

8 May 2018

Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Attention:
Marcus Crudden
Director, Water Division

Dear Marcus,

Context for our Response

North East Water welcomes the Essential Services Commission's (ESC) Draft Price Determination which supports the health and prosperity of our region; importantly over an eight year price setting period.

Our business has embraced the ESC's PREMO approach to the 2018 review with our submission clearly demonstrating our pursuit of customer outcomes and in turn expenditure efficiency. Pleasingly the ESC has supported our internal assessment of 'Advanced'.

We acknowledge the working relationship between the ESC and North East Water which has been critical in our business proposing the best outcomes for our customers and communities while exploring new ways to enhance the customer experience of our products and services.

The Draft Decision has incorporated the majority of our Submission, in particular the support for an eight year determination, 0.45% annual real price increases and the correction to our treatment of New Customer Contributions revenue. Therefore the remainder of our response can be categorised as principle based responses acknowledging that with our existing commitment to under-recovering our total Revenue Requirement any further adjustments (up or down) to our expenditure forecasts will not have a financial impact on our customers.

Operating Expenditure

Controllable Operating Expenditure

North East Water's Price Submission proposed total increase above adjusted baseline of \$7.44 million for the 8 year period which included a \$2.1 million reduction in electricity costs (in addition to our 1.2% efficiency commitment) compared to baseline operating expenditure. This reduction was offset by an increase in wages of \$7.3 million over the same period relating to the amount of wages to be paid over and above CPI based on a known minimum EBA increase of 3% which will be effective from September 2018.

In the draft decision the ESC have proposed a reduction in controllable operating expenditure of \$10.33 million over 8 years. This reduction not only removes any variations above baseline controllable expenditure proposed by North East Water but results in a further net reduction of \$2.9 million to the adjusted Baseline controllable operating expenditure forecast (refer to tab Opex FO in the financial model).

A gross reduction of \$3.93 million below adjusted baseline controllable operating expenditure has been proposed by the ESC in Years 4 -8 as shown in the table below.

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
	\$mill	\$mill	\$mill	\$mill	\$mill	\$mill	\$mill	\$mill	\$mill
Adjusted Baseline controllable operating expenditure (Forecast)	37.99	38.01	38.02	38.03	38.05	38.07	38.08	38.10	304.35
Total controllable operating expenditure	38.62	38.36	38.08	37.35	37.61	37.10	37.16	37.17	301.45
Variation \$	0.63	0.35	0.06	-0.68	-0.44	-0.97	-0.92	-0.92	-2.89
Variation %	1.7%	0.9%	0.1%	-1.8%	-1.1%	-2.5%	-2.4%	-2.4%	-0.95%

North East Water's average customer growth rate is 1.23% for the 8 year period and this is largely offset by an efficiency rate proposed by North East Water of 1.2% resulting in minimal expenditure growth above the adjusted baseline. Further reducing the growth and efficiency baseline expenditure will have no benefit to customers in this determination but may have an unintended impact on performance benchmarking in future years.

North East Water request that the \$2.9 million be re-instated to reflect an expenditure profile consistent, at a minimum, with the adjusted baseline controllable expenditure forecast.

Employee Costs

North East Water is a regional employer which presents many challenges including the ability to attract and retain highly skilled employees in areas that are recognised skill shortages such as Engineering. In November 2017 it was reported that Australian construction activity boomed in the September quarter, driven by a sharp increase in the value of engineering work. According to the Australian Bureau of Statistics (ABS), the total value of construction work surged by 15.7%, against a predicted decline of 2.3%. This is attributable to state governments of both Victoria and New South Wales as well as the Commonwealth Government's infrastructure spend, signalling the commencement of an ambitious ten year major infrastructure investment programs. This challenge is compounded with the level of salaries that the Corporation can offer which are no longer competitive in this market.

The growth adjusted baseline allows for an increase of 0.03%. That is, the difference between customer growth of 1.23% and efficiency of 1.20%. Cost of labour will increase by a minimum of 3% including inflation. The Department of Environment, Land, Water and Planning (DELWP) advised North East Water in August 2017 was that there is a requirement for all Water Corporations to have a minimum increase of 3% (0.7% higher than the ESC has allowed in the Draft Decision) with a 4 year agreement and that any increases below 3% would not be approved. Not recognising this known cost requirement is inconsistent with the ESC acknowledging other known Department costs such as the Environmental Contribution and various licencing fees.

North East Water are not projecting an increase in FTE and sits in the top half of the regional urban water Corporations at 3.48 FTE staff per 1,000 connections with this ratio further reducing to 3.28 staff per 1,000 connections by Year 8.

North East Water request that at the minimum our customers be priced for the known cost of labour which is equivalent to an additional 0.67% (0.7% less growth increase of 0.03%) above the controllable baseline.

Capital Expenditure

Wodonga WWTP Major Upgrades

The Deloitte review looked into the merits of the following two projects that relate to the augmenting of the Wodonga WWTP being:

- Wodonga WWTP Capacity Upgrade and Emissions Reduction (Budget \$11.7m) – Project intent to improve capacity, through the inclusion of a cogeneration plant reduce the emission from the existing treatment process and help achieve the long-term target of zero-emission.
- Wodonga WWTP Major Upgrades (Budget \$8.1m) – project intent to improve efficiency, capacity and operability.

The Deloitte review stated that “the proposed augmentation appears to be well justified”.

Deloitte’s recommended that the proposed budgets for the projects be reduced by the contingency amount of 10% for the Wodonga WWTP Capacity Upgrade and Emissions Reduction project (revised from \$11.7m to \$10.5m); and 5% for the Wodonga WWTP Major Upgrades project (revised from \$8.1m to \$7.65m).

With respect to the margins used North East Water would argue that the project management costs (for both the contractor and client) and detailed design are real project costs on top of the base cost estimate which has been established on a supply and installation basis and are not contingency or risk costs.

Noting that the estimating accuracy for these projects is in the order of $\pm 25\%$ an additional contingency of 10% and 5% respectively for the two projects would result in the overall contingency amounts being contained within the order of accuracy of the estimates and would seem reasonable. From a project management and budgeting perspective, given the early stage of project development, North East Water would consider it prudent that these contingencies are retained and recognised to support our Corporate Plan budget and financial projections. Removing the contingencies as proposed by Deloitte’s will result in a mismatch of budgets between the price submission and actual business planning; effectively under recovering the anticipated investments.

North East Water request that the project costs remain at \$11.7m and \$8.1m respectively.

Beechworth Wastewater System Upgrade

The Deloitte review stated that “it has been demonstrated that the Beechworth Wastewater System urgently needs augmentation to address the under capacity issue to prevent further uncontrolled spills to the environment”.

The Deloitte’s report went on further to state that insufficient justification was provided to support the preferred option being the Rising Main and WWTP Upgrades at \$6.03m and recommended that the lower cost option of the Gravity Main and WWTP Upgrades at \$5.05m be adopted as the lowest cost solution.

In developing this project a full range of options were considered and evaluated against multiple criteria in consultation with the Beechworth community and key project stakeholders (DELWP, Parks Victoria and Indigo Shire). Given the nature of the project and the location of the transfer pipeline through the Beechworth Historic Park, a number of considerations in project selection were required.

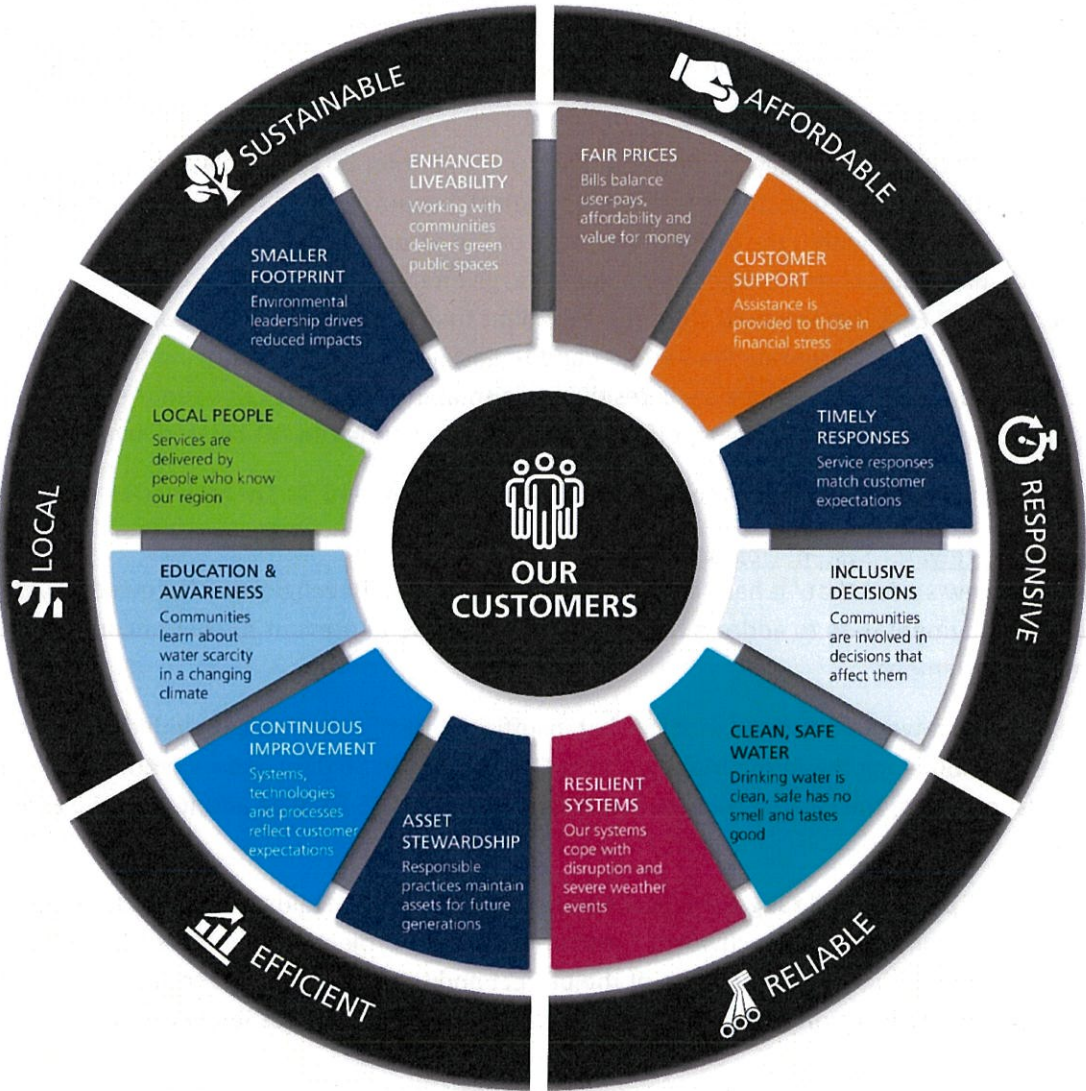
Aligning to our commitment to meaningful customer and community engagement (consistent with the ESC’s expectation) the Beechworth community and relevant environmental stakeholders are in total agreeance that an alternative solution to the option of mobilising major pipe laying operations through the Beechworth Historic Park is required for this upgrade. Pricing this project at the least cost option is contradictory to the community’s feedback, and out of step with the realities of environmental approvals.

On the basis of our continued consultation and further investigations supporting the development of the project it is clear that the lowest cost solution is not acceptable, therefore the project cost should remain at a budget of \$6.03M.

Performance Scorecards

We note in the Draft Decision the ESC’s requirement for North East Water to outline its proposals for the six-monthly and annual performance scorecards. We are currently commencing the co-design of these critical performance assessments with our customers and stakeholders (in particular the participants from our Deliberative Forum) to inform us of segments of our operations and our Price Submission that best form part of a performance report.

The basis for our Performance Assessment will be our agreed customer outcomes framework.



The minimum reporting requirements are those promised in the Price Submission. Our 2014 Customer Values Research and the Corporation's 2016-17 engagement with customers for the Price Submission, both concluded that customers are most interested in the Corporation achieving the following:

AFFORDABLE PRICES

Fair Prices	>70% of customers pay their water bill within the required 30 days
Customer Support	Continuing reductions in the number of customer connections being restricted, including zero restrictions of people eligible for the Customer Support Program

RELIABLE SERVICES

Clean, Safe Water	100% Compliance with Safe Drinking Water Regulations
Resilient Systems	Frequency of unplanned water supply interruptions per 100Kms ≤ 14

RESPONSIVE SERVICES

Timely Responses	Average unplanned minutes off customer water supply ≤ 9 minutes
Inclusive Decisions	Customer perception and engagement achieve average customer satisfaction >90%

EFFICIENT SYSTEMS

Asset Stewardship	Number of sewer blockages per 100kms < 12
Continuous Improvement	Unaccounted water losses <10%

LOCAL FOCUS

Local People	>80% of customers believe that NEW is a local organisation
Education and Awareness	Educational programs achieve > 90% satisfaction

SUSTAINABLE REGION

A Smaller Footprint	100% compliance with EPA Licence Achievement of CO ₂ reduction targets
Enhanced Livability	100% support for endorsed community priority open space projects

We are currently designing the engagement process and preliminary reporting formats and look forward to working with the Commission to finalise this work. We commit to completing this well in advance of our first six-monthly commitment of December 2018.

Supporting Information

The following will be supplied to the Commission as outlined in the Draft Decision;

- Updated regulatory financial model – based on NEW response to this Draft Decision
- Revised Tariff Schedules based on the March 2018 quarter inflation
- Justification of 2013 Determined Actual Capital Expenditure

In Closing

Whilst acknowledging the strong alignment of the Draft Decision to North East Water's submission it is important to ensure that any principle based decisions do not have any perverse long term outcomes. This could be particularly relevant to any future benchmarking discussions. The proposed amendments in this response will not have a customer impact regardless of whether they are accepted by the ESC.

North East Water shares the views of the ESC regarding risks associated with a longer regulatory period in that expenditure or revenue outcomes could significantly diverge from the benchmarks used to establish price. This response is aimed at mitigating a number of these risks prior to the release of the Final Determination.

Should you require any further information or clarity please contact myself or Nicholas Moore, Manager Finance at this office.

I would also welcome the opportunity to meet with the ESC in Melbourne in the coming weeks to discuss North East Water's response to the Draft Price Determination in person.

Yours Sincerely,



Craig Heiner
Managing Director
North East Water