

26 April 2016

Dr Ron Ben-David  
Chairperson  
Essential Services Commission  
Level 37, 2 Lonsdale Street  
MELBOURNE VIC 3000

Dear Ron

### **Draft Decision on Melbourne Water's Price Submission**

We welcome the opportunity to provide comments on the Commission's Draft Decision on Melbourne Water's Price Submission on behalf of our customers. Our customer research indicates that water prices are an important aspect of customer satisfaction for our customers and our response is focussed around this.

We are supportive of many of the matters contained in the Commission's Draft Decision including:

- adoption of the proposed service levels
- Melbourne Water continuing to fund its share of the Government Rebate of \$100 per year to residential customers in 2016/17 and 2017/18
- adoption of new headworks' tariffs based on bulk entitlement volumes.

There are a number of matters we would like to raise with the Commission in relation to its Draft Decision:

#### **Price path**

Melbourne Water proposed a large  $P_0$  price adjustment in 2016/17 followed by smaller adjustments, and this was accepted by the Commission. For the Commission's final determination, our preference is for a price path that matches the annual revenue requirement to minimise subsequent price adjustments in the next regulatory period associated with scissor effects, which can have substantial customer pricing impacts at that time.

#### **Capitalisation of desalination water security payments**

The Commission has adopted Melbourne Water's proposal for \$20 million per annum of capitalisation, but invited Melbourne Water to increase this amount of capitalisation. The amount of capitalisation of desalinated water security payments has a major impact on the price reduction proposed in 2016/17 from a customer perspective.

The issue under consideration is which generations of customers should pay for the cost of the Victorian Desalination Plant – should it be restricted to customers in the first 27 years of the life of the plant (which is the contract period), or should it be extended to those customers receiving its benefits over the full 60 years of asset life?

We support the generally accepted principle that customers who benefit from a service should pay their fair share of its cost. For the Victorian Desalination Plant, this would mean a number of generations of customers paying for it over its asset life of 60 years – our calculations indicate full capitalisation of desalination payments over 60 years would require capitalisation of \$100 million per annum.

We note there were mixed customer perspectives regarding this issue emanating from Melbourne Water's research. Given the complexity of the issue, we would caution against an over-reliance on the research. From our understanding one of the reasons as to why some customers favoured a shorter repayment period was that the amount to be saved wasn't considered material. We believe this perception might alter now that all other elements of future prices are known (i.e. the overall price path for Melbourne Water and the costs associated with ordering water from the desalination plant).

We have undertaken analysis of various capitalisation options of the desalinated water security payments to understand the impacts on Melbourne Water and the benefits for customers, particularly the price reduction in 2016/17. Our analysis indicates that for all the options presented below, Melbourne Water's financial ratios fall within the Commission's benchmarks and it should continue to have an investment grade credit rating for the next regulatory period:

- *approximately \$45 million per annum*: this option is the average capitalisation for taxation purposes likely to be incurred by Melbourne Water in relation to the desalination security service payments that are due to be paid over the next five years
- *\$45 million for 2017/18 and \$72.5 million thereafter*: this option reflects the proposal in Melbourne Water's 2013 Water Plan
- *up to \$80 million per annum*: this option is the mid-point between the contract period of 27 years and full asset life of 60 years and reflects the even split of customers' views in Melbourne Water's customer research.

For the Commission's final determination, our preference is for a capitalisation option in line with the above band, based on the principle that customers who benefit from a service should pay their share of its cost. Any capitalisation option should also take into account Melbourne Water's long-term financial viability.

### **Government Rebate**

The Government is committed to returning water industry efficiencies to residential customers via a \$100 annual rebate on an annual basis through to 2017/18. In its Price Submission and at the Commission's public meeting, Melbourne Water confirmed it would continue to contribute its share of the Government Rebate in 2016/17 and 2017/18, funded from efficiencies. These efficiencies amount to \$42 per residential customer in 2016/17 and \$39 per residential customer in 2017/18. We request that the Commission reflect in its final determination for Melbourne Water the commitment of the Government, Melbourne Water and the retail water utilities to continue to return the full benefit of Melbourne Water's share of efficiencies through the \$100 rebate for the next two years.

Yarra Valley Water proposes to continue to pass on Melbourne Water's contributions, as detailed above, via the \$100 Government Rebate to residential customers. The additional decreases in bulk charges will be fully passed onto our customers through lower prices. We plan to use this methodology as the basis of our Annual Proposed Prices Submissions to the Commission for 2016/17 and 2017/18.

## **Operating costs**

Melbourne Water's operating costs are increasing substantially above the net growth efficiency factor of -0.2 per cent from 2016/17 to 2020/21 (refer page 33 of the Commission's Draft Decision). In this regard, we support the Commission's comment in its draft decision:

Whilst Melbourne Water's submission and the Deloitte review address some of these cost increases, we are seeking to better understand the drivers for these cost increases and what mitigation steps are being implemented by Melbourne Water. (page 33)

## **Capital expenditure**

The Commission has proposed a reduction of \$355.5 million in total capital expenditure from Melbourne Water's Price Submission proposal. We believe the Commission's decision is appropriate and will bring Melbourne Water's capital expenditure benchmark over the regulatory period to around the pre and post millennium drought expenditure level. Unless there is evidence that the overall asset base is deteriorating and, consequently, risk level is increasing, we believe the Commission's Draft Decision is appropriate.

## **Rolling Weighted Average Cost of Capital (WACC)**

In its Price Submission, Melbourne Water proposed a 10-year rolling WACC based on its trailing historical debt. In its Draft Decision, the Commission has rejected Melbourne Water's proposal and retained its existing 'on the day' method. This produced a post-tax real WACC of 4.2%. However, the Commission left it open for Melbourne Water to refine its Price Submission proposal to overcome a number of concerns.

We understand that Melbourne Water will be proposing a variation of its ten-year rolling WACC methodology based principally around Treasury Corporation of Victoria (TCV) lending rates plus a corresponding Financial Accommodation Levy (FAL) to determine final rates at which a BBB rated entity could have borrowed from TCV for each year. We understand that applying this latest methodology produces a WACC of 4.3% for 2016/17 with an average WACC over the regulatory period of around 4.2% based on TCV forward estimates of the cost of debt.

We would be supportive of a revised proposal from Melbourne Water that incorporates a ten-year rolling WACC that is initially based on a backward calculation, but removes the anomalies of the GFC and is updated annually.

Given this methodology is backward looking using actual past results, we have a preference for the opening 2016/17 WACC to be assumed across the period rather than introducing forward TCV estimates which result in an additional price adjustment each year based on the actual WACC calculated annually.

## **Headworks harvesting tariffs**

The metropolitan retail water utilities proposed to Melbourne Water that it should implement a harvesting tariff for the headworks component of its bulk water charges. The proposal included the retail water utilities paying for the actual costs of pumping and treatment of water at the headworks based on the estimated harvesting costs and volume rather than a fixed charge.

We note in Melbourne Water's Price Submission that it is proposing to undertake a review relating to this matter:

Melbourne Water believes the best way to directly address this issue is through a comprehensive and collaborative review of the operating rules and guidelines underpinning these decisions and how they are communicated through the AOP process. A tariff alone may be one output of this revision but is unlikely to resolve the underlying issue. (page 50)

As a consequence, we suggest that the Commission's final decision enable Melbourne Water to implement any changes to its headworks tariffs, supported by the entitlement holders, during the forthcoming regulatory period such as from 1 July 2018.

Other matters:

- **Transfer of 8 GL of Thomson bulk entitlement volumes to the Victorian Environmental Water Holder on 1 July 2016:** On 1 July 2016, the Government plans to transfer 8 GL of the metropolitan retail water utilities' Greater Yarra system – Thomson River Pool bulk entitlements to the environment. This necessitates changes to the computation of prices for Melbourne Water's headworks tariffs – the three retail water utilities' individual bulk entitlements will be reduced by about 8 GL in total and the total volume for the Greater Yarra system – Thomson River Pool bulk entitlements will be reduced by around 8 GL from 624.310 GL.

If you or your staff have any queries regarding the above, please contact Brett Mathieson, Manager Regulation and Planning by email on [Brett.Mathieson@yvw.com.au](mailto:Brett.Mathieson@yvw.com.au) or by phone on 9872 2441.

Yours sincerely



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