

20 Corporate Drive
Heatherton VIC 3202
Locked Bag 1
Moorabbin VIC 3189 Australia

Telephone (03) 9552 3000
Facsimile (03) 9552 3001
DX 36006 Moorabbin
info@sewl.com.au
southeastwater.com.au

30 August 2011

Mr Andrew Chow
Director, Water and Local Government
Essential Services Commission
Level 2, 35 Spring Street
Melbourne VIC 3000

Dear Andrew,

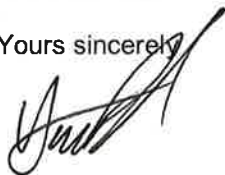
Essential Services Commission Tariff Issues Paper

South East Water welcomes the opportunity to participate and provide a response to the Essential Services Commission's Tariff Issues paper.

The Issues paper raises a number of important issues and factors to consider in formulating tariffs for the 2013 regulatory period. The attached document outlines South East Water's position across the key areas covered in the issues paper. South East Water looks forward to working with the ESC in further exploring a number of the issues identified in formulating tariffs and price control mechanisms for the next regulatory period.

Should you wish to discuss or require any further information in addition to the attachment, please feel free to contact Rob Nolan on 9552 3523.

Yours sincerely



Dr Hamish Reid
General Manager Strategy



ESC TARIFF ISSUES PAPER

South East Water submission

Introduction

As part of the preparation for the 2013 Water Price Review, the Essential Services Commission (ESC) released an issues paper on price control mechanisms and tariff structures for bulk water and sewerage, retail water, recycled water and sewerage services.

The purpose of the issues paper was to identify a number of factors in formulating tariffs for the 2013 regulatory period and is structured around four key areas:

- Pricing principles and regulatory framework;
- Issues related to form of price control;
- Bulk and retail tariff structure and design issues; and
- Tariff issues related to customer choice.

South East Water is currently developing its tariff structures for the 2013 regulatory period. A number of the issues raised in this paper are consistent with those we have identified in developing our tariff reform strategy to date.

The issues paper seeks specific input into the ESC's thinking on the criteria and factors it will consider during its review of tariffs included in the 2013 Water Plans. In the following section, South East Water responds to the issues raised in order to identify:

- areas of agreement or where we disagree;
- areas where we seek further clarification; and
- areas where we have an initial preference, but require further development between now and the finalisation of the 2013 Water Plan.

Proposed Pricing Principles

The ESC proposed a set of pricing principles for developing tariff structures, which comprised of:

- Economically sustainable revenue
- Subsidy free pricing and inefficient bypass
- Simple, understandable and cost reflective tariff structures
- Volumetric charge having regard to relevant marginal costs
- Customer focus and equity.

South East Water supports the ESC's proposed principles to apply to the formulation of tariff structures, as they are generally consistent with the Water Industry Regulatory Order and the principles being used to develop our tariff strategy. While the issues paper is focused on tariffs, it is noteworthy that the broader decisions of the ESC need to have regard to water businesses' capacity to achieve economically sustainable revenues.

Our tariff strategy may encompass changes to our current tariffs that:

- Has regard to the long run marginal cost of supply for volumetric charges
- Incorporates policy requirements on the percentage of volumetric charges in customers' bills
- Makes changes to the current tariff structures for residential and non-residential customers.

The proposed set of pricing principles applies to each of the above potential changes and will require consideration of:

- Adequate transition strategies in place to deal with any customer impacts, particularly on low income and vulnerable customers. We also understand that with tariff reform there will be positive and negative customer impacts, and this should not be a reason to not proceed with tariff reform.
- Balance between competing principles, such as seeking to set volumetric charges with regard to marginal cost may conflict with the customer preferences for higher volumetric component of their bill.

South East Water will seek further clarification from the ESC to ensure it is adequately balancing competing pricing principles when formulating its tariff strategy for the Water Plan. Additionally, when assessing tariff structure changes against the proposed pricing principles we consider that they need to be assessed as a total package of structure changes for each customer type rather than as individual tariff changes.

Form of price control

South East Water notes that the ESC raised some important contextual issues regarding the appropriate price control mechanisms for the next regulatory period, including:

- given increased uncertainty of climate and demand, consideration could be given to price control mechanisms targeted at managing and allocating risk equitably between water businesses and customers;
- the exposure of Melbourne Water to possible significant cash flow variations from the annual supply order from the desalination plant and how that is passed on to the end customer; and
- with the introduction of customer choice in tariffs consideration of more flexible forms of price control may be required.

South East Water agrees with the ESC on the issues for determining the appropriate form of price control. In addition to the above uncertainties, South East Water's final position on the most appropriate form of price control also needs to take account of its tariff strategy for the next regulatory period which is still being developed.

South East Water's preliminary view at this stage is there is a need to consider a change from our current form of price control (individual price caps) to a weighted average price cap, which provides flexibility in making individual price changes during the regulatory period. This may account for a number of changes in circumstances during the regulatory period, including:

- changes in demand
- tariff restructures
- customers not responding to price signals
- the introduction of new choice tariffs.

South East Water considers that given the level of uncertainty with desalination ordering and the associated variable charges, a pass through mechanism that adjusts for variable charges associated with the desalination plant has merit and needs to be explored. The key driver will be the likely extent of this uncertainty on business risk and the appropriate balance of risk between customers and businesses.

We also acknowledge that given the uncertainty in forecasting bounceback in demand, following the removal of restrictions, that investigation into an adjustment mechanism for significant under and over recovery of revenue due to sales variability be undertaken.

Tariff Structure and design levels

Bulk charges

Water

In its discussion of Melbourne Water's bulk water charges the ESC questioned whether, given that headworks assets and the desalination plant have different fixed and variable costs, it would be a good idea to make bulk water resource charges more transparent and cost reflective. A proposal put forward included creating separate charges for headworks and the desalination plant. The ESC also questioned whether there should be different bulk volumetric charges according to the bulk supply point for a retailer.

On the basis that Melbourne's interconnected water supply system provides security to all of Melbourne's customers, South East Water would not support different volumetric charges for bulk resource costs according to the bulk supply point for a retailer. As all customers benefit from the security it provides, headworks costs should be spread across customers according to demand not location on the system.

With regard to bulk water tariff structures, South East Water considers that an alignment of risk needs to occur between retail tariffs and Melbourne Water's bulk volumetric charges. This being where if Melbourne Water has a lower proportion of revenue recovered from variable charges compared to South East Water, we bear more risk of lower than forecast sales, but benefit more from higher than forecast sales. Given that the makeup of bulk and retail tariffs may be set in the next regulatory period with different and competing pricing objectives we will look to ensure that an alignment of risk is achieved.

Sewerage

The ESC questioned whether the structure of Melbourne Water's bulk sewerage charges needs to be reviewed. A major component of bulk sewage volumes during wet weather events are out of South East Water's direct control as they occur through inflows and infiltration. South East Water acknowledges that Melbourne Water would incur some additional costs as a result of wet weather events, however it is not clear that these are reflective of the additional charges currently incur. South East Water is looking at options in the sharing of volumetric risk associated with bulk sewage volumes with Melbourne Water.

General

South East Water considers that the structure of water and sewerage bulk charges for the next regulatory period needs to be cognisant that there may be a need to establish prices for new access seekers to Melbourne Water's infrastructure.

Retail tariffs

Water

The ESC noted that a key element of its assessment of retail tariff structures proposed by the water businesses will be how they align with the pricing principles described above. The ESC also stated that it will also need to consider any tariff structure changes that alter the allocation

of risk between retailers and customers. These considerations are consistent with the approach South East Water is taking in developing its tariff structures to date.

Regarding Inclining Block Tariffs (IBT) the ESC noted there is considerable evidence that questions whether an IBT is effective in protecting the low income and vulnerable customers. It also stated that it would look for evidence that a water business has an adequate transition strategy for shifting from IBTs.

These considerations are also consistent with the current approach South East Water is taking in developing its tariff strategy, which is assessing the efficiency and equity of the current IBT in place for residential customers.

Regarding location-based charging South East Water will retain its current postage stamp pricing approach for water and sewerage services. We consider that New Customer Contributions are a more appropriate mechanism for sending locational price signals.

The ESC considered that vertically integrated businesses should look to separate retail and distribution costs to enable choice tariffs and to enable third party access pricing. It is our view that identifying costs for each activity is also required as a priority for retail minus pricing rather than necessarily separation of charges. South East Water will require further clarity and guidance and will work with the ESC on developing the approach to access pricing and hence the allocation of costs.

Sewerage

The ESC questioned whether the structure of the Melbourne water retailers' sewage disposal charges provides the right balance between efficiency, simplicity and equity. South East Water considers that the sewage disposal charge is not easily understood by residential customers given the complexity in its calculation. Given this, South East Water is reviewing the current charge and aiming to simplify the calculation, to enable better communication of the charge to residential customers. In considering any alternatives to the current sewage disposal charge, South East Water will also need to consider any customer impacts and the general customer preference for greater control over their bills.

Recycled Water

Regarding recycled water pricing, the ESC noted the current approach to setting tariffs (bottom tier of the inclining block tariff) and stated it will be guided by the outcomes of the MAC review on the approach to recycled water tariffs for the next regulatory period. We are currently reviewing our tariff strategy for recycled water in the next regulatory period and the proposed set of principles is not inconsistent with our approach. In reviewing recycled water prices, given the high cost to supply recycled water, we will need to take account the level of cross subsidy between recycled water customers and the remaining customer base.

Tariffs and customer choice

In evaluating customer tariff choice proposals, the ESC's current thinking is that businesses' choice tariff strategy:

- must include consultation with customers on tariff options;
- must be well developed with clear communication, implementation and monitoring plans;
- must demonstrate compliance with government policy;
- clearly communicate the comparison with the default tariff; and

- be reflective of efficient costs.

The ESC also proposed that in setting tariffs for the next regulatory period a default set of tariffs is required. Where businesses wish to introduce optional choice tariffs, customers can exercise their choice though they are not required to do so.

South East Water supports the ESC's approach to allow businesses to offer choice in products and tariff options. Our tariff strategy has also comprised of developing a default set of tariffs with choice tariffs remaining as optional for customers, consistent with the ESC's proposed approach.

The ESC considered that the regulatory framework applied to each choice tariff would depend on the type of tariff, being either:

- consumer preference or risk allocation tariff option – this tariff option would enable customers to manage their risk according to their preferences, such as a high security tariff. The ESC would need to be satisfied that by allowing this choice tariff it would fit within the allowed regulated revenue
- additional service choice tariff – this could include contribution to green tariffs and community services. The revenue and costs could be quarantined from the regulated revenue requirement.

South East Water supports greater flexibility in the regulatory framework to enable businesses to introduce optional choice tariffs and products during the regulatory period. This may be through more flexible price control mechanisms for the default set of tariffs for standard water and sewerage services and then allowing businesses to determine appropriate charges for optional choice tariffs based on a set of choice pricing principles.