Melbourne Water

18 March 2013

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

Dear Ron

FURTHER INFORMATION TO 2013 WATER PLAN

We refer to Melbourne Water's 2013 Water Plan proposal submitted on 26 October 2012.

We are also aware that a range of submissions have been made from various parties including a joint submission from the Consumer Utilities Advocacy Centre and Consumer Action Law Centre about the treatment of the capitalisation of the cost of the Victorian Desalination Plant (VDP).

Since submitting our 2013 Water Plan, the Essential Services Commission (ESC) has engaged with Melbourne Water at an officer level seeking additional information in relation to the possible capitalisation of the desalination payments.

Given the significance of this issue, we believe that it is appropriate for Melbourne Water to present the further supplementary information in one document, to assist you in your deliberations.

Consequently, we now attach this additional information to this letter.

Yours sincerely

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Supplementary information to 2013 Water Plan Submission

1. Executive Summary

We understand that the Essential Services Commission (ESC) is exploring options for spreading the costs Melbourne Water will incur in relation to the Victorian Desalination Plant (VDP) over a timeframe longer than the contract (i.e. 'capitalising' the cost). This reflects both Melbourne Water's consideration of this option in its 2013 Water Plan as well as submissions received from community interest groups on the matter.

Melbourne Water recognises that the ESC will make a determination in relation to this option that has regard to:

- the interests of customers;
- Melbourne Water's efficient cost of compliance with relevant legislation;
- the need to ensure that Melbourne Water has a sustainable revenue stream over the regulatory period that enables it to meet its obligations and deliver the level of service required by customers; and
- the financial viability of Melbourne Water.

This document provides further information on the option of capitalising the VDP costs as it relates to the above matters. When incorporating the recovery of VDP costs in its 2013 Water Plan submission, Melbourne Water had regard to each of these matters. In summary:

- The interests of customers have been at the forefront of Melbourne Water's thinking, and the prices in Melbourne Water's 2013 Water Plan submission take those interests into account. In addition to managing the VDP payments efficiently, we have worked constructively with the Retail Water Authorities to minimise the non-VDP costs.
- Melbourne Water has a legislative obligation to pay all monies payable by the State under the Project Deed between the State and Aquasure Pty Ltd. Melbourne Water has taken action to ensure it efficiently complies with this obligation.
- We believe that a sustainable revenue stream for Melbourne Water is one that covers the full costs of the VDP payments Melbourne Water must make to the State, and we believe that this interpretation is consistent with the ESC's 2009 Water Price Review Final Decision. We note that the ESC did not contemplate any form of cost capitalisation for the VDP payments in the 2009 Water Plan period.
- Capitalising a portion of the VDP costs may impact on Melbourne Water's financial viability, increasing the risk that Melbourne Water will be unable to meet its broader service level obligations and service its debt.

Finally, we wish to note that should the ESC elect to propose some form of capitalisation of the VDP payments for the 2013 Water Plan, careful consideration would need to be given to the implications of this for future price determinations.

2. Interests of customers

Melbourne Water recognises that that in examining the option of capitalising the VDP costs, the ESC must have regard to the interests of customers of the regulated entity, including low income and vulnerable customers (Water Industry Regulatory Order (WIRO), cl.14(1)(c)). Melbourne Water is very cognisant of customers' interests. While our direct relationship is with the Retail Water Corporations we constantly interact with those authorities to understand pricing and level of service implications for their customers – being the end customer.

During the consultation period for the draft 2013 Water Plan, views from both our Retail Water Corporation customers and end customers were received on a variety of pricing issues. Feedback was in relation to the option of having a large initial price increase, or ongoing smaller increases, there were mixed views from end customers, with some having regard to the short term financial impacts and others being aware of longer term impacts. We note that it is the long term interests of Victorian consumers that the ESC must promote in making its determination (ESC Act, ss.8(1), 33(2)).

In preparing our 2013 Water Plan submission, our objective has been to minimise our overall costs and hence the price impact on our retail customers and the end customer. As outlined below, we have ensured that via an Agreement with the State, we have oversight of the VDP contract costs and a mechanism for reviewing and discussing any issues relating to costs and payments. We have also recommended to the ESC mechanisms for ensuring pass through of any VDP security payment savings and ensuring customers only pay for water if and when it is ordered.

Wherever possible we have found efficiencies and innovations in our non-desalination planning and operations to drive value for money in all of our services. Melbourne Water has undertaken the following initiatives:

- Minimised business as usual costs, particularly through competitively tendering 99% of capital expenditures and 75% of operating expenditures, ensuring they are subject to market forces.
- In the recent renewal of our operating expenditure maintenance contracts we achieved 4-5% efficiency gains.
- Proposed a capital expenditure program that is $1.5 billion lower than the current Water Plan, with a focus on renewals and maintenance and catering for growth (while continuing to meet performance targets).
- Worked constructively with our Retail Water Corporation customers to tailor the capital program ensuring what we believe to be the right balance between risk and cost.
- Factoring in the early benefits that should accrue from Integrated Water Cycle Management initiatives.

Furthermore both the Government and the Retail Water Corporations have a range of initiatives for protecting the low income and vulnerable members of our customer base.

3. Melbourne Water's compliance costs

Melbourne Water is required under clause 16.1(b) of the Statement of Obligations dated 26 June 2009 (**Statement of Obligations**) to enter into an agreement under which it agrees to pay all monies payable by the State under the Project Deed between the State and Aquasure Pty Ltd dated 2 September 2009 (**Project Deed**). To fulfil this obligation, Melbourne Water has entered into a contractual arrangement with the State (referred to as the "Water Interface Agreement") under which Melbourne Water agrees to pay all such monies. Both the State and Melbourne Water treat this as a Finance Lease for accounting purposes.

In making a determination, we note that the ESC must have regard to:

> the efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry (Essential Services Commission Act 2001 (**ESC Act**), s.33(3)(b)).

Section 4I(4) of the *Water Industry Act* is "relevant legislation" (Water Industry Act, s.4B(1)(a)), and requires Melbourne Water to comply with the Statement of Obligations. In order to comply with the Statement of Obligations, Melbourne Water must pay whatever amount is payable by the State under the Project Deed. Melbourne Water cannot pay a lesser amount and still comply with the relevant legislation. As such, we believe that the costs incurred by Melbourne Water under the Water Interface Agreement are "efficient" costs of complying with relevant legislation. Melbourne Water is the 'regulated industry' in question with regard to applying the ESC Act and the matter of VDP payments.

To ensure that its payments under the Water Interface Agreement do not exceed the amount required to comply with the Statement of Obligations, the Water Interface Agreement incorporates the capacity for Melbourne Water to review and discuss the overall costs we receive from the State for the VDP and expenditure paid under the Project Deed.

Furthermore, to ensure that it does not recover more than is necessary to meet its obligations under the Water Interface Agreement, Melbourne Water in conjunction with its retail customers has put forward proposals to the ESC for ensuring pass through of any cost reductions relating to the security payments it must make to the State for the VDP. Indeed Melbourne Water has already advised the ESC of reductions in VDP costs which will be incorporated into the 2013 price determination. We are also proposing a pricing mechanism that would only allow recovery of volumetric charges for actual volumes of water ordered. In the event that no water is ordered for a given year, no costs associated with volumetric charges will form part of the prices.

4. A sustainable revenue stream

Melbourne Water notes that under the WIRO, the ESC must be satisfied that the prices contained in the 2013 Water Plan are such as to provide for a sustainable revenue stream to Melbourne Water that does not reflect monopoly rents or inefficient expenditure. As outlined in Section 3 above, Melbourne Water has put in place a number of measures to ensure we act efficiently in complying with our legislative requirements to pay all monies payable by the State under the Project Deed between the State and Aquasure Pty Ltd. This has included ensuring, via the Water Interface Agreement, transparency of the VDP contract costs and a mechanism for reviewing and discussing these costs prior to payment. We have also recommended to the ESC mechanisms for ensuring pass through of any VDP security payment savings and ensuring customers only pay for water if and when it is ordered.

Melbourne Water believes a "sustainable" revenue stream, in the context of the WIRO, means a revenue stream which would enable it to sustain its business operations and support an appropriate investment grade credit rating. In order to be sustainable, the revenue stream would need to allow Melbourne Water to recover costs it is under a regulatory obligation to incur. If such a component were not included, the resultant shortfall in revenue may impact Melbourne Water's recovery of its other operating expenditure and its return on capital expenditure, force it to increase its borrowings (if capital is available), or require it to reduce its expenditure. As such, Melbourne Water's ability to sustain its business operations could be compromised.

Furthermore the principle that costs incurred to comply with known regulatory obligations should be recoverable in the regulatory period in which they are incurred seems consistent with the views expressed by the ESC in its previous determination. In Chapter 3 of its 2009 Water Price Review Final Decision, the ESC summarised the revenue requirement as follows:

> The ESC must be satisfied that the prices it approves will provide each business with sufficient revenue over the regulatory period to meet its obligations and deliver the level of service required by customers.

Furthermore in Section 1.2 of that Final Decision, the ESC summarised its approach to assessing Water Plans as follows:

> The ESC is required to assess the Water Plans against the regulatory principles outlined in the WIRO. In deciding whether to approve a business' proposed prices, the ESC must be satisfied that they provide the business with only enough revenue over the regulatory period to meet its obligations and deliver the level of service required by customers. Revenue must be sufficient to allow the business to recover operating and capital expenditure and receive a reasonable return on assets, but not allow monopoly profits.
>
> The ESC's approach to assessing proposed prices (often described as a 'building block' approach) is characterised by three steps... The first step involves identifying the service standards and other outcomes that a business proposes to deliver over the regulatory period. These standards and outcomes reflect obligations imposed by the Minister for Water through the Statement of Obligations...

Hence we believe that the recovery of the VDP costs that Melbourne Water must pay to comply with a legislative obligation is required in order to ensure a sustainable revenue stream, and that this is consistent with past statements made by the ESC. Further, previous regulatory treatment of finance lease obligations by the ESC, has given Melbourne Water and the rest of the water industry the ability to pass through their finance lease costs in the period in which they are incurred.

5. The financial viability of Melbourne Water

Melbourne Water notes that the objective of the ESC under the ESC Act is to promote the long term interests of Victorian consumers and in meeting this objective, the ESC is required to have regard to certain matters, including "the financial viability of the industry" (ESC Act, ss.8(1), 8A(1)(b)). Our view is that, in this context, the reference to the "industry" should be read as a reference to the "regulated water industry" as defined in the Water Industry Act, which is the water industry as constituted by Melbourne Water, Metropolitan Water Corporations, Regional Urban Water Corporations and Rural Water Corporations.

Melbourne Water has undertaken an extensive review and is of the view that its non-desalination operations are efficient and there are no further savings to be gained to offset the cost of VDP capitalisation. Furthermore ESC itself is undertaking an audit of these costs as part of the Water Plan 3 price determination. We believe at this point the only viable option would be to borrow the additional funds required. Furthermore, servicing these additional borrowings for what is a non-infrastructure related requirement, would impact on the business's capacity to meet its service level obligations. The availability of borrowing to the organisation is subject to approval each year by DTF.

Melbourne Water has explored its capacity to spread the VDP costs over a longer time than the 27 year contract period (specifically, the average asset life of 50 years). However, as noted in the 2013 Water Plan submission, such cost spreading would not deliver a material reduction of prices without major impacts on financial viability or service levels. By way of illustration, a capitalisation of $90m of VDP contract payments per year during the 2013 Water Plan regulatory period would result in a reduction to the average end consumer's bill of just under $10 per quarter compared to the full pass-through of VDP contract payments. If the 2013 Water Plan submission were to be accepted in all other respects, the impact of this revenue shortfall scenario would be as follows:

- Melbourne Water would be required to borrow an additional $300M (approximately) over the 2013 Water Plan regulatory period. This would increase our overall debt levels by 6.5%;
- Melbourne Water's average return on equity over the 2013 Water Plan period would be reduced from 2.4% to 1.1%. This is significantly lower than comparable Government owned water business results over the last two years (see Attachment 1) and would reflect a significant erosion of value for Melbourne Water's shareholders (ie. the Government on behalf of the Victorian community);

- Further diminish Melbourne Water's liquidity and its ability to service its debt. Even ahead of the 2013 Water Plan price determination, the Victorian Auditor General assessed Melbourne Water's ability to service its debt as a high risk (*Victorian Auditor-General's Report, Water Entities: Results of the 2011-12 Audits*).

- This revenue shortfall would otherwise force Melbourne Water to reduce its non-desalination capital or operating expenditure below the level set in its price determination (which is already set at an efficient level). This would in turn affect Melbourne Water's capacity to meet its obligations and deliver the level of service required by customers.

To put Melbourne Water's financial position in context, Attachments 1 and 2 compare its financial position against publicly available information for regulated water companies in the United Kingdom and Australia. Melbourne Water's current financial metrics (consistent with its 2013 Water Plan proposal) are considerably worse than other water companies, without the further capitalisation of $90M of VDP payments per year during the 2013 regulatory period.

It should be noted, that this financial modelling is dependent on a WACC assumption of 5.1% and the ESC approving all capital and operating expenditures proposed in the 2013 Water Plan submission. If the WACC or these expenditures were to be lower, this will negatively impact Melbourne Water's financial metrics further.

In conclusion, we realise that for customers Australia wide, water pricing presents a challenge as the costs of major drought-related projects for all capital cities are reflected in prices.

We understand the need to balance the requirements discussed above when considering the option of capitalising a portion of the VDP payments. Melbourne Water believes that on balance an outcome that delivers a sustainable revenue stream covering the full costs of the VDP payments in the 2013 Water Plan period is appropriate and in the long-term interests of customers.

Attachment 1. Return on Equity ratio for Australian water companies [1]

Australian water companies	Return on equity		
	2010/11	2011/12	2013-14 to 2017-18 Forecast
Melbourne Water	3.8%	6.1%	
Yarra Valley Water	4.5%	4.4%	
South East Water	4.5%	5.6%	
City West Water	7.9%	6.1%	
Sydney Water	4.8%	6.2%	
Sydney Catchment Authority	4.5%	11.7%	
WA Water Corp	6.0%	5.7%	
SA Water	10.0%	4.2%	
ACTEW	6.4%	7.8%	
Australian Water Company Mean	**5.8%**	**6.4%**	
Melbourne Water (2013 Water Plan)*			2.5%
Melbourne Water (2013 Water Plan with $90M per annum desalination capitalisation)*			1.1%
* Based on the Melbourne Water's own modelling			

[1] *Source: Water company annual reports*

Attachment 2.

Financial metrics for United Kingdom water companies [2]

Company	Rating	Outlook	FFO Interest Cover	FFO to Debt	Net Debt to RAB
Severn Trent Water Ltd	A3	Stable	4.4	14.7%	62.4%
United Utilities Water PLC	A3	Stable	4.9	13.2%	64.6%
Veolia Water Central Ltd	A3	Stable	5.5	19.7%	61.7%
Wessex Water Services Ltd	A3	Stable	5.5	14.3%	67.3%
Dwr Cymru Cyfyngedig (Welsh Water)	A3	Stable	3.2	10.8%	66.1%
Anglian Water Services Ltd	Baa1	Stable	2.9	9.5%	79.8%
Northumbrian Water Ltd	Baa1	Negative	3.3	11.1%	71.3%
Severn Trent PLC	Baa1	Stable	4.4	15.4%	61.9%
Sutton & East Surry Water	Baa1	Stable	6.0	17.9%	68.5%
Thames Water Utilities Ltd	Baa1	Stable	4.1	11.0%	78.2%
United Utilities PLC	Baa1	Stable	6.4	18.3%	60.1%
Yorkshire Water Services Ltd	Baa1	Stable	2.6	9.3%	74.6%
Southern Water Services Ltd	Baa2	Negative	2.3	7.3%	83.4%
South East Water Ltd	Baa2	Stable	3.6	11.2%	80.5%
South Staffordshire Water	Baa2	Stable	6.2	19.0%	73.2%
All Company Mean			**4.4**	**13.5%**	**70.2%**

Financial metrics (regulatory basis) for Sydney Water and Melbourne Water

Sydney Water (current)*	Baa2	Stable	1.8	6.1%	51.8%
Melbourne Water (2013 Water Plan)**	BBB- (Baa3)		1.6	5.9%	83.2%
Melbourne Water (2013 Water Plan with $90M per annum desalination capitalisation)*			1.5	5.0%	81.9%
* Based on Sydney Water's own modelling and rating assessment ** Shadow credit rating as per Deloitte Report September 2011					

[2] Source: Sydney Water Submission to IPART discussion paper: *Financeability test in price regulation*