

8 March 2018

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

Dear Ron

Yarra Valley Water welcomes the Commission's draft decision on our Price Submission, covering the period 1 July 2018 to 30 June 2023. Consistent with the new PREMO framework, we have extensively and deeply engaged with our customers, which included our Citizens' Jury, to ensure our submission reflected their expectations and values. To deliver on our customer's overarching sentiment of 'no bill increases', we have optimised customer value through a number of varied initiatives including a 2.5% per year operating efficiency. We are also committed to seven key outcomes and to report annually on them to our customers with \$1.5 million per outcome per year at risk. These factors combined were reflected in the Commission releasing an early draft decision and fast-tracking our submission.

The Commission has requested that we provide additional information in our response to the draft decision associated with:

- an updated financial model
- our revenue cap formula in real terms rather than nominal terms
- pass through of costs relating to the sale and purchase of water allocations
- the success criteria for the digital water metering pilot to enable any broader roll-out to proceed.

Updated financial model

In the Commission's draft decision (page 23), the following request was made:

Yarra Valley Water must submit a response to our draft decision and provide an updated financial model by 9 March 2018 (via email to water@esc.vic.gov.au). The response will be publicly available on our website.

The attached financial template contains our updated financial model incorporating the changes to the revenue associated with the annual sale of our Northern Victorian water allocations. Additionally, we have included a further \$5 million to be returned to customers in a revenue cap adjustment due to forecast increased net revenue in 2017/18.

Our revenue cap formula

In the Commission's draft decision (page 23), the following request was made:

On Yarra Valley Water's proposed revenue cap formula, our preference is to calculate annual price adjustments in real terms for consistency with other businesses, and our preferred approach to estimating the regulated rate of return. We invite Yarra Valley Water to resubmit a revised revenue cap formula in real terms.

In accordance with the Commission's request, we have updated our revenue cap formula to be in real terms rather than nominal terms. Further details on our updated revenue cap formula are provided in Appendix 1.

Pass through of water allocation costs

In the Commission's draft decision (page 23), the following request was made:

We seek further information from Yarra Valley Water on its proposal to pass through costs relating to the sale and purchase of water allocations. We understand these water allocations reflect temporary water purchases. Our view is that the pass through of these costs transfers demand risk to customers, and that demand risk is most efficiently managed by a water corporation

Further to the Commission's query, we have updated our revenue amounts from our planned sale of Northern Victorian water allocations to be based on the weighted average sale for the period 2012/13 to 2016/17. The revised amounts are contained in Appendix 2 and these amounts have been incorporated into the updated financial template.

We have proposed a pass-through mechanism to support potential water trading in Southern Central Victoria, consistent with the South Central Victorian water market trial proposed in the Government's *Water for Victoria* Water Plan. This pass-through mechanism would recover the cost associated with the benefit of increased water security, in a similar manner to the incremental cost of a desalination water order.

Success criteria for digital metering

In the Commission's draft decision (page 16), the following request was made:

In response to this draft decision, we request Yarra Valley Water define the success criteria for the digital water metering pilot before any broader roll-out could proceed. At a minimum, we expect this would include the requirement that expenditure for a full roll-out would deliver a positive net present value for the water corporation.

In our Price Submission (page 12), we indicated that we would be:

..... advancing the potential of digital meters through the completion of pilots. We will then consider broader implementation (as recommended by the citizens' jury), including a maximum customer contribution of \$12.50 per annum. Our preference is to roll-out at no cost to customers and we would not seek to recover any costs before 2023.

A full roll-out of digital metering will be subject to establishing a positive business case for the project taking account of the preferences of our customers including the value attributable by them to digital services.

Other matters

We note the Commission's request for additional information (pages 8) prior to its final decision:

... Yarra Valley Water must update its revenue requirement and prices to reflect:

- our updates to cost of debt and inflation estimates, which we will provide in late April 2018
- changes to its forecast bulk water charges, arising from changes to Melbourne Water's prices.

There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination, and impact on the revenue requirement, Yarra Valley Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

We plan to provide this information at the requested time.

In discussions between staff from Yarra Valley Water and staff of the Commission, we have raised concerns about the potential customer impact of prescribing the Regulatory Rate of Return (RRR) to one decimal point. Currently a small change in the cost of debt can have a large impact on the revenue requirement. For example, if the cost of debt for 2017/18 is 6.54%, the RRR would be 4.2% but if it was 6.55% the RRR would increase to 4.3% thus increasing our revenue requirement by about \$4.3 million per annum. If the RRR was prescribed to two decimal points, the RRR would be 4.25% in both instances.

It may be opportune for the Commission to review this matter and issue a revised template for all water corporations to complete for the required May 2018 lodgement.

If you require further information, please contact Brett Mathieson, Manager Regulation and Planning by telephone on [REDACTED] or email [REDACTED]

Yours sincerely



Pat McCafferty
Managing Director

Yarra Valley Water's revenue cap

The revenue cap formula has been revised to use the real regulatory rate of return. The revenue cap formula calculates the revenue cap adjustment A_t to be applied in the regulatory year t as a result of over- or under-recovery of revenue in the two previous regulatory years $t-1$ and $t-2$.

$$A_t = \left((R_{t-1}^{for} - C_{t-1}^{for}) - (R_{t-1}^{set} - C_{t-1}^{set}) \right) + \left((R_{t-2}^{act} - C_{t-2}^{act}) - (R_{t-2}^{for} - C_{t-2}^{for}) \right) \times (1 + RRR_{t-2}) \times \frac{CPI_{t-1}}{CPI_{t-2}} \\ \times (1 + RRR_{t-1}) \times \frac{CPI_t}{CPI_{t-1}}$$

where:

t	is the regulatory year in respect of which the calculation is being made
for	is the forecast value at April
set	is the value at the time of determination with revenue cap adjustments and the pass through of costs/benefits made outside of the revenue cap for: <ul style="list-style-type: none"> • annual regulatory rate of return update • change in environmental contribution • non-achievement of outcome targets • leakage reduction adjustment • deferral of "top 10" projects adjustment • bulk charges
act	is the actual value at June
A_t	is the required revenue cap adjustment in year t dollars
R_{t-1}^{for}	are the (for , set , or act) revenue to be received by Yarra Valley Water (for year $t - 1$ or $t - 2$) and include:
R_{t-1}^{set}	<ul style="list-style-type: none"> • water supply system charges • water supply usage charges
R_{t-2}^{act}	<ul style="list-style-type: none"> • sewerage system charges • sewerage disposal charges
R_{t-2}^{for}	<ul style="list-style-type: none"> • trade waste charges • trade waste volume and load charges • recycled water system charges • recycled water usage charges
	This will be in year $t - 1$ and $t - 2$ dollars respectively.
	t , for , set , act are as defined above.
C_{t-1}^{for}	are the (for , set , or act) bulk charges to Yarra Valley Water (for year $t - 1$ or $t - 2$) and include adjustments for:
C_{t-1}^{set}	<ul style="list-style-type: none"> • Melbourne Water's annual weighted average cost of capital update • changes in desalination contract costs
C_{t-2}^{act}	<ul style="list-style-type: none"> • desalination water orders • purchase of water allocations
C_{t-2}^{for}	<ul style="list-style-type: none"> • Melbourne Water's 2021 Determination

These will be in year $t - 1$ and $t - 2$ dollars respectively.

t , *for*, *set*, *act* are as defined above.

CPI_t are the Consumer Price Index: All Groups Index for the Eight Capital Cities as published by the Australian Bureau of Statistics (6401.0 – Table 8), for the March Quarter immediately preceding

CPI_{t-1} the start of the relevant **regulatory year** (t , $t - 1$, $t - 2$)

CPI_{t-2} t is defined above.

RRR_{t-1} are the post-tax 'vanilla' regulatory rate of return in real terms, which is adjusted annually, for the relevant **regulatory year** ($t - 1$, $t - 2$).

RRR_{t-2} t is defined above.

Northern Victorian water allocations sales

The average price for the period 2012/13 to 2016/17 based on 2016/17 allocation volumes is shown in Table 1 below with a weighted median price of \$108.66/ML in 2017/18 \$ levels.

Table 1: Median five-year weighted average price (nominal and 2017/18 dollars)

Year	Median annual price (\$/ML)						2016/17 allocation volumes (ML)
	2012/13	2013/14	2014/15	2015/16	2016/17	5-year average	
Goulburn zone 1A	45	75	122	230	48	104.00	6,833.00
Murray Zone 6	45	75.031	120	220	48	101.61	2,312.90
Murray Zone 7	45	74.796	122	230	48	104.16	2,473.60
Weighted average (nominal)	45.00	74.96	121.60	228.01	48.21	103.56	11,619.50
Weighted average (2017/18 dollars)	49.77	80.89	127.48	235.91	49.23	108.66	11,619.50

Based on this price, the forecast water sales in Northern Victoria for 2018/19 to 2022/23 period is shown in Table 2 below.

Table 2: Updated annual water allocation sales revenue estimates

Item	2018/19	2019/20	2020/21	2021/22	2022/23
Anticipated water sales (ML)	13,491	14,427	15,363	15,363	15,363
Sales revenue	\$1,465,944	\$1,567,628	\$1,669,313	\$1,669,313	\$1,669,313