Chapter 4

Framework for economic regulation

Independent economic regulation of the Victorian water sector is in its fourth year and while much has been achieved, further refinement is possible to strengthen incentives for improved performance, allocate risks appropriately and minimise compliance costs.

Melbourne Water supports moving to a longer regulatory period. In doing so, the framework applied to waterways and drainage services should include a revised end-of-period pass through mechanism for additional regulatory obligations arising once the 2008 regulatory period has commenced.

Refinements are also proposed to the Commission's approach for determining the regulatory asset value at 1 July 2008, as well as assessing new obligations and operating cost efficiency improvements.

This chapter identifies the nature of the uncertainties facing Melbourne Water and outlines the regulatory mechanisms Melbourne Water believes are necessary to manage these uncertainties. It also sets out Melbourne Water's views on the appropriate basis for determining the regulatory asset value at 1 July 2008.

4.1 Challenges associated with the current operating environment

Chapter 2 outlined the following unanticipated changes in Melbourne Water's operating environment since the Commission set prices in mid 2005:

- Climate variability and the worsening drought
- New legislative and regulatory obligations
- Higher than planned increases in some input costs.

As discussed in Chapter 2, these factors have impacted on performance over the current period and contribute to both the level and potential variance in expenditures over the next regulatory period. Melbourne Water continues to review and improve its forecasting methodologies as new information becomes available. However, it is realistic to expect that there will be a significant level of uncertainty with respect to business requirements and costs during the 2008 regulatory period.

4.2 Approach to managing risks and uncertainties

The regulatory framework should be designed to create meaningful and achievable incentives for businesses to deliver improved performance to customers. This should include sound risk allocation. Inappropriate risk allocation could lead to inefficient investment and resource use, and stifle innovation.

As the next regulatory period for waterway services is expected to be five years, it will be particularly important to ensure there are appropriate mechanisms to enable water businesses to deal with any significant risks and uncertainties that may arise over that period. This includes risks and uncertainties around obligations, demands and the timing and cost of small number of very large capital projects.

Melbourne Water considers it is important to distinguish between risks for which a business may be expected to have some understanding of the likelihood of the event occurring and uncertainties, which are essentially unknowns. The principle of optimal risk allocation suggests that risks should be allocated to those parties who are best able to manage the risk and that where the risk is unmanageable that it is allocated to those parties best able to absorb the risk.

In terms of uncertainties, the current climatic conditions and potential for ongoing drought are outside historical planning expectations. Melbourne Water considers that this uncertainty will not be fully manageable through the normal reprioritisation of projects and cost estimation approaches.

In its March 2007 Guidance Paper, the Commission accepted that the regulatory framework should include adjustment mechanisms that deal with uncertainty around demand, predetermined major projects under consideration by the State Government at the time of any determination, and not yet decided upon, as well as material changes or the introduction of legislative obligations during the regulatory period. The Commission also listed the following possible mechanisms for dealing with uncertainty:

- Re-opening of the determination triggered by particular materiality thresholds or triggers
- Predetermined pass throughs
- Forms of price control
- Mid period reviews.

Taking account of experiences over the 2005 regulatory period and in light of expected future uncertainties, Melbourne Water supports retention of an end-of-period pass through mechanism for additional legislative or regulatory obligations. However, it considers that the materiality threshold should be revised to 1% of waterways and drainage revenues over the regulatory period, instead of the current 2.5% of total revenues.

Melbourne Water notes that on a business wide basis the current 2.5% threshold of revenues over the regulatory period equates to approximately 6% of the Commission’s allowed return on assets (profit) in the 2005 Water Plan. Melbourne Water believes that the current threshold places an unacceptable level of risk on it given experiences over the current regulatory period and the fact that it has a limited ability to manage the introduction of new obligations.

As detailed in Chapter 3, the new obligations placed on Melbourne Water’s waterways and drainage services since the 2005 regulatory period total more than $11 million (operating expenditure and unfunded financing costs). This figure increases to $25.1 million when additional water and sewerage obligations are also considered and represents approximately 57% of the 2.5% materiality threshold. It also represents approximately 3.1% of Melbourne Water’s return on assets allowed by the Commission in the 2005 Water Plan.

Further expenditure as a result of additional obligations, over which in many cases the business has little influence, may result in:

- Increased borrowings, with less scope to do so without affecting the financial viability of the business
- Reduced returns to shareholders.

Melbourne Water has also previously noted its support for a within period pass through mechanism for certain predetermined major projects which are either in the very early stages of development or are still being considered by Government or regulatory agencies. While appropriate for a number of major water supply projects (e.g. the Sugarloaf Pipeline) and sewerage projects (e.g. the Eastern Treatment Plant tertiary treatment upgrade), current information suggests that there are no uncertain waterways and drainage projects that are sufficiently large enough to warrant application of this mechanism.

Melbourne Water considers that over the 2008 regulatory period individual price caps should be applied to its waterways prices provided a revised end-of-period pass through mechanism is incorporated into the regulatory framework to manage uncertainty and ensure optimal risk allocation. An alternative price control mechanism is likely to be sought in the event that the revised pass through mechanism is not incorporated into the regulatory framework and/or the Commission's draft decision on expenditures and demands is materially different to Melbourne Water's proposals.

Melbourne Water considers that its proposed approach appropriately balances the Commission's competing objectives in relation to protecting customers, minimising administrative costs of making pricing adjustments, protecting business' financial viability and creating incentives for efficient investment and system operation.

4.3 Opening regulatory asset value

The opening regulatory asset value is a key input to determining prices for a given regulatory period.

In its March 2007 Guidance Paper, the Commission noted its preferred approach to determining the regulatory asset base at 1 July 2008 is to use the actual capital expenditure, contributions and proceeds from disposals for the period from 1 July 2004 to 30 June 2006, and the forecasts of 2007/08 capital expenditure, contributions and proceeds from disposals used in the Commission's 2005 Price Determination. The regulatory depreciation used in determining the opening regulatory asset value is that forecast in the Commission's 2005 Price Determination. The Commission proposed that an adjustment would be made in 2013 for any difference between assumed and actual net capital expenditure for 2007/08 when the opening regulatory asset value is calculated for the next regulatory period.

However, the Commission also noted that it would be willing to consider the use of updated forecasts for 2007/08 where water businesses are able to present a compelling case for doing so.

Melbourne Water proposes to use updated capital expenditure forecasts for 2007/08 in determining the regulatory asset value at 1 July 2008. These forecasts are based on updated information, as are the actual capital expenditures for 2005/06 and 2006/07, and reflect Melbourne Water's changed operating environment as well as improved asset condition and operational information.

As discussed in Chapter 3, the current capital expenditure forecasts for 2007/08 waterway and drainage services are around $34.7 million higher than the estimate in the Commission's 2005 Price Determination. This significant and unanticipated increase has largely been driven by new obligations not included in the Commission's 2005 Price Determination, the extension of Melbourne Water's waterways and drainage operating boundary and increased developer-funded drainage growth works.

4.4 Approach to assessing expenditures

This section discusses Melbourne Water's positions on:

- Provision of information on expenditure associated with new obligations
- The approach for assessing efficiency improvements.

4.4.1 Information on new obligations

The Commission has defined new obligations as those that come into effect from 1 July 2008. It has indicated that the intent of distinguishing between the costs associated with business as usual and new obligations is to transparently identify the additional costs associated with regulatory decisions that are expected to take effect over the 2008 regulatory period.

The Commission has also indicated that the expenditure assessment process should be largely forward looking, with the focus on the outcomes to be delivered for the 2008 regulatory period and the expenditure needed to deliver these outcomes, rather than revisiting the forecasts from the last review.

Melbourne Water considers that a supplementary approach is to identify obligations which came into effect within the 2005 regulatory period and which were not included in the 2005 Water Plan.

As noted in Chapter 3, there have been a significant number of new obligations since the commencement of the 2005 regulatory period. These do not form a part of Melbourne Water's business as usual activities (e.g. Government initiatives under the Yarra River Action Plan to reduce the environmental impact of stormwater on urban waterway).

Supplying information on the cost of new obligations occurring since 1 July 2005 and which were not included in the 2005 Water Plan:

- Provides stakeholders with greater transparency around the factors contributing to price rises in the 2008 regulatory period
- To the extent that expenditure in relation to these obligations is forecast to increase, it provides transparency around future drivers of expenditure
- Provides a clearer basis to determine whether efficiency improvement assumptions can be reasonably applied (see next 4.4.2).

Provision of information on expenditures related to obligations put in place subsequent to the 2005 Water Plan is also consistent with the proposed technical review the Commission will undertake of capital and operating expenditures. As an example, the review of "business as usual" expenditures is typically commenced through a trend analysis of historical expenditures. In the case of obligations that have been imposed since 1 July 2005, little or no historical trend information will be available. The review of expenditures related to post 2005 obligations will have to be undertaken in a similar manner to the way in which post 2008 obligations are reviewed, i.e. prudency and efficiency. Therefore, Melbourne Water believes that it is appropriate to capture all new obligations, either post 1 July 2005 or 2008, in the same expenditure category.

In subsequent chapters Melbourne Water has used this approach when referring to new obligations, i.e. those obligations which came into effect within the 2005 regulatory period and which were not included in the 2005 Water Plan. At this stage, there are only two new obligations which can reasonably be expected to take effect from 1 July 2008 (the Commission's approach). These come into effect from 1 July 2008 under the Waterways Operating Charter and relate to implementing flood protection measures to reduce currently known intolerable flooding risks and undertaking load reduction programs to remove a range of pollutants from stormwater and catchment run-off.

4.4.2 Assessing efficiency improvements

Seeking efficiency improvements will continue to be an important part of the way in which Melbourne Water operates its business. However, the current operating environment, which holds greater uncertainty about demands, capital and operating expenditures, as well as shortages of skilled labour, and meeting stakeholder project delivery expectations, increases the challenge associated with achieving ongoing material efficiency gains.

In Chapter 9, Melbourne Water has set out its proposed efficiency improvements for operating expenditure and provides detail as to why it considers such gains are realistic in the current operating environment. These efficiency improvements relate to business as usual expenditures and not expenditures associated with new obligations.

The rationale for removing new obligations from efficiency considerations is that the operating expenditure associated with these obligations will, in the majority, be undertaken via contracting and the price will be struck at the most competitive industry rate available. The opportunity to derive material efficiencies from these services will only become available if the service/works are ongoing and when the contract comes up for renewal.

In its March 2007 Guidance Paper, the Commission has noted that, where businesses cannot demonstrate how they have accounted for efficiency gains, it will make an adjustment to expenditure levels. While it has not detailed how it will do so, Melbourne Water would have concerns if the Commission was to adopt the approach it used in the 2005 regulatory period. Under this approach, businesses were required to achieve a minimum of a 1% per year productivity improvement on their growth adjusted business as usual expenditure over the regulatory period, where growth was based on volume growth for water and sewerage and customer growth for waterways and drainage. Melbourne Water's concerns arise in the waterways and drainage context primarily because the Commission's definition of new obligations would imply that business as usual expenditure will incorporate expenditure to meet new obligations that occurred prior to 1 July 2008 and this will contribute to significant growth in business as usual expenditure.

In the event the Commission were to make efficiency adjustments, Melbourne Water believes that an appropriate approach would be to continue to apply an efficiency factor. However, it is proposed that application of the efficiency factor be limited to business as usual costs, excluding new obligations coming into effect from 1 July 2005 that were not included in the 2005 Water Plan. It is noted that the extended area operating expenditure is considered to be business as usual costs.

Further, it is proposed that growth of business as usual expenditure should be established by assessing specific operating expenditure resource inputs, such as labour and materials, and the different drivers of these expenditures. Two different drivers have been identified as being relevant, growth in business as usual assets[1] and growth in customers. Both business as usual assets and customer numbers are experiencing growth. As noted in Chapter 8, increased business as usual investment is largely due to acceleration of works to restore waterway health to meet Regional River Health Strategy objectives and increased developer-funded growth works.

[1] This is based on the regulatory asset value associated with business as usual activities, i.e. it does not include the regulatory asset value associated with new obligations coming into effect from 1 July 2005 which were not included in the 2005 Water Plan.

Table 4.1 sets out the various operating expenditure resource inputs, proposed drivers of growth and reasoning as to why these drivers are appropriate. The same classification has been used by Melbourne Water in reviewing its water and sewerage operating expenditures.

Table 4.1 – Operating expenditure resource inputs and proposed drivers of growth

Resource input	Growth driver	Reasoning
Labour	Asset growth	Labour costs are largely driven by the increasing size of Melbourne Water's asset base – more people are required to plan, deliver and operate an increasing business as usual asset base
External Services	Asset growth	External service costs are largely driven by the increasing size of Melbourne Water's asset base – more services are required to maintain an increasing business as usual asset base
Materials	Customer growth	Materials costs are a very small component of overall waterways expenditure and can be seen as being driven by customer growth
Information Technology	Asset growth	Information Technology costs are largely driven by headcount and are therefore affected by the same driver as labour
Energy	Customer growth	Energy costs are a very small component of overall waterways expenditure and can be seen as being driven by customer growth
Fees and Charges	Asset growth	Fees and charges are largely driven by the increasing size of Melbourne Water's asset base
Transport	Asset growth	Transport costs, e.g. fleet services, are largely driven by headcount and are therefore affected by the same driver as labour
Other	Asset growth	Other costs are largely driven by the increasing size of Melbourne Water's asset base
Land Tax	Asset growth	Land tax costs are driven by the increasing size of Melbourne Water's asset base as additional land is acquired where required for further assets

Consistent with the Commission's advice in its March 2007 Guidance Paper, Melbourne Water has assumed the efficiency factor would be applied to business as usual expenditure as incurred at the end of the regulatory period, i.e. in 2007/08.