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Mr Greg Wilson
Chairman
Essential Services Commission
Level 2, 35 Spring Street
Melbourne 3000

Dear Greg

Yarra Valley Water response to ESC Guidance on Water Plans

Yarra Valley Water welcomes the publication of the Commission's *2008 Water Price Review Guidance on Water Plans* ("the Guidance"). This letter sets out Yarra Valley Water's comments on the Guidance.

Yarra Valley Water sees considerable merit in the Commission providing clear and comprehensive guidance to the water companies, to assist them in the preparation of their water plans, and to ensure that the Commission obtains all of the information it reasonably requires for regulatory decision-making purposes. At the same time, it is important that the requirements on the businesses be specified in a manner and at a level which is appropriate, having regard to:

- the costs to the businesses of preparing that information;
- the wider benefits flowing from the production and publication of the information; and
- the costs incurred by the Commission itself in assessing the information provided and in making its decisions.

Overall, Yarra Valley Water considers that the Guidance provides a useful description of the structure and contents of Water Plans for the 2008 water price review. It is noted that the Commission intends to provide further guidance to the water companies in December of this year.

The Guidance notes that the key role of the Water Plan is to clearly articulate and commit to a set of outcomes and prices to be delivered over the regulatory period. The Water Plan also provides a mechanism for businesses to resolve tradeoffs with customers, regulators and the Minister for Water. Yarra Valley Water agrees that the Water Plan is a key vehicle for resolving tradeoffs with all stakeholders.

In addition, the Guidance indicates (on pages 3 and 4) that the Commission intends to consult on ten key issues over the next few months. These will inform the further guidance proposed for December. The Commission also states that the comments received in response to the September Guidance paper will help it to develop its consultation timetable as well as highlighting any other issues that need to be addressed.

Yarra Valley Water supports this overall approach by the Commission. However, the company is concerned that a more detailed timetable and process are yet to be established for the various consultation exercises envisaged by the Commission. The next three months will be a critical period for the Commission in finalising its Guidance, and in working towards resolving the many issues that must be settled before May 2007. Yarra Valley Water therefore urges the Commission to carefully consider the timing and resource requirements of these processes, and to finalise and publish its proposed timetable and detailed work plan for these processes - and the overall price review - as soon as possible. It might be helpful to prioritise the consultations according to their impact on the Water Plan and ultimately the Review.

In addition to these general comments, Yarra Valley Water has some further specific comments on the Guidance, as follows:

- The list of issues on which the Commission proposes to consult appears to include all the main issues that are relevant to the finalisation of Water Plans. At this time, the Company is not aware of any other issues on which the Commission should consult.
- Yarra Valley Water is concerned about the potential impact of an extended drought and related water restrictions. This will create uncertainty over the medium- to long-term that may have a significant bearing on a number of areas. These include the length of the regulatory period, the form of the price control, demand forecasts and, of course, arrangements for dealing with unforeseen events. Yarra Valley Water will be particularly interested to explore how the prospect of continuing drought affects the efficient management of revenue risk and cost risk over the forthcoming regulatory period and beyond. As part of this water review, it will be important to consider the regulatory mechanisms that can mitigate the revenue and cost impacts of events such as drought that are beyond the Company's control.
- Further to the particular matter of demand forecasts, Yarra Valley Water notes the Commission's view that "rigorous demand forecasts are somewhat less important in the case of a revenue cap" (on page 31 of the Guidance). The Company will endeavour to produce a demand forecast that is as rigorous as possible. However, there is heightened uncertainty surrounding demand forecasting at a time of extended drought and climate change. The Commission's view suggests the possibility of a revenue cap as a way of addressing that uncertainty and the Company is interested in exploring further the suitability of revenue capping. The Company would urge the Commission to keep an open mind on the issue of the form of the price control, notwithstanding the position it adopted on the matter in the 2005-08 Urban Water Price Review.
- The Commission proposes to require businesses to substantiate their capital expenditure forecasts in terms of the key drivers of expenditure as well as providing an assessment of prudent and efficient capital expenditure levels on a (specified) expenditure category basis. In addition, the Commission proposes to require businesses to provide specific details on "the top ten projects/programs to be delivered over the regulatory period". The purpose of providing the project-specific information is not clear, given the other information that the businesses will be required to provide. The rationale for the requirement for businesses to provide details of ten projects -rather than some other number - is also

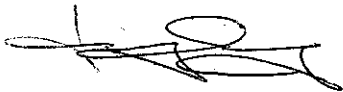
unclear. In drafting its further Guidance, the Commission should ensure that its information requirements for capital expenditure provide the companies with appropriate latitude and do not impose arbitrary information requirements on the businesses.

- The Company notes the Commission's comments regarding regulatory depreciation (on page 29 of the Guidance). Regulatory depreciation can provide a useful means of managing price changes that arise from time to time due to longer-term fluctuations in the investment requirements of capital-intensive sectors such as water. It would be useful if the Commission's guidance specifically noted the role that regulatory depreciation could play in managing price shocks.
- The Guidance proposes that companies provide a breakdown of capital and operating expenditure on the basis of "business as usual" delivery of obligations coming into effect before 1 July 2008. (This requirement appears in sections 4.2.1 to 4.2.4 and 5.2.2.) A breakdown of these costs would be inconsistent with the Water Plan information template and the regulatory accounts. Yarra Valley Water would incur additional unnecessary expenditure to provide a breakdown of pre-July 2008 expenditure in accordance with the requirement proposed in the Guidance. However, the Company will provide a view of the cost breakdown for new obligations coming into effect after 1 July 2008.
- Section 4.2 of the Guidance also asks for details of customer consultation where the Company proposes to go beyond strict compliance with regulatory and government obligations in the Water Plan. However, the guidance for particular obligations (4.2.1 etc) asks that the Water Plan clearly identifies any consultation undertaken without specifying whether it relates to additional outputs beyond strict compliance. The Company would not expect to consult with customers about meeting obligations imposed by regulators and government. The other reading is that the Commission seeks details of discussions between the Company and the bodies setting the obligations about how the obligations should be interpreted and compliance achieved. This matter should be clarified in the further guidance to be provided by the Commission.
- The Guidance sets out how the Commission will assess claims for additional expenditure that arise from changes to legislative obligations (section 7.4.1). In the Water Price Determination for the current period the stated threshold is 2.5% of revenue for the period (paragraph 4.1(d)(i)(A)). Looking forward, the Company believes the materiality threshold needs to be revisited. It may well be prudent to lower the threshold further because the total revenue will be considerably higher as it includes an additional two years.
- Events such as extended drought, flash flooding and bush fire create uncertain and potentially significant cost burdens and revenue risks. Yarra Valley Water therefore welcomes the Commission's intention to consult on mechanisms to adjust prices due to unforeseen events (section 7.4.2). This should cover the triggers for considering adjustments for the occurrence of specific events. Triggers may include additional regulatory or government obligations or events beyond the Company's control, particularly related to climate change.
- The core service standards listed at Box 4.1 in the Guidance refer to 'specified numbers' of multiple unplanned water supply interruptions and multiple sewer blockages. Yarra Valley Water has noticed that the measures set out in the information template for the Water Plan are different from those in the current price determination. Five unplanned water supply interruptions has become more than five. Four sewer blockages has become more than three. Whilst there might not be a difference in practice, the Company urges the Commission to take care to note any changes in terminology or definitions to avoid misunderstandings and to be specific where there is a proposed change. Changes should also be subject to consultation with stakeholders.

Yarra Valley Water looks forward to working constructively with the Commission and all other stakeholders over the course of the forthcoming water price review.

Should you have any further queries in relation to the matters raised in this response, please contact Brett Mathieson (Manager, Regulation and Planning) on 9872 2441.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Tony Kelly', with a stylized flourish at the end.

Tony Kelly
MANAGING DIRECTOR