.5.1 Uncertain and Unforeseen Events

The ESC guidance noted that it proposed for the uncertain and unforeseen events mechanism to continue in its current form.

LMW has complied with this request and confirms it does not propose any change to the uncertain and unforeseen events mechanism in the response to the draft decision.

7.5.2 Cost of Debt

LMW note that the ESC has not approved LMW's pricing adjustment mechanism for the cost of debt. The draft decision suggested that the proposed mechanism is based on a price cap, which is the form of price control that LMW proposed albeit via a tariff basket. LMW has sought professional advice who is of the belief the proposed mechanism's formula should be adequate to allow for the calculation of the annual price adjustment.

However, in discussion with the ESC on an appropriate price adjust mechanism for the cost of debt, LMW understand that the ESC wishes to develop a consistent price adjustment mechanism for all Victorian water agencies.

LMW propose to work with the ESC to develop an appropriate consistent Victorian Water Industry cost of debt pricing mechanism over the next 3 months. Being consistent with the current regulatory period, the price adjustment mechanism will be used to adjust LMW's urban water domestic and non-domestic service charges, water domestic and non-domestic usage tariffs, sewerage domestic and non-domestic service charges and minor trade waste charges. The pricing adjustment mechanism would not be applicable to LMW's miscellaneous charges.

7.5.3 Electricity Costs Price Adjustment Mechanism

Lower Murray Water note that price adjustment mechanism for electricity is proposed not to be approved in the draft decision.

LMW's Board and Management are responsible for maintaining sound financial viability and this is done by maintaining sound financial governance, investing prudently and efficiently, operating efficiently and managing commercial risk effectively. Electricity costs represent 20% of LMW's total business controllable operating expenditure and determining how best to respond to the volatility in the electricity market and negotiate through this difficult period is a challenge for LMW.

LMW proposed the "collar" price adjustment mechanism due to the extreme volatility and high energy prices being disseminated by numerous sources at the time of our pricing submission. This enabled LMW to propose prices for services at a level where LMW took risk on behalf of the customer of the actual energy prices being higher. If extreme energy prices did eventuate, LMW would share the financial cost with the customer however the customer's cost was initially protected to the value of the upper collar price level. Just as important, if the energy prices dropped dramatically, the mechanism would benefit customers through lower prices.

LMW do agree that the adjustment formula is challenging for customers to understand however it can be noted that many contracts today contain price adjustment mechanisms to hedge risk for either party of a contract, for example; CPI, index prices, interest rates or oversea exchange rates.

LMW considers that the electricity market has stabilised recently however to protect LMW and its customers in the later years of the pricing submission, some 3-5 years away, LMW are requesting that the ESC re-consider the merit of the proposed price adjustment mechanism for electricity costs

LMW will consult with its urban customers via its Strategic Advisory Council and Customer Consultative Committees in May 2018 to discuss the key issues of electricity pricing. The customers' ability to understand the concepts of the proposed price adjustment mechanism and the benefits it has for both customers and LMW will be re-tested. The results of this consultation will be provided to the ESC to inform its deliberations on the final determination.

8. New Customer Contributions

8.1 New Customer Contributions

LMW acknowledges that the ESC has proposed to approve the new customer contribution charges submitted in our pricing submission in the draft decision.

LMW is not proposing any adjustments to the price of new customer contribution in this submission to the draft decision.

9. PREMO rating

9.1 PREMO Rating – Return on Equity

LMW acknowledges that the ESC agrees with LMW's self-assessed PREMO rating of 'Standard' in the draft decision.

LMW also acknowledges that the ESC accepts as a result of the 'Standard' rating LMW's proposed return on equity of 4.5 per cent per annum.

LMW is not proposing to change its assessed PREMO rating in this submission to the draft decision.