17 September 2011

Andrew Chow
Director, Local Government & Water
Essential Services Commission
Level 2, 35 Spring Street
MELBOURNE VIC 3000

Dear Andrew

2013 WATER PRICE REVIEW – TARIFF ISSUES PAPER

I am writing to provide a response to the Tariff Issues Paper, which you released on 29 July 2011.

The Issues Paper raises a number of important issues regarding urban water tariffs and highlights the challenges that face City West Water, our customers and the ESC in coming up with the best way in which to charge for water and sewerage services in the next regulatory period.

The focus for our submission is on three key areas, that are quite interrelated, these being:

- The volumetric charge for water and sewerage
- The degree of uncertainty in the next regulatory period, and
- The form of price control.

Our submission also provides some comments on the other issues raised in the paper.

I look forward to you providing your thoughts on the issues outlined in our response in your guidance paper, which I understand will be released in the next few months.

Yours sincerely,

Sean Crees
General Manager, Corporate Services

BACKGROUND

As part of its consultation for the 2013 price review the ESC released a Tariff Issues Paper that identified issues relating to water and sewerage tariffs as well as its initial views on how it will address these issues when reviewing the proposed prices in City West Water's (CWW's) Water Plan.

The Issues Paper set out the context for the price review, proposed pricing principles for its assessment of the tariff proposals put forward by water businesses, discussed the options for the form of price control, outlined tariff design issues and provided preliminary views on the issues surrounding introducing customer choice.

This submission focuses on the following key areas:

- The volumetric charge for water and sewerage
- The degree of uncertainty in the next regulatory period, and
- The form of price control.

Our submission also provides some comments on the other issues raised in the paper.

The volumetric charge for water and sewerage

City West Water currently charges its residential customers an inclining block tariff structure for water and a sewerage disposal charge for sewerage services. For non-residential customer, we charge a single volumetric charge for water and a sewerage disposal charge for sewerage services. Some of our non-residential customers also pay a trade waste charge.

The Issues Paper proposes that volumetric charges should be set having regard to marginal cost. The ESC has previously stated that it preferred water businesses have regard to long run marginal cost when setting volumetric tariffs. However, in this Issues Paper it has proposed that other relevant marginal costs be considered.

It is our view that the volumetric prices currently charged by CWW are above marginal cost, and may in fact be substantially higher in some cases. The inclining block tariff charged on residential water customers and the sewerage disposal charge are two examples of where the tariff is somewhat higher than marginal cost. However, these tariffs have been in place for quite some time and, in the case of inclining block tariffs, provided the most appropriate signal to customers at a time where water availability was low.

CWW supports the proposal to move away from inclining block tariffs and the sewerage disposal charge. However, there are other issues to be considered when implementing such a change. First is the impact this restructure will have on some customers. Second is the conflict this restructure may have with the desire by customers and government policy that a large proportion of the bill is made up of variable charges.

The negative impact on some customers can be ameliorated to some extent by phasing the tariff restructure over a number of years. However, the issue of the proportion of the bill being related to a variable charge is more problematic.

A residential customer consuming 160kL per annum would currently see around 55% of that bill being attributable to variable charges. If we were to remove the sewerage disposal

charge, that proportion would reduce to around 35%. In order to maintain the same variable proportion of the bill, the water volumetric charge would need to rise to $2.85 per kL, which is more than $1.00 per kL higher than the current first tier of the inclining block tariff and would be substantially greater than any estimate of the marginal cost of water given the current supply conditions.

The degree of uncertainty in the next regulatory period

The regulatory framework requires CWW to develop a water plan that proposes prices for a five-year period. The prices are developed by estimating an appropriate revenue requirement and a view on the demand for water-related services. Forming a view of costs and demand for a five-year period is done so with a degree of uncertainty, however, the next regulatory period will see a far greater level of uncertainty for two key reasons:

- the annual costs associated with purchasing desalinated water, and
- the level of demand for water-related services once restrictions have been lifted.

The water that is supplied to Melbourne by the desalination plant will be ordered on an annual basis by the Minister for Water by 1 April. The contract allows for the ordering of 0, 50, 75, 100, 125 or 150GL, and the costs for these options ranges from around $650million for zero, to $760million for 150GL.

The amount that is ordered each year will be determined based on the level of storages at the time the order is placed and the forecast demand for the future few years. This effectively means that the amount of desalinated water ordered is highly dependant on annual streamflows, which are highly variable from year to year.

The cost profile of desalinated water and the uncertainty around how much water will be ordered each year creates a great deal of uncertainty with regards to this cost item.

The other element of uncertainty relates to the demand for water in the next regulatory period. Our customers have been subject to severe water restrictions for the last 5 years and as a result have dramatically reduced their water consumption. Our customers currently consume around 15% less water when compared to 2005-06, which was before the severe restrictions were introduced at the height of the drought.

It is anticipated that the next regulatory period will have little or no restrictions due to the augmentation projects that will have been delivered. Therefore, a key issue in forecasting demand for water for the next regulatory period centres on how our customers will use water in an unrestricted environment.

The form of price control

The form of price control refers to the way in which prices are adjusted each year within a regulatory period. CWW is currently subject to individual price caps, with an option of applying a tariff basket if certain criteria are met. Individual price caps mean that all of our prices are set for the entire regulatory period and are adjusted each year for inflation.

This form of price control provides a great deal of certainty to customers with regards to prices over an extended period of time and are very appropriate in circumstance where either costs are stable or prices are set in line with short run marginal cost.

The current price determination does have a mechanism for addressing the issue of uncertainty. It is essentially dealt with by adjusting prices when variations in costs and/or revenue stray too far from the assumptions that underpin the prices in the determination. The water business or the ESC are able to initiate such an adjustment.

CWW would propose that an alternate price control to what is currently in place is preferable for the next regulatory period. This alternate price control could address the issues of the:

- uncertainty of the annual desalination costs and
- the demand uncertainty when pricing above marginal cost.

In terms of the annual desalination order, we propose that prices be adjusted each year in accordance with the order for that year. This approach effectively means that the costs for desalination are passed through to customers in full each year. Given the majority of the costs associated with desalinated water are fixed, the variability in prices year on year would be small. For example if we went from ordering zero desalinated water in one year to ordering 150 GL the following year, prices would only need to increase by around 4 per cent.

As described above, our water and sewerage prices are currently set above marginal cost. The current policy constraints, together with customer preferences regarding the ability to control their bills, means that a move to pricing strictly in accordance to marginal costs, however they are estimated, is problematic.

The pricing of our services above marginal cost becomes a greater issue when demand uncertainty is also taken into account. If we were to set the variable price at $2.85 per kL (as described above), this may represent a level up to $1.50 per kL above our short run marginal cost. If the bounce back in demand for water from residential customers, which is difficult to estimate, is wrong by 5 per cent, this would represent a variance in annual revenue of around $7 million and a corresponding variance in costs of nearly $4 million. This would mean that CWW could either earn $3 million additional profit each year (or conversely lose $3 million) due to the uncertainty associated with demand forecasting in the next regulatory period when pricing above marginal cost.

In order to ameliorate the impact on our profit or loss CWW proposes consideration be given to a price control that adjusts prices each year after the actual demand for the previous year is known. The adjustment would be calculated with reference to the price CWW would have charged had we set our variable water and sewerage tariffs at short run marginal cost. In the above example the $3 million would be added to (or subtracted from) the prices we charged in the following year. If the size of the adjustment led to price shocks for customers, which could be predetermined to be a certain percentage, the adjustment may be able to be phased over a number of years.