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Marcus Crudden
Director, Water
Essential Services Commission
Level 37
2 Lonsdale Street
MELBOURNE VIC 3000

Dear Marcus,

Submission to Melbourne Water's 2016 Price Review

City West Water is pleased to provide comments on Melbourne Water's 2016 Price Submission. We recognise Melbourne Water's efforts to consult with us in the development of its programs and priorities. We focus these comments on aspects of Melbourne Water's proposal that affect bulk water and sewerage services and their associated charges. However, we note that the price submission also covers expenditures and tariffs associated with Melbourne Water's waterways and drainage functions.

We are broadly supportive of the major themes in the submission including proposed reforms to wholesale tariffs, a new methodology for assessing the cost of debt and capitalisation of Victorian Desalination Project (VDP) payments. We have therefore focused our submission on the following three aspects of Melbourne Water's submission: (1) the level of operating expenditure, (2) drivers and deliverability of proposed capital expenditure, and (3) the scale of capitalisation of VDP payments. Our comments on these three issues are set out below.

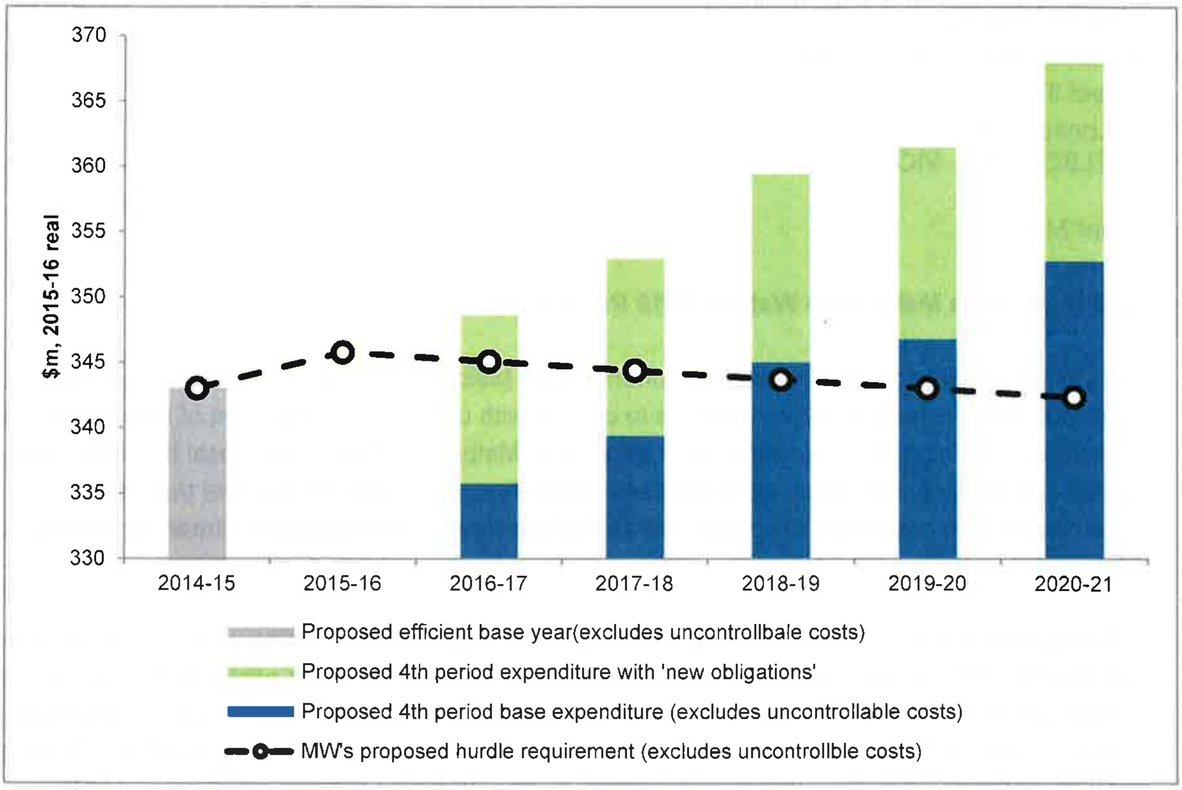
Operating expenditure

The Commission's 2016 Price Review Guidance Paper established an expectation that Melbourne Water (MW) should propose operating expenditure that achieves a growth adjusted efficiency hurdle for the 4^{th} regulatory period of 2.0% per annum. This should be applied to an efficient operating cost base for the 2014-15 year.

MW's 2014-15 actual expenditure is significantly lower than the benchmark allowance provided in the Commission's 2013 Price Determination ($401.4m versus $366.2m – excluding VDP costs) and we understand that this reflects efficiencies delivered as part of the Government Efficiency Program. We note that the Guidance Paper specified that a 2% efficiency factor should be applied to the 2014-15 baseline operating expenditure, whereas MW has applied 1% for 2015-16 (last year of the third regulatory period) and 2% thereafter.

MW's operating expenditure proposal for the 4th regulatory period is made up of 'base operating expenditure' with additional proposed expenditures on 'new obligations'. MW has proposed $70.8m for new obligations during the 4th regulatory period of which $55.8m relate to renewable energy (see figure 1). MW's base operating expenditure appears to firstly decrease significantly from 2014-15 ($343.0m) to 2016-17 ($335.7m) from which it is forecast to increase at an annual rate of approximately 1.3%, well above the growth-efficiency factor of -0.2% (growth rate of 1.8% per annum less 2% efficiency factor).

Figure 1: Proposed operating expenditures



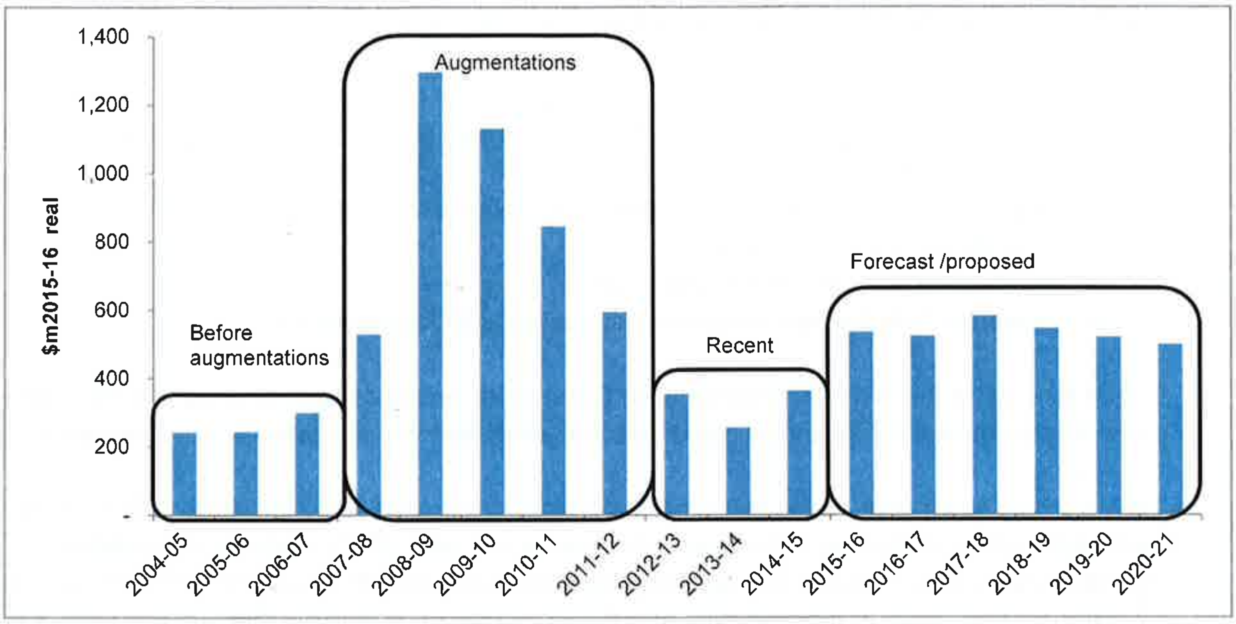
Source: MW Price Submission 2016 data template

CWW's expectation is that MW should deliver its obligations within the operating expenditure hurdle requirement as set out in the Commission's guidance.

Capital Expenditure

City West Water acknowledges that Melbourne Water provides diverse infrastructure at the city scale and that this requires a comprehensive capital expenditure program. In the past, MW has had to invest significant capital in order to deliver projects associated with the millennium drought. During the period between 2007-08 and 2011-12, MW delivered large scale projects associated with the drought, including: approximately $700m for the North-South Pipeline, $400m for the tertiary upgrade of the Eastern Treatment Plant, $90m for the reconnection of the Tarago Reservoir, $70m for the desalination interconnection project and $50m for the Winneke Treatment Plant Upgrade. We note that in the periods immediately before and after this drought-driven expenditure, MW's capital program was much lower (see Figure 2).

Figure 2: Historic and proposed capital expenditure (excluding waterways and drainage)



Data source: MW Price Submission 2016 data template

MW is proposing a significantly expanded capital program for the next five years, and has been unable to provide a coherent narrative for this level of expenditure. In the absence of a coherent narrative, we would expect MW to deliver their regulatory obligations within an expenditure envelope consistent with recent post-drought expenditure.

Where there is uncertainty about the drivers or timing for major projects, we would support the exclusion of such projects from revenue requirement with the explicit option of a reopener during the 4th regulatory period should the project proceed. This is the approach the Commission has utilised in the past for projects like Barwon Water's Melbourne-Geelong Pipeline.

Desalination capitalisation

MW is currently recovering VDP-related costs from customers over the 27 year term of the contract with AquaSure. However, MW estimates that the VDP will provide services over an estimated 60 year asset life. During its 2013 Price Review, the Commission considered, at length, the mismatch between the timing of payments under the contract and its preferred regulatory practice of recovering capital costs over an asset's life. In its 2013 Final Decision the Commission stated:

> *"For the avoidance of doubt, the Commission considers that the interests of customers (including low income and vulnerable customers) are best supported by Melbourne Water smoothing the recovery of its desalination security payments over a period that matches the plant's life. This is consistent with the principle that customers contribute to the cost of assets as they receive the benefits of those investments."*

In its 2016 Melbourne Water Price Review Guidance Paper, the Commission outlined its expectation regarding a new proposal from MW for the recovery of the capital-related component of VDP security payments. The Commission requested a proposal from MW that 'best meets' the objectives of:

1. providing price signals that reflect the efficient costs of providing services to current and future customers,
2. aligning the recovery of costs by Melbourne Water with the time period over which the security service will be provided,
3. considering the views of customers, and
4. consistent with the continued financial viability of Melbourne Water.

While MW states that it has addressed these Commission guidance requirements, it is not clear how MW's proposed $20m annual capitalisation is consistent with the objectives outlined above.

MW's pricing submission states that 'most importantly' it has considered the views of its customers and stakeholders in forming its proposal. However, in our view, MW's customer consultation provided inconclusive results, with generally equal end-user support for paying VDP costs over the 27 year contract terms or over the estimated 60 year asset life. It appears that MW has interpreted the absence of a clear majority support for capitalisation as requiring only low level of capitalisation.

In terms of the impacts on financial viability, MW has failed to articulate how it has considered this issue in determining $20m as an appropriate capitalisation amount. We would expect this to be a key focus area for the Commission given its strong stance during the last price review, as outlined above.

Thank you for the opportunity to provide comments on Melbourne Water's 2016 Price Submission. If you have any queries on these comments, please contact Sean Crees, General Manager Corporate Services on 9313 8461.

Yours sincerely,

ANNE BARKER
Managing Director