

9 March 2018

Dr Ron Ben-David
Chairperson
The Essential Services Commission
Level 38, 2 Lonsdale Street
MELBOURNE VIC 3000

Dear Dr Ben-David

Response to the ESC's draft decision on South East Water's price submission

South East Water supports the Essential Services Commission's (ESC) draft decision which has accepted the proposals contained in our 2018 price submission. The early draft decision has enabled our business to focus on delivering the customer outcomes set out in our price submission.

The ESC had requested further information on some items in our price submission to inform its final decision, and we have provided this information below. We have also taken this opportunity to respond to the submissions to the ESC in response to our 2018 price submission and the ESC's draft decision.

1. Boneo Water Recycling Plant upgrade

In our price submission we proposed an upgrade to the Boneo Water Recycling Plant at a cost of \$101.5 million, to address current and future capacity constraints arising from growth in properties connected to the sewerage network on the Mornington Peninsula (p. 72). In its draft decision (p.17), the ESC accepted our proposed capital and operating expenditure forecasts for the project, though given that the Boneo Water Recycling Plant was out to tender when it made its decision, it requested that South East Water provide a revised cost forecast prior to its final decision.

The forecast for the Boneo Water Recycling Plant included in the price submission was based on the business case that was approved by Department of Treasury and Finance (DTF). Subsequent to the price submission and the DTF approval of the business case, South East Water has been undertaking a tender process for the upgrade. The capital works, the general function of the plant, and the operational timeframe included in the submissions received in the tender process were consistent with the total expected expenditure and profile included in

our price submission. Given this, South East Water is not proposing to amend the capital and operating expenditure forecasts associated with the upgrade.

2. Success criteria of digital capability pilot

In our price submission we proposed a digital capability pilot to further develop and expand our end-to-end digital capability to enhance customer interactions, optimise water and sewerage network operation and support integrated water management initiatives for new developments. This is expected to be undertaken over 2018-19 and 2019-20 at a cost of \$10.1 million. The ESC accepted this proposal though in its draft decision sought further information on the success criteria for the pilot before any broader roll-out could proceed (p.17).

The purpose of South East Water completing an end-to-end digital capability pilot is primarily to validate assumptions associated with costs, risk, levels of control required and extent of opportunities that could be achieved with a broader installation of digital devices and systems. We will also continue to work collaboratively with the other metropolitan water corporations to share the learnings from the pilot. The following table outlines the key elements of the pilot and success criteria for each element required before we would proceed to broader application of digital devices.

Table 1 – Criteria for the digital capability pilot

Pilot objectives	Pilot outcomes
Establish end-to-end capability	All solution components including meters, communications, IT platforms and communication carrier vendors have been successfully integrated.
Prove integrated meter capability	Development and production of meters and meter functionality will be tested against specifications ensuring they are compliant and perform as specified.
Prove reliable low-powered wide area network communications	Testing communication vendors' compliance against South East Water communications carrier specifications and successful testing of performance in nominal coverage areas.
Refine inputs (costs, benefits and opportunities) into the business case.	Further business efficiencies are identified resulting in a positive net present value for the business case, and lower costs for customers over time.
Develop laboratory and field testing requirements.	Level of laboratory and field testing is known by service providers and specified for business case.
Develop processes and protocols to reduce risk	Risk mitigation relating to information security, technology integration, commercial integration and performance of the target solution has been achieved in the pilot and is scalable for a much broader installation.

3. Prices and tariff structures

We acknowledge Mike Vallis' submission to the ESC's draft decision (16 December 2017), with concerns about fixed/variable charges. On pages 81-82 of our price submission, we summarise our decision to maintain the current balance of fixed and variable charges informed by our customers' preferences after exploring alternative tariff options with them. Certainty, a sense of control, choice, simplicity and fairness were important. Customers also wanted to avoid high unexpected bills, and therefore were not supportive of higher variable bills - though some customers supported the choice to opt-in for this. The Consumer Action Law Centre in its submission to the ESC (November 2017) did not support a move to put more weight on the variable component of bills, which would result in increases to tenants' bills.

We also note Phillip Doyle's submission to the ESC's draft decision (16 January 2018), which stated that the water supply industry needs to have a greater understanding about the number of dwellers within a residential premise, as inclining block pricing structures can penalise large families. As outlined in our price submission, we have recognised this and to balance fairness and affordability for large households we are proposing to reduce the inclining block for water usage tariffs from 3 steps to 2.

We also acknowledge Gordon Meyer's concerns about rising utility costs outlined in his submission to the ESC's draft decision (5 January 2018), and our proposal is to reduce prices in 2018-19. For the average residential water use customer, bills would be reduced by approximately 7 per cent, as outlined in table 2 below.

The ESC in its draft decision (p.24) requested that South East Water update its prices to reflect its draft decision on the revenue requirement. The attached financial template includes proposed prices for the 2018 regulatory period updated to account for the revenue requirement included in the ESC's draft decision, and have also been adjusted for:

- a revised forecast of 2017–18 capital expenditure, adjusted downward from \$184.6 million to \$168.5 million
- a minor adjustment to controllable operating expenditure for 2016–17, consistent with the 2016-17 regulatory accounts.

Based on the adjusted prices in the financial template, customer impacts remain consistent with our price submission as outlined in the table below.

Table 2 – Sample of customer bill impacts for 2018–19

	Usage (kL)	2017–18 bill \$ (\$17–18)	2018–19 bill\$ (\$17–18)	\$ change	% change
Owner occupier- small user (apartment w/1-2 occupants)	90	\$772	\$759	-\$13	-1.7%
Owner occupier- average user (detached dwelling w/3 occupants)	150	\$1,017	\$945	-\$72	-7.1%
Owner occupier- large user (5 occupants; small garden)	350	\$1,959	\$1,693	-\$266	-13.6%
Tenant - small user (apartment w/1-2 occupants)	90	\$267	\$279	\$13	4.7%
Tenant - average user (detached dwelling w/3 occupants)	112	\$356	\$348	-\$9	-2.5%
Tenant - large user (5 occupants; small garden)	350	\$1,454	\$1,211	-\$243	-16.7%
Average non-residential customer	460	\$2,845	\$2,699	-\$146	-5.1%

We note that prior to the ESC's final decision and 2018 price determination for South East Water further adjustments will be required to prices to account for the annual cost of debt update, CPI, licence fees and adjustment for changes to Melbourne Water's 2018–19 bulk water and sewerage charges.

4. Annual cost of debt adjustments

The ESC requested in its draft decision (p.25) that South East Water submit price adjustment formulas to account for annual movements in the cost of debt. Attachment 1 includes South East Water's proposed wording and a draft set of formulas for calculating and applying the annual cost of debt adjustment, to be incorporated into South East Water's 2018 price determination as a new schedule. We are proposing to apply any price movements due to the change in cost of debt adjustments to be applied to water service and sewerage service charges only. We understand the ESC is looking to develop a consistent methodology for calculating the cost of debt across all businesses, and we are happy to work with your team on this prior to the final determination.

5. Customer engagement

We note the Consumer Action Law Centre's submission to the ESC (16 November) which stresses the importance of effective community engagement and consumer consultation as part of the price submission process. South East Water's customer engagement program, which directly engaged with 5,690 customers over 14 months, used a range of bespoke approaches in order to gain input from customers on the services being provided and proposed. While our customer outcomes reflect their priorities and will aim to deliver the services that they value, we recognise that customer engagement is an ongoing journey that provides opportunities for continued consultation about our services and prices during the pricing period, and our teams have plans in place to ensure this occurs.

Please contact Rob Nolan, Manager Planning and Regulation, if you or your team wish to discuss the above response.

Yours sincerely



Terri Benson
Managing Director

Attachment 1 – Annual adjustments for the cost of debt

By calculating the cost of debt on an annual basis, using a 10 year rolling average, if in any **regulatory year** the actual cost of debt differs from the forecast cost of debt, the following formula will apply for the purpose of annual adjustment of potable water service charges and sewerage service charges instead of the formula set out in clause 2.3(b):

$$WSS_t^j = WSS_{t-1}^{det,j} * CPI_t * (1 + PPM_t) * (1 + \alpha_t)$$

Where:

WSS_t^j is the price for residential and non-residential potable water service and sewerage service tariffs j, for component of regulatory year t

$WSS_{t-1}^{det,j}$ is the determination price for residential and non-residential potable water service and sewerage service tariffs j, component for regulatory year t-1, adjusted for PPM_{t-1}, and CPI_{t-1}

CPI_t for the particular **regulatory year** is:

the Consumer Price Index: All Groups Index for the Eight Capital Cities as published by the Australian Bureau of Statistics for the March quarter immediately preceding the start of the relevant **regulatory year divided by**

the Consumer Price Index: All Groups Index for the Eight Capital Cities as published by the Australian Bureau of Statistics for the March quarter immediately preceding the March quarter referred to above

PPM_t is the prescribed price movement for the price component for **regulatory year** t, in accordance with Schedule 2.

α_t is the price movement applied to water service and sewerage service charges due to the change in revenue requirement resulting from the change in cost of debt in **regulatory year** t (P_t) where:

$$\alpha_t = \frac{(RR_t^{act} - RR_t^{for})}{\sum_{j=1}^3 (WSS_{t-1}^{det,j} * Q_t^{WS,j})} * CPI_t$$

RR_t^{act} is the actual revenue requirement due to the change in cost of debt for **regulatory year** t

RR_t^{for} is the forecast revenue requirement for **regulatory year** t

$Q_t^{WS,j}$ is the determination quantity for each water service and sewerage service tariff j in year t

The following equations outline the process required to determine the actual cost of debt in any given year.

Determining the nominal cost of debt

$$CoD_t^{nominal} = \left(\sum_{i=t-10}^t \frac{CoD_i^{nominal}}{10} \right)$$

Where:

$CoD_t^{nominal}$ Is equal to the simple average of the 10 years up to (but not inclusive of) regulatory year 't' of:

- The data series outlined in Table X in Annexure; and
- *RBA Table F3 – Non-financial corporate BBB-rated bonds – Yield – 10 year target tenor [Series ID FNFYBBB10M]*

from 1 April to 31 March before the start of year t (e.g. 1 April 2018 to 31 March 2018 in relation to 2018-19)

Determining the real cost of debt

$$CoD_t^{real} = \frac{(1 + CoD_t^{nominal})}{(1 + \pi_{CoD})} - 1$$

Where:

CoD_t^{real} Is the total cost of debt in real terms for year t

$CoD_t^{nominal}$ Is the total cost of debt in nominal terms for year t

π_{CoD} Is the inflation factor which is equal to 2.3% for all regulatory years
