

8 May 2018

Our reference:
Your reference

03/04/02/31



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

Hazelwood Road
PO Box 348
Traralgon Victoria 3844
Telephone: (03) 5177 4600
Facsimile: (03) 5174 0103
contactus@gippswater.com.au
www.gippswater.com.au

Dear Marcus,

2018 WATER PRICE REVIEW GIPPSLAND WATER RESPONSE TO THE DRAFT DECISION

Gippsland Water has undertaken a review of the specific issues detailed within the Essential Services Commission's (ESC) Draft Decision released in late March 2018. Gippsland Water's responses to a range of issues outlined in the Draft Decision are detailed below.

1. Operational Expenditure - Labour

In the Draft Decision (page 13), the ESC proposes to remove a total of \$5.32M from Gippsland Water's operational expenditure on labour for the fourth regulatory period. This reduction comprises two separate issues, namely the inclusion of a 2% vacancy provision and the removal of all labour increases above CPI for the five-year period.

Response: Gippsland Water accepts the adjustment proposed by the ESC in relation to the inclusion of a 2% vacancy provision. Gippsland Water contests the reduction of all wage increases in excess of CPI for the regulatory period and seeks to retain the wage increase contained in the current enterprise agreement which expires in October 2019.

Further comment:

While accepting the proposed inclusion of a 2% vacancy provision for the fourth regulatory period, Gippsland Water would note that it has adopted a strategy aligned to full employment of all established positions and will closely monitor vacancy rates to inform the next Price Submission process.

In contesting the removal of increases above CPI, Gippsland Water firstly notes that this approach was recommended by Deloitte and adopted by the ESC in the 2013 Water Price Review process (Deloitte Report - Feb 2013 - page 15).

However, the approach in 2013 also allowed for wage increases in an existing enterprise agreement to apply until the expiry of that agreement. Gippsland Water's current enterprise agreement expires in October 2019 and allows for a 3% increase in the 2018/19 financial year. Gippsland Water seeks the re-instatement of that component of the labour reduction removed in the Draft Decision.

Gippsland Water has updated the Price Submission template in respect of labour costs to –

- Remove costs associated with the 2% vacancy provision;
- Remove costs above CPI associated with forecast future enterprise agreements; and
- Include costs above CPI for the current enterprise agreement.

2. Operational Expenditure - Electricity

In the Draft Decision (page 13), the ESC proposes to remove a total of \$2.87M from Gippsland Water's operational expenditure on electricity for the fourth regulatory period. In doing so, the ESC acknowledged that there was considerable uncertainty in forecasting electricity prices at present. The ESC requested that Gippsland Water propose a revised electricity forecast based on new contract prices that were expected to apply from July 2018, once contract negotiations had been completed.

Response: Gippsland Water has completed negotiations for a new electricity contract and has included a new electricity forecast as requested by the ESC.

Further comment:

Contract negotiations were managed by Gippsland Water's energy consultant and concluded in late March 2018. The new contract 'locks in' prices until June 2021. The table below compares the electricity costs allowed by the ESC in the Draft Decision with the current forecast for the regulatory period, based on the new contract for the period July 2018 to June 2021. Forecasts for the 2021/22 and 2022/23 year do not form part of the current contract, but are based on the latest advice from our energy consultant.

Gippsland Water: revised electricity forecast (\$M – Jan 18 \$)

	2018/19 Contract	2019/20 Contract	2020/21 Contract	2021/22 Forecast	2022/23 Forecast	Total
ESC Draft Decision	5.342	5.039	3.495	3.495	3.495	20.866
GW contract / forecast	4.868	4.595	4.312	4.303	4.331	22.409
Variation	(0.474) reduction	(0.444) reduction	0.817 increase	0.808 increase	0.836 increase	1.543 increase

As the table reveals, prices for each year of the contract period have changed, with the net position over the three year contract period slightly favourable. Gippsland Water's energy consultant has provided advice to support the use of forecast values for 2021/22 and 2022/23 in response to the Draft Decision. This advice is provided in attachment 1.

Gippsland Water has updated the Price Submission template in respect of electricity costs to include the revised contract / forecast values outlined above.

3. Operational Expenditure – non-controllable

In the Draft Decision (page 14), the ESC proposes to remove a total of \$0.18M from Gippsland Water's non-controllable operational expenditure for the fourth regulatory period.

This adjustment is based on the latest information received from the relevant regulatory authorities.

Response: Gippsland Water accepts the adjustment proposed by the ESC.

4. Capital Expenditure – specific programs

In the Draft Decision (page 22), the ESC proposes to remove \$1.6M from Gippsland Water's capital expenditure for the fourth regulatory period. This reduction comprises adjustments to two capital programs, the Sewer Reticulation Renewals Program and the Treated Water Basins and Liners Program.

Response: Gippsland Water contests both adjustments proposed by the ESC.

Further comment: Sewer Reticulation Renewals Program

For the Sewer Reticulation Renewals Program, Deloitte recommended a reduction of \$0.87 million as it did not consider Gippsland Water had sufficiently justified the need for the 16 per cent increase to maintain service levels. The ESC accepted Deloitte's recommendation, noting that 'we do not have sufficient information to assess that the proposed expenditure is prudent and efficient, as required by our guidance.'

Gippsland Water has a detailed Asset Class Plan in place for gravity sewer mains. This plan outlines the methodology discussed above in significant detail. This plan remains available for review should the ESC / Deloitte wish to confirm the information outlined above.

Gippsland Water has over 1,137 kilometres of reticulation gravity sewers across its systems. A large proportion of the reticulation sewers are constructed of materials and of an age where a substantial percentage of these would have suffered structural deterioration requiring renewal.

The reticulation sewers to which this is overwhelmingly applicable are the reinforced concrete (RC) and vitrified clay (VC) sewers laid from the 1940's to the 1970's. RC sewers undergo structural deterioration through erosion of their invert, while VC sewers undergo fracturing through ground movement. Both also undergo deterioration through root intrusions that worsen existing fractures and joint failures. This cohort comprises 616km or 54% of the total reticulation sewers. The structural condition of these sewers is being determined through a CCTV inspection program to understand which of these sewers will require renewal.

Gippsland Water has established a method to predict a fifteen year renewal program for reticulation sewers based on structural condition information obtained from sewer CCTV inspections undertaken over the last thirteen years. From 3507 sewers inspected, 17% were graded the worst structural condition of 5 and 37% were graded the second worst structural grade of 4. All of the structural condition 5 sewers are in a state of deterioration that will require renewal, while on further examination of CCTV footage, a percentage of the structural condition 4 sewers will also require renewal.

These percentages have been applied to the length of reticulation sewers to be inspected by CCTV in the fifteen year program to establish the length of sewers that will be of a structural condition 5 and 4 and so establish the length of sewers requiring renewal. For the fourth regulatory period, Gippsland Water's renewal program proposed to replace more than 51 kilometres of sewer reticulation pipe, at a total cost of more than \$8.5M, as detailed in the table below.

Gippsland Water: reticulation sewer expenditure – forecast and Price Submission request

Reticulation sewers (NB: Jan 17\$)					
	CCTV	Renewal	Total	KM relined	Price Submission Request
2018/19	\$116,504	\$1,360,292	\$1,476,796	8.871	\$1,200,000
2019/20	\$123,224	\$1,385,956	\$1,509,180	9.039	\$1,200,000
2020/21	\$125,559	\$1,653,465	\$1,779,024	10.777	\$1,300,000
2021/22	\$149,701	\$1,735,469	\$1,885,170	11.313	\$1,300,000
2022/23	\$157,147	\$1,782,312	\$1,939,459	11.624	\$1,300,000
Total			\$8,589,629	51.624	\$6,300,000

When considering capital expenditure that would be included in the Price Submission, an engineering assessment determined that a level of risk should be taken when valuing the sewer renewals work. This assessment resulted in a reduction of more than \$2.2M on the forecast value of works included in the Asset Class Plan, culminating in a Price Submission request of \$6.3M as detailed in the table above (or \$6.43M in Jan 18 \$).

Gippsland Water notes that it is currently preparing to go to market with a sewer reticulation renewal works package of \$2.3M (Jan 18 \$) for the 2018/19 year, after bringing forward works as part of a reassessment of requirements during the current corporate planning process.

Further comment: Treated Water Basin Liners and Covers Program

Deloitte recommended a reduction of \$0.66 million in relation to the Treated Water Basin Liners and Cover Replacement Program, as it considered Gippsland Water should be able to make some efficiency gains through its procurement process.

Gippsland Water disagrees with this reduction based on our experience in procuring basin liners and covers. An aggregation procurement strategy is unlikely to achieve significant savings as liners and covers are not commodity products. Every liner is designed and manufactured specifically to meet the requirements of each unique basin we operate. Given that there are also few suppliers that can provide the liners and covers, there is less downwards price pressure due to lack of competition.

Gippsland Water will always consider combining work packages where it is practical and where it will increase efficiencies and reduce costs. Gains from the proposed procurement methodology are unlikely to materialise even if the projects are packaged due to our recent experiences with liners and covers during 2017/18 –

- Each time we complete a basin project we are learning and improving the processes to take a basin offline. While we accept that we will tender a number of basins (2-3) as a package, we do not accept that the optimal process would be to tender them all

together as one lot. Our tender packaging is also structured so we can feed back lessons learned, weld quality information and materials issues, to maximise the life of these new assets;

- Significant pre-works are required to take each basin offline to perform the reinstallation of the liners and covers. Scope identification is significant for each basin and this also limits our ability to tender all packages together for the five year period.

Our recent experience has also identified additional unexpected costs over and above those proposed in our Price Submission. The main increases we have identified over the last six month period include –

- A need for external expert advice for quality assurance testing and review of the welding processes and material compliance testing to ensure we can maximise the life we can achieve from the finished product;
- Our estimates for remedial works on existing basin structures have been low and we have had to expend significant extra effort (and associated costs) to get the base material to an acceptable standard. This ensures we do not cause damage to the underside of the liner material and thus reduce the life of the liner. It was difficult to fully assess this at the time the Price Submission estimates were completed as the concrete/steel/clay was not visible. Reasonable but basic assumptions were made in lieu of complete visual inspections;
- Additional time and staff supervision costs in cleaning the liner and cover material in contact with the water and super chlorinating the liners prior to putting the basins back into service, so we protect the water supply and meet the Australian drinking water standards. This has added several weeks to the installation process from the timeline originally envisaged.

Overall, the additional costs that are now being identified in the field with these types of liner and cover projects and limitations with the procurement methodology savings, leave Gippsland Water in no doubt that the total program value should not be reduced by 5%, but should be returned to the value originally proposed in our Price Submission.

Gippsland Water has updated the Price Submission template in respect of capital expenditure costs to restore the full value of both projects outlined above.

5. Demand Forecasts

In the Draft Decision (page 25), the ESC accepted Gippsland Water's demand forecasts, while noting that Gippsland Water was considering updates to its demand forecast, to reflect the latest data in relation to its major customers.

Response: Gippsland Water has updated major customer demand forecasts as part of its response to the Draft Decision.

Further comment:

During the period since submitting its Price Submission, Gippsland Water has sought clarification from a small number of major customers to determine if any changes to the demand forecast are required. In response, one major customer has advised that our Price

Submission forecast varies significantly from their latest consumption forecast, with a notable reduction in demand evident.

Gippsland Water also renegotiated a large wastewater service contract after the Price Submission was submitted. This renegotiated contract will include additional revenue above that included in our demand forecast, as well as some additional costs.

Gippsland Water has updated the Price Submission template in respect of demand forecasts to include both the changes and the additional costs discussed above.

6. 2018 State Budget – taxation changes

In early May 2018, the State Treasurer released details of the 2018 State Budget. A reduction in payroll tax rates was included in the budget for regional employers. Budget papers indicate that from 1 July 2018, the payroll tax rate for businesses based in regional Victoria (with payrolls that comprise at least 85 per cent of Victorian wages associated with regional employees) will be reduced from 3.65 per cent to 2.425 per cent.

Gippsland Water has updated the Price Submission template to include a reduction in labour costs to reflect this drop in the payroll tax rate for all years of the fourth regulatory period.

7. Adjusting prices

As part of the transition to a 'trailing average' approach to estimating the cost of debt, the ESC asked water businesses to propose a price adjustment mechanism (including price control formulas) that allows for prices to adjust on an annual basis to reflect movements in the cost of debt. In response, Gippsland Water proposed to work with the ESC on a price adjustment mechanism that is applicable across the industry, as part of the 2018 Price Review Process.

Gippsland Water notes that it will now accept a method set by the ESC to adjust prices to reflect movements in the cost of debt.

8. 2016/17 BAU baseline adjustments

Gippsland Water's 2016/17 baseline year total operating expenditure was reduced by \$1.35 million to remove several non-regulatory cost items during discussions with ESC officers. The ESC asked Gippsland Water to provide further information to explain why these corrections to the baseline year operating expenditure necessitated a reduction in forecast efficiency improvement rate and the removal of the forecast operating expenditure savings.

Gippsland Water notes that it has corresponded on this issue at length with ESC officers in the period after the Price Submission was lodged and before the Draft Decision was released. Significant detail has been provided in relation to an oversight in Gippsland Water's bottom-up build of historical data that lead to this error. Gippsland Water is happy to take further questions on the matter, should this be required.

9. Price path outcomes

Gippsland Water advises that it has included all the adjustments to operational and capital expenditure and demand forecasts outlined above in the final template submitted with this response. As such, the price path proposed in response to the Draft Decision has been amended from the price path included in the original Price Submission. The proposed price path is outlined in the table below.

Table: Proposed real price movements (real price movements exclude CPI)

	2018/19	2019/20	2020/21	2021/22	2022/23
GW Price Submission	0.57% increase	0.57% increase	0.57% increase	0.57% increase	0.57% Increase
GW Draft Decision response	1.22% decrease	0%	0%	0%	0%

Gippsland Water has applied an upfront real reduction of 1.22% in year one, in the final template submitted to the ESC. This approach confines price movements in years 2-5 to 'CPI only', which should assist customers to clearly understand the CPI based price increases in years 2-5, while Gippsland Water remains 'no worse' or 'no better' off under this approach.

The proposed price path results in the following movements in key customer tariffs -

Table: Key customer tariffs (\$ Jan 18)

	Current	The fourth regulatory period				
	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Availability Charge - 20mm Water Service	175.89	173.74	173.74	173.74	173.74	173.74
Treated Water per kL	2.0339	2.0091	2.0091	2.0091	2.0091	2.0091
Availability Charge - Wastewater Service	808.03	798.17	798.17	798.17	798.17	798.17

As tariffs will fall in real terms, customer bills are expected to decrease marginally in 2018/19, then remain constant in real terms for the remainder of the fourth regulatory period.

As outlined below, assuming average water consumption of 168.1 kL per annum (which represents the mid-point usage during the regulatory period), an average full service customer bill will decrease by \$13 in 2018/19, while an average tenant bill is expected to decrease by \$4 in 2018/19 (Jan 18 \$), excluding CPI.

Table: Indicative customer bills (using 168.1kL per annum)

	2017/18*	2018/19	2019/20	2020/21	2021/22	2022/23
Full service residential customer	\$1,326	\$1,310	\$1,310	\$1,310	\$1,310	\$1,310
Residential tenant	\$342	\$338	\$338	\$338	\$338	\$338

* value excludes the government water rebate (\$36 full service, \$10 tenant) in 2017/18 only

Conclusion

Gippsland Water would be happy to discuss any of the matters outlined above. In the first instance, contact should be made with our Manager Financial Services, Mr Kevin Enguell, via email or telephone (5177 4684).

Yours sincerely



Sarah Cumming
MANAGING DIRECTOR

ATTACHMENTS:

- Attachment 1: Key Energy & Resources – letter to support electricity forecasts
- Attachment 2: Gippsland Water - Revised Water Price Review 2018 templates (spreadsheet)